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## Book

# Smoldering embers : do state-owned enterprises threaten fiscal stability in the Caribbean?

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# SMOLDERING EMBERS

Do State-Owned Enterprises Threaten  
**Fiscal Stability** in the Caribbean?



## Editors

Gerardo Reyes-Tagle  
Aldo Musacchio  
Carolina Pan  
Yery Park



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# Acronyms

AMPI	Act on the Management of Public Institutions
BHS	The Bahamas
BRB	Barbados
CCB	Caribbean Country Department (IDB)
CCB6	The Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago
CCH	Caja de Crédito Hipotecario (Chile)
CDB	Caribbean Development Bank
CEO	Chief executive officer
CEPI	Commodity export price index
CIPI	Commodity import price index
CODELCO	Corporación Nacional del Cobre (Chile)
CORFO	Corporación de Fomento de la Producción (Chile)
DOTS	Direction of Trade Statistics
EITI	Extractive Industries Transparency Initiative
ENAP	National Oil Company (Chile)
ESG	Environmental, social, and governance
FDI	Foreign direct investment
FOINSA	Fondo de Infraestructura S.A. (Chile)
FRF	Fiscal Responsibility Framework (Jamaica)
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GUY	Guyana
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
JAM	Jamaica
LAC	Latin America and the Caribbean
LIDCO	Livestock Development Company (Guyana)
LLC	Limited liability company

LPG	Liquefied petroleum gas
M&E	Monitoring and evaluation
MOEF	Ministry of Economy and Finance (Korea)
MOF	Ministry of Finance
NGO	Nongovernmental organization
NPI	Not-for-profit institution
OECD	Organisation for Economic Co-operation and Development
OECS	Organisation of Eastern Caribbean States
PCJ	Petroleum Corporation of Jamaica
PCS	Private company SOE
PCTOT	Commodity Terms of Trade
PDVSA	State oil company of Venezuela
PE	Performance evaluation
PEMEX	Petróleos Mexicanos
Petrotrin	Petroleum Company of Trinidad and Tobago
PFM	Public financial management
PPP	Public-private partnership
QGO	Quasi-governmental organization
ROI	Return on investment
SCI	Statement of Corporate Intent
SEP	Sistema de Empresas Públicas (Chile)
SME	Small and medium-size enterprise
SOE	State-owned enterprise
SS	Statutory SOE
SUR	Suriname
SWF	Sovereign Wealth Fund
TFP	Total factor productivity
TTO	Trinidad and Tobago
WDI	World Development Indicators
WEO	World Economic Outlook

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## Executive Summary

This book examines the role of state-owned enterprises (SOEs) in contributing to the fiscal instability of the Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago, with the aim of providing tangible guidance for policymakers seeking to address this issue. Using an original dataset of SOE performance in the Caribbean, the contributors focus on the fiscal implications of unchecked growth, poor oversight, and mismanagement of SOEs, with particular focus on commercial SOEs. The authors examine the historical, economic, and socio-political context of SOEs in the CCB6 and stress the need for simultaneous fiscal reform both at the federal level and the firm level. The authors analyze the SOE sector's growth and performance to date, revealing entrenched challenges, specifically around incentives and accountability. The recommendations propose adaptations of accepted international best practices and lay out long-term objectives and the more feasible points of entry for fiscal reform.

As the world navigates an unprecedented crisis due to the COVID-19 pandemic, economic recovery has become the main policy goal. Economically, the Caribbean has been among the worst-hit regions due to the dramatic collapse in tourism and volatility of commodity prices, and the economic outlook remains uncertain. The pandemic, however, is not to blame for the Caribbean's fragility; the region has deep-seated structural problems resulting in fiscal instability. The underperformance of SOEs contributes to these fiscal imbalances. On the one hand, COVID-19 has accentuated these issues and delayed structural transformations already taking in place in some countries in the region. On the other hand, the crisis has compelled every country to reconsider how best to spend its (limited) fiscal resources and how to rationalize and improve the monitoring of its SOEs to reduce the fiscal risk they generate.

This book explores the interrelation between the performance of SOEs and fiscal sustainability in six Caribbean economies with similar fiscal sustainability problems. The six are the Bahamas, Barbados, Guyana,

Jamaica, Suriname, and Trinidad and Tobago (henceforth the CCB6) as mentioned above. Their fiscal challenges stem, in part, from the unchecked expansion of SOEs, across many sectors, and from the use of SOEs to perform quasi-fiscal operations like employment creation. This book argues that any fiscal reform efforts within the central government must go hand in hand with corporate governance and fiscal governance reform in its SOEs. The solutions require not only consolidation and tightening of fiscal rules, but also setting up SOE oversight units in the Ministry of Finance as well as state-of-the-art corporate governance configurations in SOEs to facilitate both the ex ante and ex post monitoring of these enterprises and their budget execution.

Without committing to reforms of fiscal governance and to reforms of the monitoring and [corporate] governance of SOEs simultaneously, efforts to address either one of the problems will be futile. The structural problems of SOEs go beyond governance issues; the biggest sources of fiscal risk are often due to the ad hoc fiscal relation the government has with them, allowing them to request funds when necessary and using them to perform quasi-fiscal operations. No corporate governance reforms can solve those fiscal governance issues. In other words, reforming the governance and monitoring of SOEs requires a significant change in central government fiscal governance that may include agencies to monitor these enterprises as well as a series of ex ante rules and ex post monitoring mechanisms.

The book is divided into three sections. Section I has three chapters that diagnose the fiscal instability of the CCB6, then explore the effects of the global pandemic before moving to a more detailed analysis of the growth and performance of SOEs. This section describes the proliferation of SOEs across CCB6 countries as a macroeconomic policy problem, examines the performance issues of SOEs, and assesses the fiscal impacts over time. The contributors argue that the performance of and expansion of SOEs must be understood within the framework of small open economies with complex parliamentary systems, high volatility in the current account, and continuous migratory outflows to Europe and North America. Specifically, it is shown that SOEs are created during periods of current account surpluses, to provide subsidies or employment, but then stay as permanent fixtures. The first section also examines the vulnerability of CCB6 countries to external shocks, looking in depth at the effects of the COVID-19 shock to the region, and analyzes the fiscal vulnerabilities that come from the weak monitoring (and performance) of SOEs. The section highlights the fact that all these vulnerabilities are problematic because these economies have little fiscal room to implement countercyclical policies, in part because they have structurally high debt levels.

Section II of the book explores the origins of SOEs and their present-day challenges with a focus on the structural barriers to efficiency and performance. Across three chapters, this section focuses on understanding the

origin and current state of the SOEs in the CCB6 nations. It provides feasible solutions to improve the efficiency of administrative structures to monitor SOEs, the procedures to create new public companies, and the corporate governance mechanisms that should regulate their functioning. The contributors suggest a series of ex ante administrative measures and ex post monitoring mechanisms to reduce the fiscal risk emanating from the SOE sector.

Finally, Section III assesses macro-level risk exposures of the CCB6 and examines various approaches to reduce and contain both macro risks and the fiscal risk generated by SOEs. One chapter provides a guide on how CCB6 could adapt existing hedging strategies to deal with external shocks. The last chapter provides a guide of best practices for the implementation of fiscal consolidation, as well as the introduction of ex ante rules and ex post monitoring mechanisms. Benchmark cases of centralized SOE monitoring agencies are examined and ideas are provided to design an innovative performance evaluation mechanism already in use in other parts of the world, notably in the Republic of Korea.

The size, type,<sup>1</sup> and number of SOEs in the Caribbean is quite puzzling. Despite the many waves of privatization around the world and in the CCB6 in the early 1990s, the region has one of the largest numbers of SOEs per capita in the Western Hemisphere. In fact, while SOE creation has slowed globally since the 1990s, it has accelerated in the Caribbean over the last couple of decades. This has certainly not gone unnoticed since, among other things, these companies tend to be very large and financially weak, thus increasing their fiscal burden and also generating all sorts of fiscal risks for CCB6 governments.

CCB6 economies have 5–14 times more SOEs per capita than the most SOE-abundant countries in Latin America, even Venezuela. Compared to other islands, the number of SOEs per capita for the CCB6 is similar to the lower-income countries in the Pacific, like Samoa or Tonga, and far greater than those of Fiji or New Zealand, which have development levels comparable to those of CCB6 countries.

Despite the apparent inefficiencies of SOEs, their creation in such large numbers in the CCB6 would be less problematic if they contributed to capital

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<sup>1</sup> This book follows the taxonomy provided in Aharoni's *The Evolution and Management of State-Owned Enterprises* (1986) and defines commercial SOEs as those that effectively produce and sell goods and services. This is to differentiate them from government entities in charge of providing public services (such as health services, tourism boards, regulators, foundations to provide social services, etc.), which may have corporate or limited liability company form and depend directly on the government budget. Regulatory agencies that collect funds (rather than properly selling services), such as aeronautics agencies or tourism boards, are not counted as commercial SOEs. Finally, non-commercial SOEs include all companies, foundations, statutory boards, and limited liability companies that do not sell goods or services or that depend fully on the government budget to fund their operations (see Chapters 4, 5, and 6 for further detail on SOE classifications).

formation and/or to increases in productivity. Yet, SOEs have not proven effective instruments to increase either capital formation or total factor productivity (TFP) growth. On the contrary, in this book evidence is presented that the continuous increase in the number of SOEs in the CCB6 has been accompanied by a deceleration of GDP growth, productivity, and capital formation. Even unemployment has not abated with the swell of new SOEs. The increase in SOEs has, however, added to the total fixed costs that the government budget has to pay and contributed to the continuous and dangerous expansion of the ratio of total public debt to GDP in these countries.

There are too many SOEs in the CCB6 and they are too large, unprofitable, poorly managed, and therefore too dependent on fiscal transfers. SOEs are very costly to governments as they are compelled to cover SOE losses of up to 9 percent of GDP in any given year. And yet, SOE creation has accelerated since the global financial crisis. Why? This book argues that there are three reasons why CCB6 governments create new SOEs: to expand fiscal room, to perform quasi-fiscal operations, and to address social needs (e.g., health care).

First, SOEs are a way for CCB6 governments to *expand fiscal room*. Countries that operate with large debt-to-GDP ratios have less room to maneuver when dealing with macroeconomic shocks, and the creation of SOEs can be a way to force the hand of congress to approve large fiscal expenses over time. Moreover, operating under a variety of conditionality programs of the International Monetary Fund (IMF) and the Inter-American Development Bank (IDB) may actually constrain the CCB6 governments' countercyclical policies, especially as the conditions of these programs tend to be tied to debt-to-GDP ratios, etc.

Second, SOEs play a key role as they *perform quasi-fiscal operations* on behalf of the government. These mostly serve social purposes and range from selling inputs or providing services at below market price (and even sometimes below average cost) to generating employment. In fact, it has become increasingly popular in Latin America and the Caribbean (LAC) for governments to create new SOEs both for countercyclical policy purposes (to create employment during recession years) and as bargaining chips to negotiate with unions or other key political groups. In CCB6 countries, parliamentary electoral systems require the winning coalition to make agreements with a broad set of members of parliament (MPs) and their parties. Thus, there is a pressing need to have jobs and patronage opportunities for the members of these coalitions, which thus reinforces the temptation to create new SOEs to distribute jobs among the coalition members. In countries like Suriname, the state employs 40 percent of the labor force (World Bank, 2018).

Finally, the temptation to create SOEs to *address social needs* in CCB6 nations is compounded by the dire economic situation these societies face. All CCB6 countries have poverty rates above 25 percent, except for the

Bahamas. Beuermann and Schwartz (2018) show that when comparing GDP per capita to poverty rates, all CCB6 nations except for Jamaica have *too much* poverty.

Given these temptations to create new SOEs, governments could improve the monitoring mechanisms they currently have. Three central issues related to the monitoring and control of SOEs in the CCB6 are identified.

First, SOE performance is not just weak, it is also volatile and unpredictable. This affects the budget planning and the capacity of CCB6 governments to deal with SOE shortfalls. Most of these countries rely on *decentralized monitoring*, in which monitoring and control of the SOEs falls to the line minister (e.g., the Ministry of Energy monitors electricity companies), while leaving the Ministry of Finance in charge of budget oversight. None of the CCB6 countries has a centralized agency that monitors all SOEs, hardening their budget constraints and monitoring the use of resources and progress of these firms on budget and project execution. Even if some countries have SOE departments or SOE agencies within the Ministry of Finance, very few of those agencies have actual power to monitor and control the firms they oversee. These agencies should act as information aggregators, but SOEs often exhibit outdated and irregular reporting—timely operational and financial reports are rare—and the agencies lack regulatory capacity to impose fines or penalties for reporting late or not at all. In fact, all CCB6 countries, with the exception of Jamaica, fail to systematically collect data on SOE performance, and when they do, they rarely make it available to the public. In addition, data are often buried in lengthy reports with no standardized format or harmonization that allows for comparisons across countries or even against private sector firms.

Second, SOEs are used by central governments to perform quasi-fiscal operations. These range from providing employment, subsidizing key inputs or services to firms and voters, or helping the government to develop a region or section of the country. These quasi-fiscal activities are very costly for SOEs, sometimes driving their unprofitability. These activities, in turn, can also distort incentives for managers. On the one hand, SOEs have little motivation to be profitable (as they will be requested to undertake additional expensive quasi-fiscal operations). On the other hand, they have incentives (and grounds) to ask the government for additional resources. Both of these incentives can lead managers to not only request funds, but also to be less concerned with the overall performance of the SOE, as additional funds can be requested as needed—a dynamic that demonstrates a failure of fiscal governance more than corporate governance alone.

Third, in most countries, there have been minimal corporate governance reforms. In particular, in most countries the chair of the board of an SOE is usually the CEO of the company, there are very few firms with a large enough number of independent directors, and there is a lot of heterogeneity in

boards' composition. Within countries, some firms have dual boards (executive and advisory boards) and some firms have board committees to monitor the firm and its managers, but more often than not the boards are composed exclusively of firm executives rather than including external or independent directors.

Thus, the question is, if, as will be more fully elaborated in this report, we have abundant evidence that there are ways to improve the monitoring and financial performance of SOEs, why are CCB6 governments not adopting them more widely? As noted above and as the contributors to this volume explain more thoroughly in the following chapters, SOEs in CCB6 countries are commonly used as fiscal tools to promote employment or other quasi-fiscal operations or as bargaining chips to boost political appeal. Thus a decision to reform the SOE sector has to be taken jointly with a decision to correct fiscal imbalances and to stop using fiscal policy and SOEs as a fix for the shortcomings of the real economy. Therefore, renouncing SOEs as instruments to pursue quasi-fiscal operations must be accompanied by the decision to control fiscal deficits; reduce fiscal transfers to SOEs; rationalize which SOEs are necessary and which ones can be reformed, privatized, or closed; and ultimately to let SOEs operate with some autonomy from politicians, reporting instead to a centralized body composed of technical officers.

Simple yet effective strategies are recommended for the CCB6 economies to help alleviate the negative fiscal impact of SOEs: (i) consolidation, (ii) introduction of ex ante rules and procedures, and (iii) ex post monitoring of SOEs with periodic checkups. None of these strategies excludes the others, and they must be implemented in a holistic way that includes a combination of all of them. Reforms have to be focused on consolidation, introduction of ex ante rules and administrative procedures, and introduction of ex post monitoring of SOEs using centralized monitoring agencies and performance evaluation mechanisms. While there are many ways to implement these three reforms, the focus is on the following best practices: fiscal rules, centralized monitoring, corporate governance reforms, and performance evaluation. The latter part of the book dives deeply into the best practices for centralized monitoring, including reporting, controls over SOE liabilities and investment, and the performance evaluation system adopted in South Korea.



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# Introduction

## Background and Context

As the world navigates an unprecedented crisis due to the COVID-19 pandemic, economic recovery has become the main policy goal. Economically, the Caribbean has been among the worst-hit regions due to the dramatic collapse in tourism and volatility of commodity prices, and the economic outlook remains uncertain. The pandemic, however, is not to blame for the Caribbean's fragility; the region has deep structural problems resulting in fiscal instability. On the one hand, COVID-19 has accentuated these issues and delayed structural transformations already taking place in some countries. On the other hand, the crisis has compelled every country to reconsider how best to spend their (limited) fiscal resources and, more specifically, the role of the state and its public enterprises.

This book explores the interrelation between the performance of state-owned enterprises (SOEs) and fiscal sustainability in Caribbean nations. We focus our attention on six specific countries with similar fiscal sustainability problems: the Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago, henceforth referred to as the CCB6. Their fiscal challenges stem, in part, from the unchecked expansion of SOEs across many sectors, and from the use of SOEs to perform quasi-fiscal operations like employment creation.

SOEs in the CCB6 economies were created to address market failures, provide vital public services, and pursue pressing developmental objectives. We compiled an original dataset of the historical performance of SOEs in the CCB6, including financial variables and other characteristics, and combined these with economic indicators for each country to create the IDB CCB6 State-Owned Enterprises Database. Our findings show that over the last two decades CCB6 countries have created hundreds of new

SOEs, which have made zero or a negligible contribution to capital formation or productivity growth yet have contributed to increasing fiscal risk.

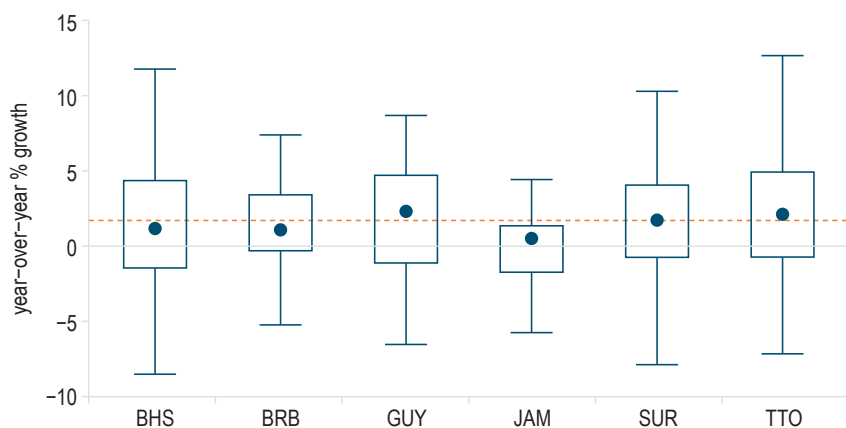
In this book, we argue that any fiscal reform efforts within the central governments must go hand in hand with fiscal reform of SOEs. Without committing to both reforms simultaneously, efforts to address either one of the problems will be futile. The structural problems of SOEs call for reforms that go beyond the restructuring of corporate governance. They require a significant change in fiscal governance that may include agencies to monitor SOEs, as well as a series of *ex ante* rules and *ex post* monitoring mechanisms.

In order to understand the role that SOEs play in CCB6 countries, it is important to start by characterizing their macroeconomic and fiscal profiles (see Chapter 1 for a full depiction). These select Caribbean nations are small open economies prone to natural disasters and vulnerable to external macroeconomic shocks. They are middle-income countries with significant heterogeneity (among them) in both the structure of their economies and their history of fiscal indiscipline and large debt burdens. While they all rely on exports as an engine of growth, the economies of the Bahamas, Barbados, and Jamaica are dependent on tourism, while the economies of Guyana, Suriname, and Trinidad and Tobago are concentrated in commodities. This export dependency has increased over the past decade and is the primary reason behind the region's high exposure and vulnerability to external shocks.

Consequently, the income per capita of most of the CCB6 countries has been drifting apart from that of member countries of the Organisation for Economic Co-operation and Development (OECD) since the 1990s. Alarmingly, this trend has been more marked since the global financial crisis of 2008–2009 and the subsequent collapse of commodity prices. In fact, there has been an important deceleration of growth in the CCB6 nations following 2009 (see Figure A0.1 in the appendix to this chapter). The median growth rate has usually been close to or below the median growth rate for Latin America, and the volatility in growth rates for most of the CCB6 is extremely high (Figure 0.1). Jamaica has the lowest volatility, but also the lowest rates of growth. The volatility and challenging economic environment worsen with each new natural disaster that strikes these nations, especially commodity-dependent countries (Chamon, Garcia, and Souza, 2017).

The poor economic performance of the CCB6, however, cannot be fully attributed to external factors. For decades, the Caribbean has relied on an economic model of procyclical spending during booms and borrowing during crises. During good times governments overestimate their capacity to pay for increases in expenditures and end up creating permanent increases in fixed costs that are politically hard to reverse. The creation of SOEs also follows this pattern of expansion during good times and inflexibility of expenditures in downcycles.

**Figure 0.1. Median Values and Volatility of the GDP per capita Growth Rates for CCB6 Countries**



Source: World Bank (n.d.).

Note: Blue dot markers represent the medians. Boxes represent the inter-quartile (IQ) range. Whiskers account for the IQ adjacent values (i.e.,  $\pm 1.5 \times$  IQ range), and the orange dashed line is the median for Latin America and the Caribbean.

The first part of this book describes the proliferation of SOEs across CCB6 countries as a macroeconomic policy problem, examines the performance issues of SOEs, and assesses the fiscal impacts over time. The contributors argue that the performance of and expansion of SOEs must be understood within the framework of small open economies with complex parliamentary systems, high volatility of the current account, and continuous migratory outflows to Europe and North America. Specifically, it is shown that SOEs are created during periods of current account surpluses, to provide subsidies or employment, but then stay on as permanent fixtures.

The rest of the book focuses on understanding the origin and current state of the SOEs in CCB6 nations. It provides feasible solutions to more effective administrative structures and corporate governance mechanisms to improve the functioning of SOEs and to constrain the creation of new SOEs. The contributors suggest a series of ex ante administrative measures and ex post monitoring mechanisms to reduce the fiscal risk emanating from the SOE sector.

## The Fiscal Problem of SOEs

The creation of SOEs is driven by the perceived utility of these entities to perform quasi-fiscal operations or to provide employment. In good times, policymakers confidently introduce SOEs. However, they are frequently noncommercial in nature or exhibit weak financial performance, and rarely

contribute resources to the government budget. On the contrary, they often require fiscal transfers to fund their operations and to cover their losses—ultimately increasing fiscal risk.

Despite the apparent inefficiencies found in SOEs, their creation in such large numbers in the CCB6 would be less problematic if they contributed to capital formation and/or to increases in productivity. Yet, SOEs have not proven effective instruments to increase either capital formation or total factor productivity (TFP) growth. On the contrary, in this book evidence is presented that the continuous increase in the number of SOEs in the CCB6 has been accompanied by a deceleration of GDP growth, productivity, and capital formation. Even unemployment has not abated with the swell of new SOEs. The increase in SOEs has, however, added to the total fixed costs that the government budget has to cover and contributed to the continuous and dangerous expansion of the ratio of total public debt to GDP in these countries. As a result, existing volatility issues (due to a high external dependency) are aggravated. SOE creation, it seems, has been a tool for politicians in the CCB6 to deal with short-term political pressures, yet it generates larger macroeconomic risks that will haunt these nations for many years. Governments have resorted to creating new SOEs, while avoiding the restructuring necessary to improve the efficiency of existing ones, which has created a vicious circle of SOE creation, expansion in government expenditures and public debt, and deceleration of GDP growth and living standards.

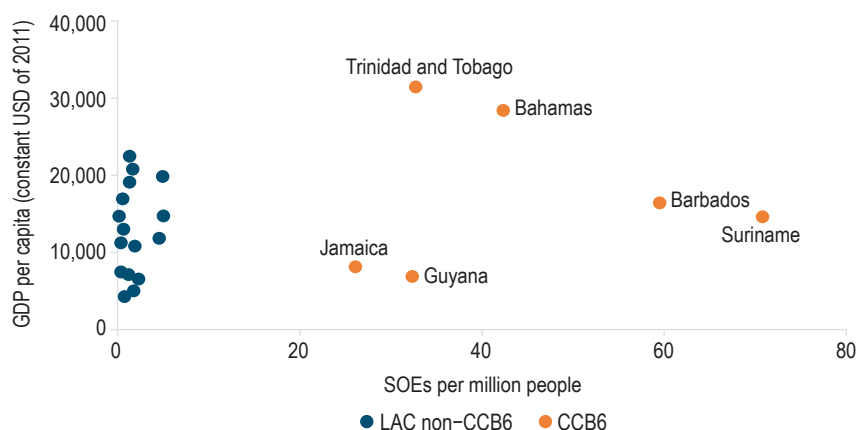
The size, type,<sup>1</sup> and number of SOEs in the Caribbean are quite puzzling. Despite the many waves of privatization around the world and in the CCB6 in the early 1990s, the region has one of the largest numbers of SOEs per capita in the Western Hemisphere. In fact, while SOE creation has slowed globally since the 1990s, it has accelerated in the Caribbean over the last couple of decades. This has certainly not gone unnoticed since, among other things, these companies tend to be very large and financially weak, thus constituting a fiscal burden for the CCB6.

One could argue that the number of SOEs should be linked to the level of development, either because richer countries can afford more SOEs or because richer countries have more complex welfare states that rely more

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<sup>1</sup> This book follows the taxonomy provided in Aharoni's *The Evolution and Management of State-Owned Enterprises* (1986) and defines commercial SOEs as those that effectively produce and sell goods and services. This is to differentiate them from government entities in charge of providing public services (such as health services, tourism boards, regulators, foundations to provide social services, etc.), which may have corporate or limited liability company form and depend directly on the government budget. Regulatory agencies that collect funds (rather than properly selling services), such as aeronautics agencies or tourism boards, are not counted as commercial SOEs. Finally, non-commercial SOEs include all companies, foundations, statutory boards, and limited liability companies that do not sell goods or services or that depend fully on the government budget to fund their operations (see Chapters 4, 5, and 6 for further detail on SOE classifications).

**Figure 0.2. Operating SOEs per Million People and Real GDP per capita (2010–2016)**



Sources: World Bank (n.d.); IMF (2019); Musacchio, Pineda Ayerbe, and García (2015); IDB Database on State-Owned Enterprises in Latin America; and own calculations.

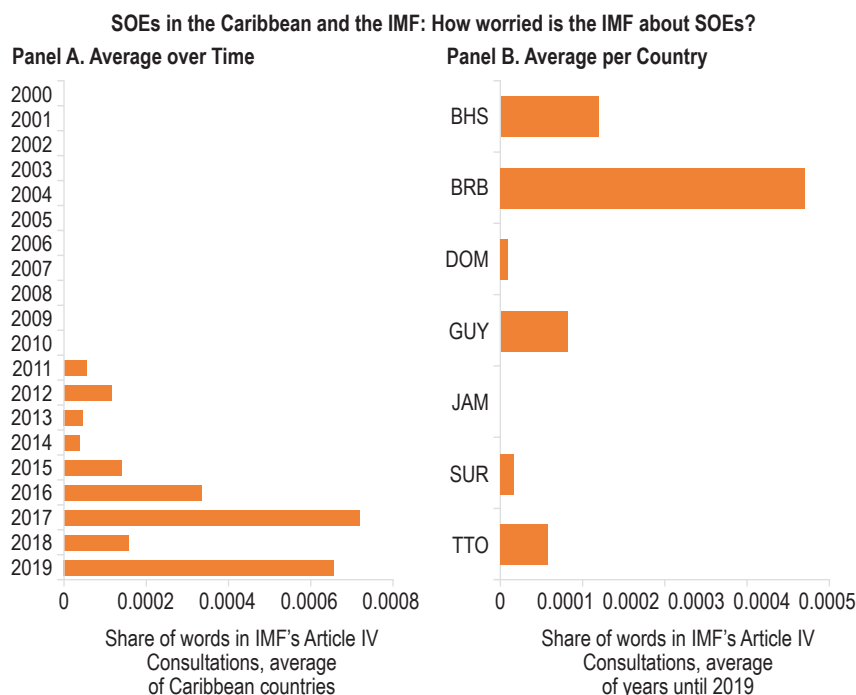
on SOEs to provide certain services. Yet, the relationships between the number of SOEs per capita and GDP per capita in the Caribbean and Latin America follow completely different trends and there is no clear correlation between the level of development and the number of SOEs. While for most of Latin America the number of SOEs per capita seems to increase with income within a narrow range, in the CCB6 the increase in the number of SOEs relative to population seems to be greater as GDP per capita increases (see Figure 0.2). In fact, as Chapter 2 further explores, the CCB6 nations have 5–14 times as many SOEs per capita as the most SOE-abundant countries in Latin America, even including Venezuela.<sup>2</sup> Compared to those of other islands, the figures of SOEs per capita for the CCB6 are similar to the lower-income countries in the Pacific, like Samoa or Tonga, and far greater than those of Fiji or New Zealand, which have development levels more similar to those of CCB6 countries.<sup>3</sup>

It is also worth noting that SOEs in the CCB6 are not just a legacy problem. While concerns about poorly managed public companies being resource drains are certainly not new (see Chapter 3), criticism has intensified over the

<sup>2</sup> Venezuela has made nationalizations a state policy, yet all CCB6 countries exceed Venezuela's SOEs per capita.

<sup>3</sup> Samoa and Tonga have a total of 26 and 17 SOEs respectively, significant numbers for their tiny sizes. On the other hand, Fiji has 26 and New Zealand less than eight per million inhabitants (this includes both commercial and noncommercial and financial and nonfinancial companies) (Asian Development Bank, 2009; New Zealand Department of the Prime Minister and Cabinet, 2020).



**Figure 0.3. SOEs Mentioned in IMF Article IV Consultation Reports until 2019**

*Source:* Data comes from text extracted by Rodrigo Wagner from the IMF's Article IV Consultation Reports and summarized by country and year.

*Note:* For each report the measure is divided by the overall number of words, getting a measure of the SOE share of the text. This helps control for the overall size of the IMF report. Panel A displays the un-weighted average across countries by year, while Panel B shows the weighted average across years for each country in the CCB6 group.

past decade. This is due to the tightening of fiscal space following a series of external shocks: the global financial crisis, several natural disasters, the decline in commodity prices, and now the COVID-19 pandemic (see Chapters 1 and 2).

Another way to understand the intensification of the SOE problem in the last decade is to examine the attention the International Monetary Fund (IMF) has put into this topic as part of its Article IV consultations in CCB6 nations. Text analysis of the Article IV Consultation Reports reveals that SOEs in CCB6 countries have been an increasing concern for the IMF in recent years, with a secular increase since 2011. Figures 0.3 and A0.2 show SOE references in annual Article IV Consultation Reports for the CCB6 countries; there were no mentions prior to 2011 but they have since steadily risen, led by Barbados and the Bahamas and peaking in 2017.<sup>4</sup>

<sup>4</sup> While this text-based measure of the fiscal concerns about SOEs is only suggestive, it seems quite accurate in capturing some of the main worries in these countries (e.g., news from the Bahamas repeatedly complains about loss-making SOEs).

## SOEs as Sources of Fiscal Risk

An alarming finding of this book, explored further in Chapter 2, is that these growing SOEs (in size and number) are not profitable and have significantly increased fiscal risk in the region. The fiscal problem of SOEs stems from the large and frequent losses they face and their dependence on liquidity injections from the government to keep operating. Chapter 2 provides a detailed overview of the financial (under)performance of SOEs, which depicts this ugly truth: SOEs have high fixed costs, mostly from payroll expenses, and low profits. In fact, average net comprehensive income during the past decade has been negative for almost all countries when netting out government transfers.

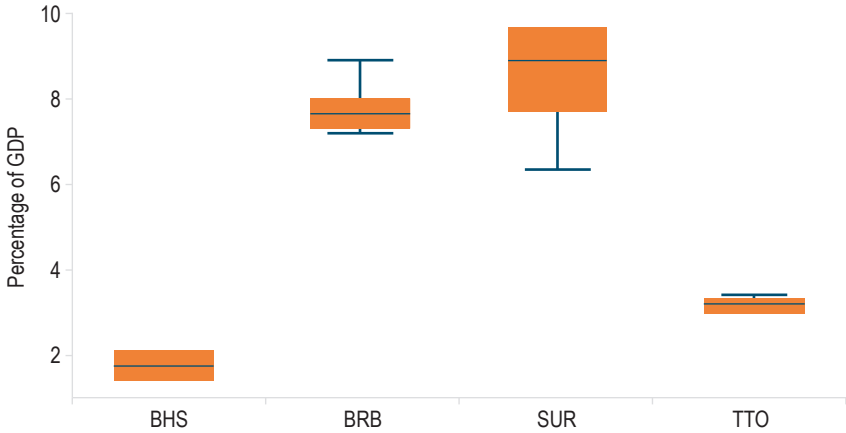
According to our calculations, CCB6 countries spend on average between 5.3 percent and 8 percent of GDP per year to cover SOEs' operations and losses. The real fiscal efforts, however, are even larger. These average transfers, by construction, do not include the "rare disaster" occasions, which occur very sporadically and in which large companies require government bailouts. Oftentimes, aggregate SOE losses are driven by a single unprofitable company. The problem in the small CCB6 economies is that very large SOEs can have losses of over 5 percent of national income, taking a large toll on public finances. For economies struggling to achieve primary surpluses, these numbers are massive. Ultimately, these companies are not just "too big to fail" but also "too big to be bailed out" and "too grim to be privatized."

Recurrent financial underperformance can be partly attributed to the noncommercial nature of most newly established SOEs (providing public services, operating as regulatory bodies, or providing technical support), which generate little to no revenue aside from government transfers.<sup>5</sup> This policy of creating noncommercial SOEs may serve an ultimate social and political goal for these governments (i.e., providing employment). However, they do not contribute sufficient funds to the government's coffers to cover their own costs and thus require liquidity injections to continue. Most SOEs receive such funds, and in some cases, fiscal transfers are so large that they make even public companies seem profitable (when they are not) as they inflate the overall comprehensive income.

In the end, the cost of SOEs to governments in CCB6 is extremely large. The constant need for transfers adds a burden to budgets that are already showing large deficits (see the next section). As a result, the creation of these new SOEs ends up being financed with fresh public debt issues. As the size of total debt continues to increase, the cost of financing such debt also goes up, which means that, ultimately, the fiscal cost of opening new SOEs is increasing over time. Figure 0.4 depicts the magnitude of this problem: fiscal

<sup>5</sup> However, as Chapter 2 describes, even commercial SOEs need frequent bailouts.

**Figure 0.4. Government Transfers to SOEs (2010–2018)**



*Source:* Data for government transfers has been manually extracted from all available IMF Article IV Consultation Reports and merged with aggregate SOE financials by country.

*Note:* Data on fiscal transfers for Jamaica and Guyana is not available. The box plot showcases the distribution of the data. The middle line represents the median, while the blue lines at the extremes are the minimum and maximum. The edges of the orange boxes represent the first and third quartile, respectively.

transfers in the CCB6 can be as high as 9.7 percent of GDP. For countries such as Barbados or Suriname, government transfers over the past decade have never fallen below 6 percent.<sup>6</sup> As SOEs grow in size and number, their exposure to negative shocks grows, increasing cash-flow risk, the likelihood of requiring bailouts, and, ultimately, overall fiscal risk.

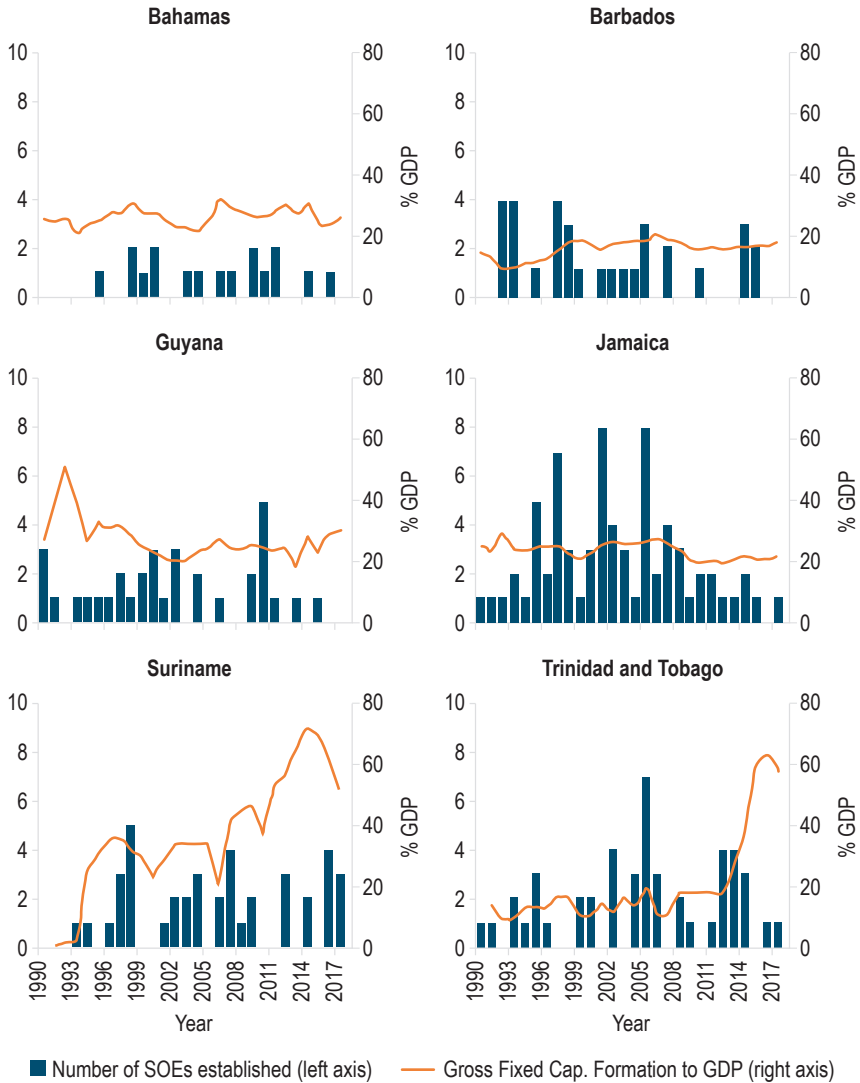
### SOEs in the Caribbean Do Not Contribute to Capital Formation and Productivity Growth

The fact that CCB6 countries have created a large number of SOEs in the last two decades would not be that big of a problem for the economic development or fiscal sustainability of the region if these new SOEs were contributing to capital formation and/or to productivity growth. However, the disassociation between SOE creation and growth, capital formation, and productivity growth is so evident in simple graphs that we abstain from further formal econometric analysis of the matter. The kinds of SOEs being created in CCB6 nations are costing governments more in precious fiscal resources and are not contributing to growth. In most cases, they are not actually helping to reduce unemployment either.

Figure 0.5 examines the trends in gross fixed capital formation (GFCF) and SOE creation since 1990. The most important finding to highlight is that gross capital formation in the Bahamas and Jamaica has gone down, even as more

<sup>6</sup> Note that these numbers are based on data availability and thus understate the real toll and fiscal risk of SOEs.

**Figure 0.5. Gross Fixed Capital Formation as a Percentage of GDP and Number of SOEs Established**

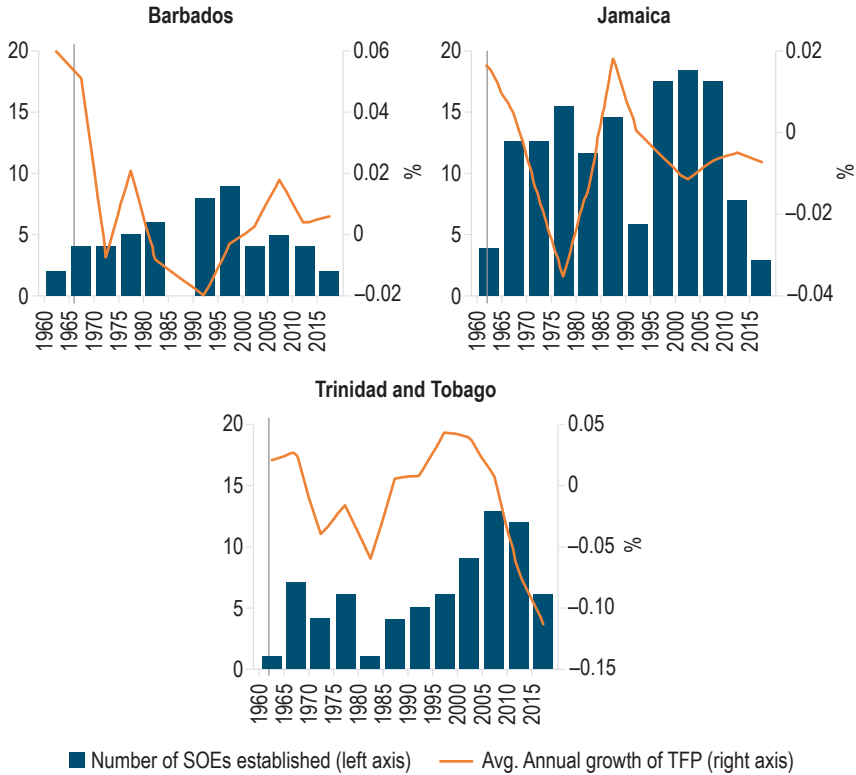


Sources: IDB CCB6 State-Owned Enterprises Database; World Bank (n.d.); and IDB estimations.

Note: For Trinidad and Tobago, data on gross fixed capital formation is unavailable; gross capital formation was plotted instead.

and more SOEs were created. In the Bahamas and Guyana there is an uptick in capital formation in the later years, but the relationship with SOE creation in the past 20 years is not very clear; no explicit patterns stand out for any of the CCB6 countries. These graphs and the linear correlation tests in Chapter 2 suggest that creation of SOEs is not highly correlated with investment.

**Figure 0.6. Trends in SOE Creation and TFP Growth (in five-year intervals)**



Sources: IDB CCB6 State-Owned Enterprises Database; Feenstra, Inklaar, and Timmer (2015). TFP estimates for the Bahamas, Barbados, and Guyana are not available.

Figure 0.6 examines trends in SOE creation and TFP growth in the CCB6 countries for which data are available to calculate TFP growth in a systematic way.<sup>7</sup> The most notable development is that TFP growth in Jamaica and Trinidad and Tobago has had a secular decline in the last two decades or so, and that the creation of new SOEs has failed to reverse this trend. In Barbados, the story is a bit more complicated as there is more volatility in the series, but no clear correlation is evident between SOE creation and TFP growth. In the last 10 years TFP growth in Barbados has been falling, while new SOEs have continued to be created in significant numbers. Thus, there is no evidence that SOE creation has improved productivity at all; in fact, it may even have worsened it. It is most likely that as fiscal sustainability

<sup>7</sup> Estimates of TFP are based on cross-country differences in real GDP and national accounts data on factor inputs (labor and capital). Further details on the TFP estimation procedure can be found in Feenstra, Inklaar, and Timmer (2015).

and productivity have been declining, governments in CCB6 countries have resorted to creating more SOEs as a way to buffer employment from such macroeconomic trends.

## Diagnosing SOE Problems in the Caribbean

So far, this chapter has established the stickiness of SOEs in the Caribbean, a large increase in their numbers in the last decade, their financial underperformance and reliance on government transfers, their lack of contribution to productivity, and how this all combines to magnify fiscal risk in the region. The examination now turns to the root causes of SOEs' poor performance: a combination of unfavorable macroeconomic conditions and perverse incentives.

Three central issues related to the monitoring and control of SOEs in the CCB6 are identified. First, SOE performance is not just weak, it is also volatile and unpredictable. This affects the budget planning and the capacity of CCB6 governments to deal with SOE shortfalls. Most of these countries rely on *decentralized monitoring*, in which monitoring and control of the SOEs falls to the line minister (e.g., the Ministry of Energy monitors electricity companies), while leaving the Ministry of Finance in charge of budget oversight. None of the CCB6 countries has a centralized agency that monitors all SOEs, hardening their budget constraints and monitoring the use of resources and progress of these firms on budget and project execution.

Even if some countries have SOE departments or SOE agencies within the Ministry of Finance, very few of those agencies have actual power to monitor and control the firms they oversee. These agencies should act as information aggregators, but SOEs often exhibit outdated and irregular reporting—timely operational and financial reports are rare—and the agencies lack regulatory capacity to impose fines or penalties for reporting late or not at all. In fact, all CCB6 countries except for Jamaica fail to systematically collect data on SOE performance, and when they do, they rarely make it available to the public. In addition, data is often buried in lengthy reports with no standardized format or harmonization that allows for comparisons across countries or even against private sector firms.

Second, SOEs are used by central governments to perform quasi-fiscal operations. These range from providing employment, subsidizing key inputs or services to firms and voters, or helping the government to develop a region or section of the country. These quasi-fiscal activities are very costly for SOEs, sometimes driving their unprofitability, and, in turn, distorting incentives for their managers. On the one hand, SOEs have little motivation to be profitable (as they will be requested to undertake additional expensive quasi-fiscal operations). On the other hand, they have incentives (and grounds) to ask the government for additional resources. Both of these incentives can lead managers to not only request funds, but also to be less

concerned with the overall performance of the SOE, as additional funds can be requested as needed—a dynamic that demonstrates a failure of fiscal governance more than corporate governance alone.

Third, in most countries, there have been minimal corporate governance reforms. In particular, as Chapter 6 explains, in most countries the chair of the board of an SOE is usually the CEO of the company, there are very few firms with a large enough number of independent directors, and there is a lot of heterogeneity in boards' composition. Within countries, some firms have dual boards (executive and advisory boards) and in some firms there are committees to monitor the firm and its managers, but often the boards are composed exclusively of firm executives rather than including external or independent directors.

Thus, we conclude that the problems of SOEs in CCB6 countries are a combination of corporate governance problems and fiscal governance issues. In our view, corporate governance in SOEs suffers from two major problems. First, there is misinformation and there are weak incentives for SOE managers to generate cash flow and account for contingent liability risk. That is, the managers of SOEs have more information about the SOE and its financial performance than the ministers in charge of monitoring it. Thus, the managers may report unexpected losses or request additional funds for projects in an ad hoc fashion. Moreover, they may pile up liabilities or know in advance of equity depletion, generating contingent liability risk for the government. This problem happens because SOEs are monitored infrequently (e.g., once a year), SOE managers rarely have to report detailed comprehensive financials, and managers lack incentives to deliver good financial results or to minimize fiscal risk. In general, we also think that boards have no power or “teeth” to execute their monitoring responsibility, to set incentives for managers, or even to select managers according to qualifications.

The second corporate governance problem in SOEs in CCB6 nations is that they have weak monitoring due to a “multiple principals” problem. In CCB6 nations, monitoring is decentralized (i.e., multiple ministries monitor the same SOE), and the ministries themselves may not perform a strong role in monitoring due to free riding or confusion as to which ministry has to perform what functions. This generates latitude for additional central government cash flow (transfers) to and contingent liability risk of SOEs because it gives more leeway to SOE administrators for mismanagement—piling up liabilities and requesting funds in an ad hoc and unexpected fashion throughout the year.

The main fiscal governance issue in CCB6 countries is that SOEs enjoy a soft budget constraint. Governments allow ad hoc requests for funds, capital injections, and major bailouts without hardening the budget constraint of the companies. SOEs are oftentimes not even asked to adhere to

strict timelines when requesting additional funds. To a large extent, this is a consequence of another fiscal governance problem: the imposition of quasi-fiscal operations on SOEs. The tolerance of ad hoc requests for funding, in exchange for quasi-fiscal operations, encourages further mismanagement and sanctions fiscal risk as a normal business practice.

Additionally, having such loose fiscal governance discourages any effort to strengthen monitoring and reduce the corporate governance issues. From the agency perspective, there is no point in requesting quarterly financials from an SOE if the SOE can still request funds at any point during the year. Nor is there an expectation that financials, if produced, would be accurate or that the SOE would be held accountable to them. Similarly, there is no point in strengthening the role of boards of directors to monitor the firm or to incentivize and select managers if the government is going to impose quasi-fiscal operations that may endanger key capital investments and throw off the financial performance of the firm.

For these reasons it is our view that, despite great efforts by multilateral organizations to strengthen the corporate governance of SOEs around the world, corporate governance reforms are insufficient without robust fiscal governance reforms. The latter will harden the budget constraint of SOEs by creating ex ante rules, such as strict timelines for requesting funds and for frequent and detailed financial reporting, while also regulating to what extent SOEs should be expected to perform. The best practice is to calculate the cost to the SOE of a quasi-fiscal operation and to compensate the firm for it to avoid surprises (what we call fiscal risk). In Chile, some of the subsidies that SOEs provide to voters are compensated by the Treasury to the SOE. Suriname has begun to calculate the cost of the electricity subsidy in order to transfer that amount to their utility SOE, *EnergieBedrijven Suriname* (EBS).

Another way to attempt to improve both the corporate and fiscal governance problems is to introduce a centralized monitoring agency that can impose ex ante rules, provide frequent monitoring of SOEs, and also impose penalties ex post for underperformance, underreporting, late reporting, etc. The separation of SOEs from ministries can also reduce the fiscal governance problem as it shifts away from the perception of SOEs as part of bureaucrats' portfolios and allows SOEs to focus more on both improving the quality of service and reducing fiscal risk through better financial management.

## Why Do SOEs Proliferate in These Countries?

There are too many SOEs in the CCB6 and they are too large, unprofitable, poorly managed, and therefore too dependent on fiscal transfers. SOEs are very costly to governments, especially in a region that is so vulnerable to external shocks and has very limited fiscal space, in which governments are



nonetheless compelled to cover SOE losses of up to 9 percent of GDP in any given year. And yet, SOE creation has accelerated since the global financial crisis. Why? This book argues that there are three reasons why CCB6 governments create new SOEs: to expand fiscal room, to perform quasi-fiscal operations, and to address social needs.

First, SOEs are a way for CCB6 governments to *expand fiscal room*. Countries that operate with large debt-to-GDP ratios have less room to maneuver when dealing with macroeconomic shocks, and the creation of SOEs can be a way to force the hand of congress to approve large fiscal expenses over time. Moreover, operating under a variety of conditionality programs of the IMF and the Inter-American Development Bank (IDB) may actually constrain the CCB6 governments' countercyclical policies, especially as the conditions of these programs tend to be tied to debt-to-GDP ratios, etc.

Second, SOEs play a key role as they *perform quasi-fiscal operations* on behalf of the government. These mostly serve social purposes and range from selling inputs or providing services below market price (and even sometimes average cost) to generating employment. In fact, it has become increasingly popular in Latin America and the Caribbean for governments to create new SOEs both for countercyclical policy (to create employment during recession years) and as bargaining chips to negotiate with unions or other key political groups. In CCB6 countries, parliamentary electoral systems require the winning coalition to make agreements with a broad set of parliament members and their parties. Thus, there is a pressing need to have jobs and patronage opportunities for the members of these coalitions, which thus reinforces the temptation to create new SOEs to distribute jobs among the coalition members. In countries like Suriname, the state employs 40 percent of the labor force (World Bank, 2018).

Finally, the temptation to create SOEs to *address social needs* in CCB6 nations is compounded by the dire economic situation these societies face. All CCB6 countries have poverty rates above 25 percent, except for the Bahamas. Beuermann and Schwartz (2018) show that when plotting GDP per capita versus adjusted poverty rates, all Caribbean nations, except for Jamaica, are above the regression line. That is, given their level of income, CCB6 countries tend to have *too much* poverty.

Chapter 2 shows that SOE creation is tied to fluctuations in the current account. Consistent with the Caribbean fiscal policy and time inconsistencies when planning and spending, the CCB6 open more SOEs when they have current account surpluses and tend to open fewer SOEs when their exports of commodities or services are not doing well. This constant spending has led to tight fiscal space even in the best of times. In addition, while SOEs are created during booms, in which there is liquidity and a surplus of resources, they are not dissolved during crises (since doing so would be very costly politically). This means that SOEs add to current expenditures and

remain as fixed costs to governments in the long run. In other words, the SOEs play a key role in the fiscal trap of high debt–low growth as major contributors to the constant (high) fiscal deficit.

CCB6 governments have resorted to the creation of new SOEs as a mechanism to smooth volatility, cushion external shocks, and reduce unemployment, but evidence reveals that they have caused more harm than good. Three major problems associated with the interdependence between SOEs and fiscal policy are developed extensively throughout this book. First, companies use their policy duties as an excuse for their losses and to obtain fiscal transfers. Therefore, they have few incentives to improve their productivity and performance. In addition, SOE spending is rarely subject to approval or supervision and is quite invisible (not publicly disclosed), making SOEs very attractive for less-than-honorable practices such as corruption. Finally, and most importantly, they add significant fiscal risk, mostly in the form of cash-flow risk and bailout risk.

### **Why Haven't These Problems Been Fixed? The Credible Commitment Problem**

The fact that CCB6 governments fall short in the implementation of state-of-the-art mechanisms to monitor and control SOEs is puzzling given the variety of tools based on best practices in corporate governance and the variety of insights now available on the design of SOE monitoring bodies (OECD, 2015; World Bank, 2014). Furthermore, there is evidence that countries that have implemented some of these state-of-the-art reforms, especially centralized monitoring agencies for SOEs, have benefitted from improvements in the performance of their SOEs (Musacchio and Pineda Ayerbe, 2019).

For instance, we know that partial privatization of SOEs leads to improvements in performance. There is a variety of studies that show how shared ownership with the private sector improves performance (Gupta, 2005; Lazarini and Musacchio, 2018; Megginson and Netter, 2001). We argue that these improvements in performance are associated with more transparency and better monitoring (Pocztar, 2016), but also with better corporate governance—setting objectives in a clearer way and improving the monitoring by boards of directors, although for this latter point there is less systematic evidence. Still, there is evidence that partial privatization hardens the soft budget constraint of SOEs and is usually also linked to changes in competition. More importantly, governments usually partially privatize companies that face international competition. Thus, it is not easy to discern whether improvements come from changes in corporate governance or improvements made in response to competitive pressures.

There is also a myriad of evidence that introducing centralized monitoring agencies or holding companies (to monitor SOEs) also improves their performance and reduces not only the dependence on government transfers but also the contingent liability risk that governments face when SOEs are poorly monitored and have latitude to increase their debt levels (Musacchio and Pineda Ayerbe, 2019). The fragmentary and qualitative evidence on the introduction of centralized monitoring agencies in OECD countries points towards improvements in performance and less fiscal dependence on the government (Christiansen, 2013; OECD, 2005, 2015; Penfold, Oneto, and Rodríguez Guzmán, 2015). According to Musacchio and Pineda Ayerbe (2019), countries with centralized monitoring agencies for SOEs have, on average, better financial performance (e.g., going from negative to positive overall performance) and lower ratios of SOE liabilities to GDP. They highlight the importance of having government commitment to improving the performance of SOEs; otherwise, any reform to governance and monitoring is ineffective.

Thus, the question is, if there is all this evidence that there are ways to improve the monitoring and financial performance of SOEs, why are CCB6 governments not adopting them more widely? As the contributors to this volume explain, in CCB6 countries, SOEs are commonly used as fiscal tools to promote employment or other quasi-fiscal operations or as bargaining chips to boost political appeal. A decision to reform the SOE sector has to be taken jointly with the decision to correct fiscal imbalances and to stop using fiscal policy and SOEs as a fix for the shortcomings of the real economy. Therefore, renouncing SOEs as instruments to pursue quasi-fiscal operations must be accompanied by the decision to control fiscal deficits; reduce fiscal transfers to SOEs; rationalize which SOEs are necessary and which ones can be reformed, privatized, or closed; and ultimately to let SOEs operate with some autonomy from politicians, reporting instead to a centralized body composed of technical officers.

In other words, most Caribbean countries face two interrelated problems that have to do with budget constraints attributable to SOEs. First, they have an ad hoc system to govern the fiscal relationships between the government and SOEs. Governments can charge SOEs with pursuing fiscal and social policy—reducing unemployment, subsidizing inputs for companies, etc.—and in exchange SOEs have the right to ask for ad hoc fiscal transfers to cover losses whenever needed. Essentially, governments can extract resources from SOEs and, in exchange, SOEs enjoy a soft budget constraint—they can expect to be bailed out when needed. Second, because governments in CCB6 countries allow their SOEs to enjoy a soft budget constraint, they suffer from two varieties of fiscal risk. First is what Musacchio and Pineda Ayerbe (2019) call cash-flow risk. That is, governments face uncertainty as to whether their SOEs will sustain losses and how large

those losses will be and as to whether the government will have to provide small injections of capital to cover such losses in the short run (some SOEs can cover some losses from their own capital, but they usually operate with small capital cushions, requiring continuous transfers from the government). Second, governments face what Musacchio and Pineda Ayerbe (2019) call contingent liability risk—that is, the risk that SOEs may go bankrupt or have insufficient cash flows to cover their liabilities, which would then require governments to step in and provide resources for a large bailout. These bailouts are usually larger as SOEs tend to have large liabilities relative to GDP.

The most difficult step to putting SOEs back on track is the decision to harden their budget constraints. This is difficult for CCB6 governments because it requires accountability and enforcement of monitoring processes that prevent frequent, unforeseen ad hoc capital requests from SOEs and restraint by policymakers to stop using SOEs for quasi-fiscal operations—without compensating them for the cost of such policies. The challenge for SOEs will be in accurately forecasting their budgets and regularly providing comprehensive financial and project reports. In other words, there has to be a clear procedure for the fiscal governance of SOEs. For example, these firms can request funds once a year as part of their budget approval and according to the procedures that the centralized agency imposes on them, and simultaneously politicians have to both step back and delegate monitoring of SOEs to centralized agencies—with capacity to punish SOEs, change management, etc.—and compensate for and make transparent all quasi-fiscal operations of SOEs. For example, if the national electricity company is to subsidize energy rates for users, the part of the tariff that will be subsidized has to be transparent and the Ministry of Finance needs to compensate the SOE directly for such subsidy as part of their budgetary allocation. That way the SOE will not have a financial shortfall at the end of the year nor will they need to ask for fiscal support from the government.

The problem is that politicians need to make both commitments simultaneously. Governments have to stop using SOEs for quasi-fiscal operations without compensation and they have to let a centralized agency monitor SOEs directly and impose strict administrative procedures on SOE financial performance, reporting, and requests. Usually, countries commit to certain fiscal targets—particularly if they are part of an IMF or IDB program—and they end up using SOEs as a way to loosen that fiscal pressure, either because SOEs are used for quasi-fiscal operations such as providing employment or selling inputs below their cost, or because they can issue debt that is often off the balance sheet of the central government. Alternatively, no matter how much governments want to follow a balanced budget, if SOEs can request funds on an ad hoc basis, then the possibility of throwing off government finances at any point during the fiscal year is ever present.

Our hope is that with the evidence presented in this volume, politicians in the CCB6 can see that the cost of doing nothing goes far beyond the cost of covering the structural deficits of SOEs and extends to the unexpected fiscal costs of these firms, which can be sizable (e.g., 2–8 percent of GDP depending on the country). These unexpected fiscal costs further add to government debt burdens and to the fiscal and macroeconomic vulnerability in these countries, putting them at greater risk when external shocks like the COVID-19 pandemic occur because they already lack a fiscal buffer.

## Chapter Content

This book is organized into seven chapters and a conclusion after this introduction.

In **Chapter 1**, Carolina Pan and Fernando Yu dive deeply into the macroeconomic struggles of the CCB6. They identify the region's macroeconomic volatility and fiscal misbehavior as the main causes for the region's lackluster growth. While volatility is driven by high exposure to outside shocks due to the nature of the CCB6 economies (small open island economies that rely on the exports of tourism or commodities), decades-long procyclical fiscal policies are to blame for the tight fiscal space. During good times, the CCB6 spend (a lot). During bad times, they borrow. Debt-to-GDP ratios have thus spiked over the past decade, creating concerns about sustainability. The authors suggest, among other things, that a better approach would include countercyclical spending in crises, a move away from fixed exchange rate pegs, consideration of debt consolidation, and introduction (or further strengthening) of fiscal rules. The authors also discuss how the COVID-19 pandemic has presented new challenges and deepened existing ones in the CCB6; because of their tight fiscal space, Caribbean governments lack the liquidity necessary to provide immediate relief (health-wise and economically) to vulnerable households and small businesses.

In **Chapter 2**, Gerardo Reyes-Tagle, Aldo Musacchio, Carolina Pan, and Yery Park analyze the financial performance of SOEs in the CCB6. They find SOEs in the region to be too many—there are even substantially more SOEs per capita in the CCB6 than in Venezuela—too large relative to their domestic economies, and too dependent on government transfers and subsidies. In addition, unlike everywhere else, SOE creation in the Caribbean has accelerated over the past two decades and has been mostly geared towards noncommercial companies. These companies are neither productive nor profitable. SOEs in the CCB6 have experienced large losses in the past decades, mostly due to high payroll expenses, and substantial debt. On the one hand, the financial underperformance generates dependence on the

governments, which provide the necessary cash injections to operate. On the other hand, financial insufficiency generates fiscal risks to governments, as SOEs have become “too big to fail” but also “too big to be bailed out.”

In **Chapter 3**, Roger Hosein and Rebecca Gookool examine the evolution of the role of SOEs in CCB6 countries. They find that the reliance on SOEs for quasi-fiscal operations and the fiscal imbalances of the region are not tied to colonial institutions per se, but rather to the catching up governments had to do in terms of education, health, and other social expenses after independence. That is, fiscal imbalances and fiscal risks emanating from the underperformance of SOEs have affected all CCB6 nations in similar fashion, regardless of what colonial economic structures they had or the identity of their European colonizer. The chapter goes on to explain how despite efforts to reform and privatize SOEs, the norm in CCB6 nations has been to continuously use and abuse SOEs for political and social objectives. Yet they also highlight how reform efforts in the 1990s actually led to improvements in performance in SOEs and how privatization efforts also had positive results. Still, the political and social pressures governments in CCB6 countries face are too high to ignore. Thus, the chapter highlights that to pursue fiscal consolidation and improve the performance of SOEs, there has to be political will to change the status quo.

In **Chapter 4**, Bernardita Escobar explores contemporary SOE institutional reforms, comprising best practices in corporate governance and fiscal monitoring, that could benefit the CCB6. Unlike earlier waves of reform that were centered around ownership like privatizations or public-private partnerships, the current best-practice institutional reforms tackle the principal-agent problem underlying poor SOE performance and high fiscal risk. This is because the reforms maintain SOE autonomy and managerial flexibility, while introducing fiscal controls and monitoring systems that incentivize improved management and public accountability. Good practices involve reviewing the role that the state plays in ownership, regulation and rule enforcement, policymaking, and financing. The author suggests that current governance structures in the CCB6, currently controlled by different ministries, be reorganized into a central agency that behaves as the unique owner of all SOEs.

In **Chapter 5**, Tamira La Cruz and Yery Park examine the institutional and regulatory framework of SOEs, including the state of corporate governance and transparency institutions. Overall, the chapter shows that the ownership role for SOEs is mostly decentralized across countries, with ministries maintaining insufficient power to create SOEs, designate managers, etcetera. The ex ante and ex post monitoring of SOEs, therefore, suffers. This is because the SOE monitoring units (of the Ministry of Finance) in CCB6 countries lack teeth to exercise their role as fiduciaries, the transparency initiatives for

SOEs are still a work in progress, and corruption is still a prominent problem in the region. The authors provide recommendations to adhere to best practices throughout, but also warn that some of the global best practices may be too expensive for CCB6 SOEs to adopt.

In **Chapter 6**, Tamira La Cruz and Yery Park examine the state of corporate governance in SOEs across CCB6 countries, in respect to the configuration of boards. In this chapter the authors notice that larger or higher-income countries are farther along in the implementation of best practices. Yet, they also highlight the extreme heterogeneity when it comes to adopting codes of best practices and formal procedures to guarantee that the appointment of board members is based on qualifications and/or independence. For instance, the authors show that in Barbados, Jamaica, and Trinidad and Tobago ministers cannot serve on boards of directors of SOEs, while there are no restrictions in Suriname, Guyana, and the Bahamas. They also examine how transparent firms are in terms of publishing information about their boards, and how much power boards have to appoint CEOs, finding that in most CCB6 countries they have little power. In fact, the authors uncover systemic political intervention on boards. Throughout the chapter they provide suggestions to improve the adoption of global best practices for the boards of directors of SOEs.

In **Chapter 7**, Sergio Araya, Camila Figueroa, Lucas Rosso, and Rodrigo Wagner conduct multiple sensitivity analyses and find that the CCB6 are very exposed to external shocks such as changes in commodity prices or tourist arrivals. They propose the use of hedging and risk management practices to smooth income volatility, reduce fiscal risk, and improve access to capital both at the firm and at the governance level. Case studies from programs in Mexico and Chile are explored in detail, discussing the trade-offs of forwards versus options, as well as alternative arrangements such as a combination approach, real hedges, savings, or targeted insurance. The authors suggest hedging the overall net fiscal risk, rather than a company-by-company approach, and propose various applications for the Caribbean context.

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## **SECTION I**

# **Macro and Fiscal Vulnerabilities of State- Owned Enterprises in the Caribbean**



## CHAPTER 1

# Fiscal Struggles in the Caribbean: Macroeconomic Causes and Microeconomic Symptoms

### Introduction: Getting the Right Diagnosis

Recent dynamics in the CCB6 (Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago) economies have shown an economic boom followed by a plateau. The region is very volatile, due to both its exposure to climate change and natural disasters and its dependence on the global macroeconomic cycle. Combined with the procyclicality of policymaking, this volatility poses important challenges to the economic welfare and development of the Caribbean economies. In addition, the COVID-19 pandemic has hit all economies worldwide with very large, unexpected health expenses, instigating an unprecedented global economic crisis. As a result, public spending spiked and revenues plummeted, leaving governments with little to no margin for policymaking. The Caribbean economies were among the worst hit, due to both their economic structures (globally dependent on tourism and commodities) and their limited fiscal space resulting from high debt-to-GDP ratios.

The long history of high fiscal deficits in the Caribbean stems from procyclical fiscal policies during the good times (e.g., commodity booms) and countercyclical policies in bad times (e.g., the global financial crisis or climate shocks). Budget imbalances can, in part, be attributed to the creation and (mis)management of state-owned enterprises (SOEs). In good times, policymakers spend on the growth of SOEs, while in bad times these enterprises expose their financial vulnerability.

Not surprisingly, debt-to-GDP ratios have been on the rise since the 1990s, due to the accumulation of liabilities during crisis and failure to repay during good times. Debt levels are currently high and still climbing, contributing to the CCB6 high debt-low growth trap. Furthermore, high debt levels have in some cases acted as binding constraints to performing countercyclical fiscal policy during crises as they significantly restrict the governments' fiscal space. Only a few countries have adopted fiscal rules to reduce debt and other comprehensive reforms; most rely on ad hoc fiscal adjustments. In addition, fiscal policy has an impact on the preexisting monetary framework, which in most cases in the region follows a soft or hard version of an exchange rate peg.

The aim of this study is to provide a detailed diagnosis of the economic trajectory of the CCB6, with an emphasis on the fiscal struggles that preceded the outbreak of COVID-19. The pandemic deepened the existing macroeconomic problems of the region and generated new ones, as in most developing countries that entered the crisis with poorer structural conditions, worse infrastructure, lesser capacity, and lower economic resiliency. This chapter devotes a section to the COVID-19 economic downturn and recovery. The fiscal analysis starts with the observed phases of GDP growth, which differ depending on the structure of the economy (commodity or tourism based), and then attempts to find an explanation based on other macroeconomic and microeconomic indicators.

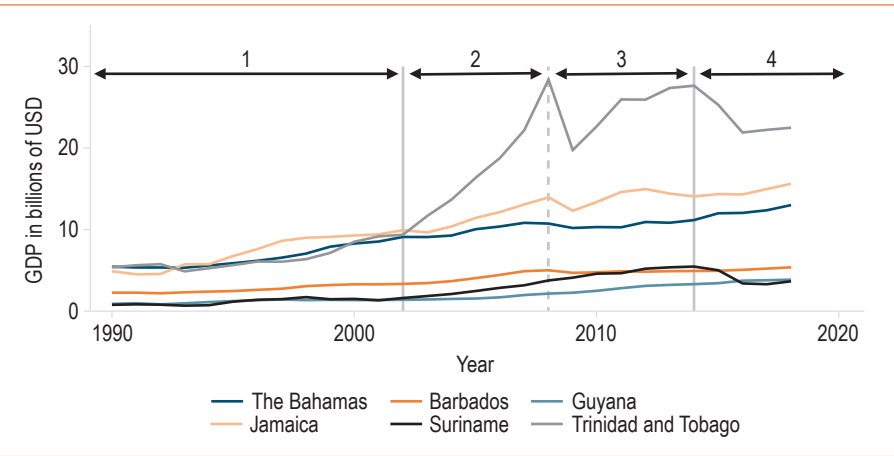
This chapter has five additional sections. The first section analyzes the macroeconomic context of the Caribbean region and describes GDP trends, exports, labor dynamics, debt, and government spending. It focuses on the problems of fiscal procyclicality and the particular dynamics involving SOEs. The second section describes the fiscal impact of COVID-19 in the CCB6 economies, and the struggle to overcome the crisis. The third section presents some plausible solutions for the fiscal struggles in the region, while the fourth section presents a simplified growth diagnostics analysis in the spirit of Hausmann, Klinger, and Wagner (2008). Finally, the last section concludes and discusses next steps.

## **Background and Context: The Caribbean Region in Perspective**

### **The Four Phases of GDP Growth**

The evolution of output in the Caribbean economies since 1990 can be divided into four periods: the high growth period of the '90s, the acceleration at the beginning of the century, the period of post-financial crisis, and the recent plateau in economic growth (see Figure 1.1). The first period coincides with a decade of openness and a great escalation of global trade and capital flows. Annual GDP growth rates for the depicted economies are between 3.6 percent (Barbados) and 8 percent (Suriname), with a mean of

Figure 1.1. GDP Trends in the CCB6 Region

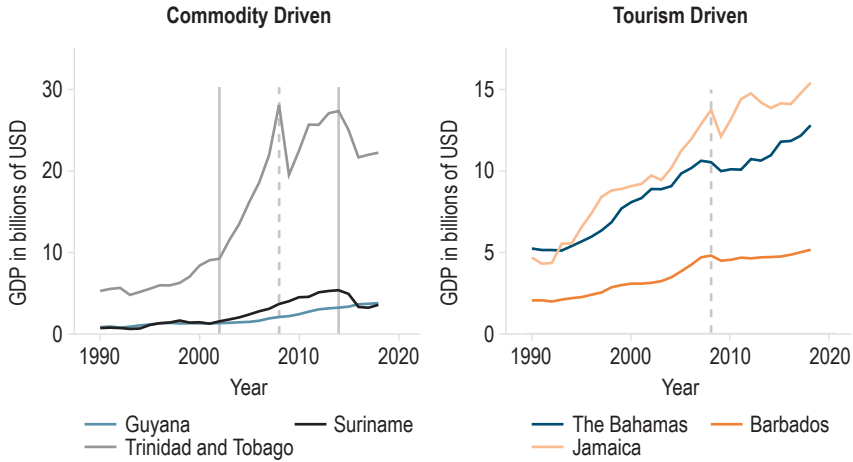


Source: IMF (2020).

5.4 percent. The second period starts with the oil (and other commodities) boom of 2002. Annual growth rates jumped substantially, especially for the commodity-driven economies (Guyana, Suriname, and Trinidad and Tobago), reaching 20.7 percent in Trinidad and Tobago and 17 percent in Suriname. The financial crisis of 2008 put an end to the golden years, with drops in output growth of up to 30 percent in one year (Trinidad and Tobago). Guyana and Suriname were able to use the (still high) commodity prices as a buffer and were the only countries with positive GDP growth rates. For this same reason, growth rates rose again after the crisis, though more moderately. Finally, the fourth period starts with the end of the commodity bonanza in 2014. As prices collapsed so did economic performance, with a negative average growth rate in the CCB6.

While the trends depicted are generalized across the region, they most accurately reflect the performance of the natural resource-based economies (see Figure 1.2). Trinidad and Tobago's economy is intensively concentrated in oil and gas, accounting for almost 45 percent of the nation's output; the oil price collapse was thus the main reason behind the sharp drop in GDP after 2014. Suriname's main economic activity is mining, mostly gold, and Guyana's economy is slightly more diversified into agriculture, precious metals, and minerals (35 percent, 30 percent, and 10 percent respectively). Tourism-driven<sup>1</sup> economies such as the Bahamas, Barbados, and Jamaica, on the other hand, exhibit two clear periods: before and after the global financial crisis. The tourism industry around the world was severely hit by the crisis, and the Caribbean region was no exception. Offering a leisure product

<sup>1</sup> Defined as those in which tourism represents more than 15 percent of GDP.

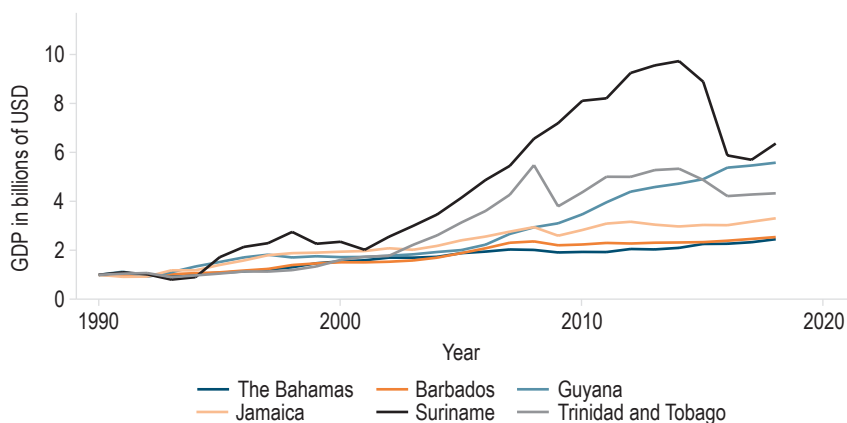
**Figure 1.2. GDP by Type of Country (commodity driven and tourism driven)**

Source: IMF (2020).

to mostly Americans, Canadians, and Europeans that accounts for over 60 percent of exports (IMF, n.d. “DOTS”), the tourism-driven economies of the Caribbean experienced a severe contraction. In the decade prior to 2008, annual growth rates were between 2.4 percent and 3 percent; they slowed to 0.7–2 percent following the crisis. These trends remain the same, and for some countries are even more pronounced, when looking at per capita GDP (see Figure A1.1 in the appendix to this chapter).

Finally, Figure 1.3 shows the evolution of GDPs in the Caribbean using 1990 as the base year. In this layout, which allows for further comparisons between countries, the trends are even more pronounced. The most extreme ups (and downs) occur in commodity-driven economies. It is worth noting that the latter can be further divided into oil exporters (Trinidad and Tobago) and minerals/stone exporters (Guyana and Suriname). In all cases, they are price takers and GDP volatility results from commodity price volatility. However, in the case of Guyana and Suriname, an additional price volatility arises from exporting a primary good like bauxite/alumina, the main source of aluminum. Since the process of converting bauxite to aluminum requires electricity-intensive chemical transformations, demand is driven by a few Asian countries with comparative advantage in electrolysis (mostly China). This makes the world price more reactive to a country-specific demand shock. For both Guyana and Suriname, bauxite/alumina exports were overtaken by gold after 2010.<sup>2</sup>

<sup>2</sup> While a tourism-driven economy, Jamaica also exports alumina.

**Figure 1.3. GDP Relative to 1990**

Source: IMF (2020).

### Export Dynamics: Commodities versus Tourism

Exports of goods and services constitute a source of foreign currency for the economy and provide an exogenous engine of growth that is independent of the regional and domestic macroeconomic cycle. At the firm level, there is also evidence that exporting further increases productivity and profit margins. Countries can boost their exports by either increasing the quantity of goods/services in the existing export lines (i.e., the intensive margin) or by opening new lines of exports through innovating on or selling abroad existing products or services that are currently successful in the domestic market (i.e., the extensive margin). There is some evidence that the latter is costlier, as opening new lines entails a high initial fixed cost but has diversification benefits in the export portfolio and can prove to be more profitable in the medium and longer term.

In the Caribbean, the small size of domestic markets makes the economies dependent on international trade to produce at efficient scale and to generate employment. CCB6 economies are, in fact, very open to trade, which is the reason for their high reactivity to external shocks. The share of the exporting sector in GDP is currently very high in these countries, close to 40 percent of GDP (see Table 1.1), even compared to Latin America and the Caribbean (LAC). This share was even higher in the 1990s and declined over time until the commodity boom of the 2000s that revived the export sector in most of the Caribbean economies (see Figure A1.2 in the appendix to this chapter). In the post-crisis and plateau periods, exports as a share of GDP fell once again, between 5 percent and 10 percent. Finally, there is a high correlation in export performance across all countries, meaning that they have similar exposures to global shocks.



**Table 1.1. Exports as a Share of GDP**

	Total Exports 2018 (% GDP)	Total Exports 1990 (% GDP)	Natural resources (% exports 2018)	Tourism (% exports 2018)
CCB6	37.5%	52%	27.06%	30.64%
CCB6 – Commodity driven	35.5%	62.5%	55.86%	3.25%
CCB6 – Tourism driven	38%	48.5%	1.23%	58.04%
LAC	23%%	17%	N/A	7.61%

Source: Author's calculations based on World Bank (n.d., "World Development Indicators").

Note: Total natural resources rents are the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents.

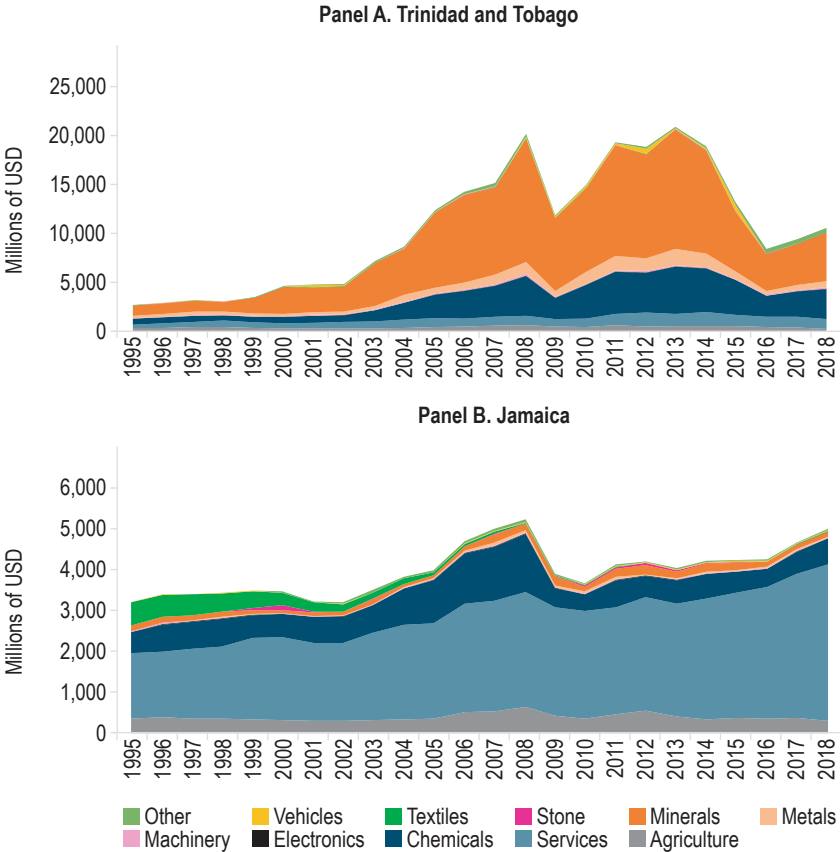
In the commodity-based economies, export values mimic the trends in commodity prices. This is because commodities represent the vast majority of their export baskets—over 55 percent currently, but significantly more during the commodity boom. Figure 1.4, Panel A, exemplifies this by showing the composition of exports of Trinidad and Tobago over the period 1995–2018. Export values have remained quite stable for agricultural products, primarily water and alcohol, and have slowly increased for services, mostly tourism. Export revenues of minerals, metals, and chemicals, on the other hand, have fluctuated with external factors, such as the ups and downs of commodity prices and the 2008 financial crisis.

In the tourism-based economies, the export share of services has increased over time, but overall export values have remained constant since the drop due to the 2008 crisis. In the case of Jamaica (see Panel B of Figure 1.4), the exports of alumina fell with the crisis and never recovered. Services, led by travel and tourism, made up for the difference, but total export values remained almost the same between 2011 and 2016. Therefore, the share of exports in output has declined over time (at least until 2017).<sup>3</sup> GDP growth in the Caribbean economies after the financial crisis was led not by exports but by very high government spending. The risks and implications of this are described in the next section.

It should be stressed that external sources of income such as commodity exports, tourism, remittances, and financial services can throw the economy and the current account into disarray. In fact, for most of these countries, the current account has been in deficit since the turn of the 21st century, as can be observed from Figure 1.5, and has progressively worsened since the global financial crisis. Commodity exporters like Trinidad and Tobago or Suriname had current account surpluses when commodity prices were

<sup>3</sup> Note that there is a recovery of services exports since 2017, though as the next chapter will show this has been completely wiped out by the COVID-19 shock.

**Figure 1.4. Exports from Trinidad and Tobago and Jamaica (1995–2018)**

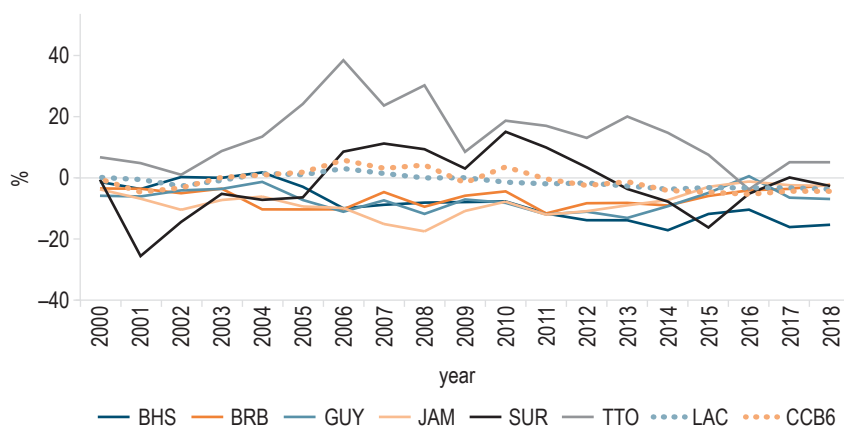


Source: UN (n.d.).

soaring, but these also turned into deficits after the end of the commodity boom. Note, however, that the (average) CCB6 dynamics are similar to the (average) dynamics of LAC.

**The Procyclicality of Government Spending**

All the Caribbean nations studied experienced not only current account deficits but also fiscal imbalances (at least over the past decade). Government spending in the Caribbean has been slowly rising since the mid-1990s but has remained, on average, below 30 percent of GDP (see Figure A1.3 in the appendix to this chapter). Rates were at or below 25 percent before 2002, at or below 27 percent before 2009, and between 28 percent and 30 percent after. These spending rates are slightly higher than in Central America, very similar to the Latin American averages, and much lower than in

**Figure 1.5. Current Account Balance (to GDP) in the CCB6**

Source: IMF (2020).

advanced economies.<sup>4</sup> In other words, the CCB6 governments spend significantly more during the good times—partly on SOE creation, as will be shown in Chapter 2—which leaves no buffer for the bad times. Thus, during crises they need to borrow and, as a result of this repetitive cycle, debt has been accumulating (unsustainably) over time. This section describes the spending patterns, and the following chapter discusses debt sustainability.

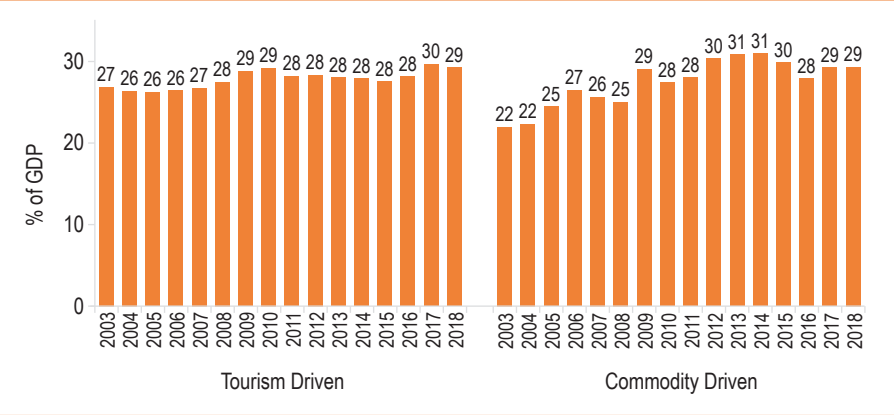
Figure 1.6 shows how spending rates differ between commodity-driven and tourism-driven economies. In the latter, government spending as a fraction of GDP increased in 2008 and 2009 due to the global financial crisis and has remained a fairly constant share of GDP (between 28 and 30 percent) since. There is not much variance, either, in the spending rates since the early 2000s. The lowest rate was 26 percent in 2004–2006, while the highest was 30 percent in 2017. Commodity-based economies show a different pattern. They start with lower public spending but exhibit a much more rapid increase alongside the commodity boom, from 22 to 31 percent of GDP. There was another jump post-crisis, in 2009, and the increasing trend continued until the 2014 decline in commodity prices.

A closer look at the CCB6 economies reveals country-specific patterns. Figure 1.7 shows government spending as a share of GDP for each economy across four periods of time. Except for the Bahamas, public spending for the CCB6 has been over 30 percent of GDP in recent years.

The Bahamas has the lowest public spending as a share of GDP, though with the fastest-growing rate (on average). Barbados has one of the highest

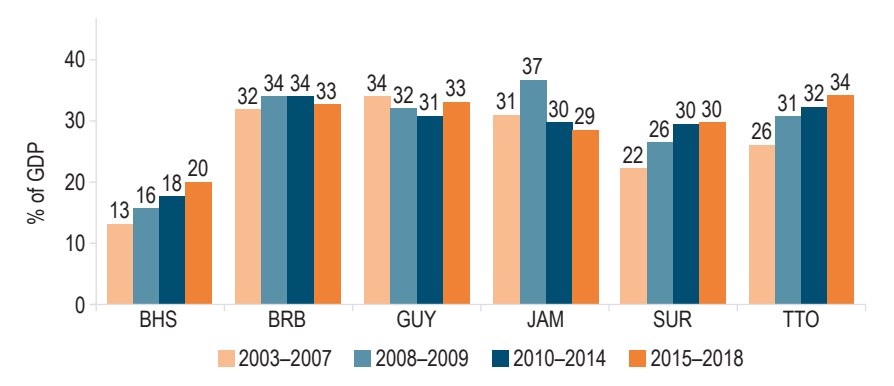
<sup>4</sup> The latter have remained quite steady over time at around 40 percent of GDP (IMF, 2020).

**Figure 1.6. Government Expenditures in Commodity-Driven vs. Tourism-Driven Economies**



Source: IMF (2020).

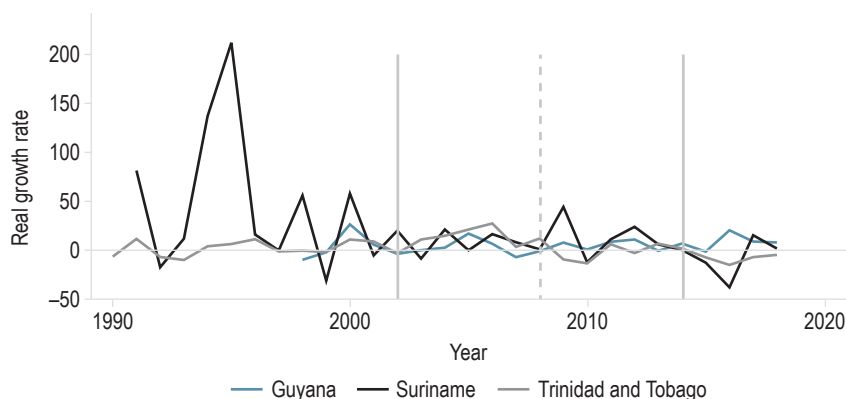
**Figure 1.7. Government Expenditures (CCB6)**



Source: IMF (2020).

spending rates but shows a steady pattern across time. Jamaica exhibits a sharp spike in the crisis years (2008–2009), reaching 37 percent before falling back down to 29–30 percent. This corresponds both to a decrease in GDP due to the severe drop in tourism from the United States and Europe, as well as an increase in public spending reflective of countercyclical policies intended to cushion this contraction. Public spending later fell in 2010.

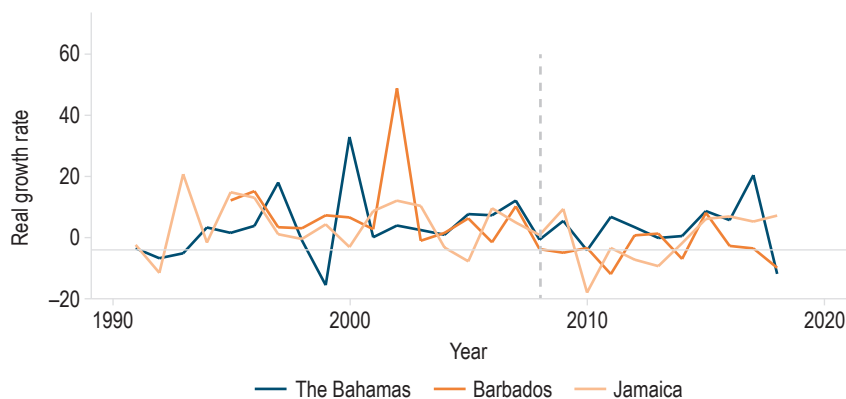
The commodity exporters Suriname and Trinidad and Tobago follow a very similar (increasing) trend. The latter has the highest spending share of all economies for the period 2015–2018, a direct result of the declining oil prices. Even though there was a fiscal contraction in this period, GDP experienced a massive drop that increased the share of public spending. Finally,

**Figure 1.8. Government Expenditures (CCB6 commodity based)**

Source: IMF (2020).

Guyana shows a somewhat steady pattern since the 2000s, with relatively high rates of public spending.

To get a better sense of the evolution of spending levels, Figures 1.8 and 1.9 show real growth rates of government expenditures for the CCB6 countries. In all cases we observe the typical developing country procyclical pattern:<sup>5</sup> higher government spending in good times and declines in spending during the bad times. For tourism-driven economies, this was reflected by higher spending rates before the crisis and lower rates after the crisis. For commodity-driven

**Figure 1.9. Government Expenditures (CCB6 tourism based)**

Source: IMF (2020).

<sup>5</sup> See Kaminsky, Reinhart, and Vegh (2004) and Talvi and Vegh (2005).

economies, we observed higher spending during the commodity price boom, with a downward shock during the crisis. However, the fiscal contractions are usually not substantial, which makes the expenditure shares of GDP rise.

Procyclical fiscal policies are common in developing economies, and very common in LAC. Most developed countries, on the other hand, use countercyclical fiscal policy to stabilize output over the business cycle as traditional Keynesian theory would recommend. This means restraining the fiscal stance (less spending, more taxes) when the economy is growing and using fiscal stimulus (more spending, less taxes) during recessions to increase aggregate demand. Ultimately, the strategy is smoothing out the business cycle. LAC's procyclical fiscal policies, however, accomplish the opposite by increasing the volatility in the economy, which could have a negative impact on investment and growth.

This misuse of fiscal policy, also known as the procyclicality trap, stems from LAC's high dependence on external credit.<sup>6</sup> It is common in the region to overspend during good times and then borrow in bad times (sometimes to pay for the recklessness of the good years). However, when debt levels are too high, developing countries—especially in LAC—tend to experience sudden stops (loss of access to international credit) during bad times. In this sense, *when it rains it pours*: in periods of capital outflows, reduced fiscal solvency calls for contractionary macroeconomic policies (Kaminsky, Reinhart, and Vegh, 2004). In other words, procyclical fiscal policy during good times calls for countercyclical policy during bad times. Other studies have placed fault on weak institutions and political incentives for the fiscal policy. High spending during economically prosperous times, mostly due to short political horizons and a focus on reelection, leaves little to no resources or insurance for the bad times.

Finally, it is worth noting that the nature of government spending is primarily current spending. In most cases, increases in public spending are due to larger subsidies and transfers, while infrastructure investment stays constant or even decreases. In fact, capital expenditures represented only 12 percent of the total central government's expenditure in 2018 for the Caribbean economies. Izquierdo, Pessino, and Vuletin (2018) show that there has been an absolute decrease in capital expenditure as a share of total spending since the 1980s and that specific crisis periods (e.g., the 1998 Russian crisis) caused a hit to capital spending with very persistent effects. While this is true for all developing economies, the bias against capital expenditures is the largest in LAC. This is mostly due to procyclical fiscal policies, which use capital expenditure reductions as the adjustment factor during bad times and then expansion of current expenditures during good times.

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<sup>6</sup> See Gavin and Perotti (1997).

The commodity-driven economies currently spend more, on average, on public investment than tourism-driven economies do. The latter oscillate between 2 and 3 percent of GDP and have been declining for over two decades. In Jamaica, for instance, public investment has declined to less than 3 percent after reaching double digits during the 1970s and '80s. Capital expenditures in the Bahamas doubled to 3.3 percent of GDP in 2017 as part of the reconstruction efforts following Hurricane Irma but fell again to 2.3 percent in 2018. These examples reflect the very limited fiscal space within which the CCB6 economies operate, as well as structural deficiencies that inhibit public investment that is much needed, in most cases, to close the existing infrastructure gap between current/planned investments and what is required for the adequate provision of goods and services.

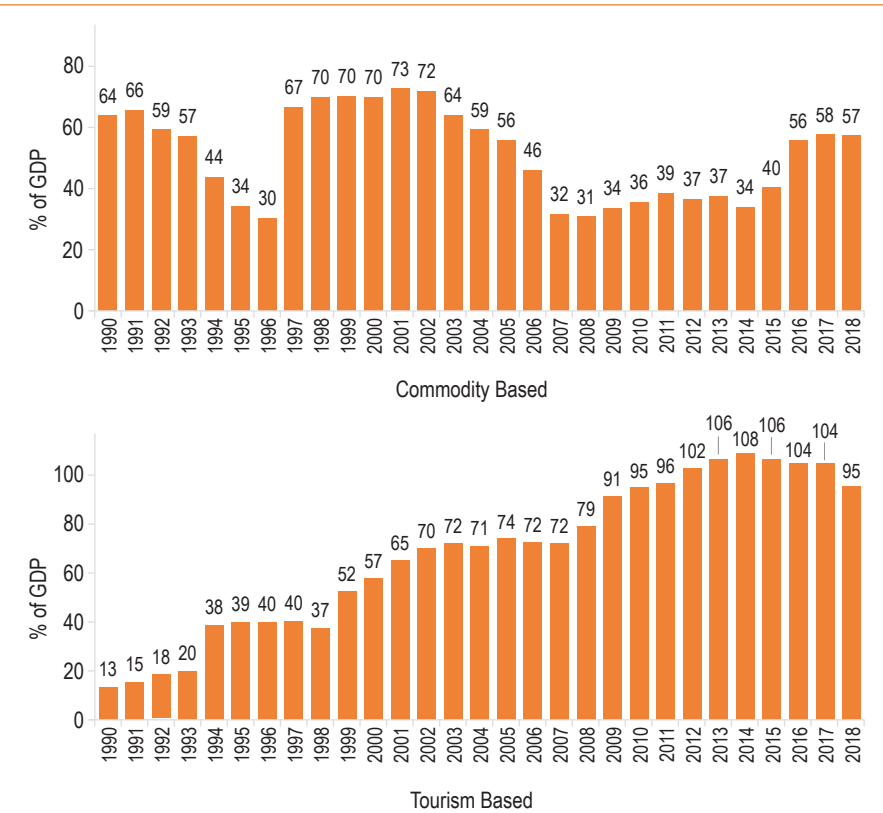
### Debt Ratios in the Caribbean

The CCB6 governments' struggle to run balanced fiscal budgets, along with their exposure to several external shocks (financial and climatic) since 2008, has translated into clear increases in the size of the public debt-to-GDP ratio. Debt-to-GDP ratios in the CCB6 are high, on average, and have been rising for over a decade (see Figure A1.4 in the appendix to this chapter) due to favorable rates for borrowing. Public debt ratios went from less than 40 percent of GDP in the mid-1990s to over 80 percent in 2017, due to primary balance deterioration. The high exposure to outside shocks has contributed to the current high debt-low growth trap. Even though countries differ in their debt path, as described below, concerns about fiscal sustainability in the region have risen.

Figure 1.10 demonstrates that debt-to-GDP ratios and their evolution vary significantly according to the structure of the economy. The top panel shows the trends of debt to GDP of commodity exporters. During the commodity boom of the 2000s these countries were able to successfully reduce their indebtedness from ratios of 70 percent to around 30 percent of GDP, mostly through a rise in GDP. In fact, they maintained these relatively low levels of debt until 2015—nearly a decade—when the collapse in commodity prices hit GDP and caused the ratio to start climbing again. It has remained near 60 percent since 2016.

The tourism-driven economies, on the other hand, started with very low debt levels in the 1990s and increased them significantly. As shown in the bottom panel of Figure 1.10, the cumulative ratio has grown steadily over time, reaching 108 percent in 2014. The global financial crisis caused debt to spike from 72 percent to 91 percent of GDP in just two years. The sudden climb in the debt ratio resulted from undermined growth (and a very slow recovery) as well as increased borrowing to counteract the declining trade balance. Interestingly, while debt ratios had remained lower than those of

Figure 1.10. Debt-to-GDP Ratios (CCB6 by group)

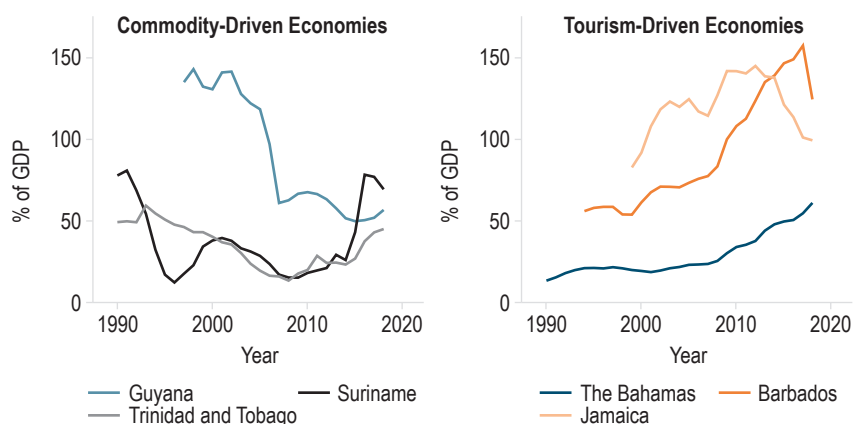


Source: IMF (2020).

the commodity-based economies up until 2002, they rose to above 90 per cent since 2009, raising major concerns over sustainability.

Figure 1.11 disaggregates the level of indebtedness for the CCB6 economies by country and again by structure of the economy. From 2017 to 2018, Guyana and Trinidad and Tobago had the lowest debt-to-GDP ratios of the sample, around 53 percent and 60 percent respectively. Guyana has managed to lower its ratio from over 65 percent in 2010 by reducing external debt considerably (domestic debt has remained around 15–18 percent of GDP). On the other hand, Trinidad and Tobago’s debt ratio has been rising over the past few years due to increases in both domestic and external debt as well as lower oil revenues. Their debt, however, is comprised mostly of medium- and long-term maturities. In both cases, the latest International Monetary Fund (IMF) Article IV assessment classified their risk of debt distress as moderate, with space to absorb shocks (IMF, 2018, 2019b).



**Figure 1.11. Debt-to-GDP Ratios**

Source: IMF (2020).

In contrast to the significant debt-to-GDP reductions managed by the oil-exporting countries, Suriname ended the commodity boom period with a higher level of debt to GDP than before. This is mostly due to external debt more than doubling between 2015 and 2016. External debt has remained stable since then at around 50 percent of GDP (with total debt over 70 percent). This procyclical behavior poses a macroeconomic risk and will require strict fiscal measures to enter a sustainable path. Note that the financial crisis increased the ratios for all three economies, though cushioned by the commodity price boom.

Barbados and Jamaica have very high (and seemingly persistent) debt-to-GDP ratios well above 100 percent. For Barbados, debt peaked at almost 160 percent of its income in 2017 but fell to 125 percent due to a major restructuring completed in November 2018. The country's debt is mostly long term and domestic (currently 93 percent of GDP and 75 percent of overall debt respectively). The IMF finds the debt ratio path sustainable and predicts it will fall below 90 percent within five years (IMF, 2019a). Jamaica's debt has been on a downward trend and is expected to remain on that path, which will safeguard the sustainability of its debt.

With a debt ratio consistently below 100 percent, the Bahamas has the lowest debt ratio among the tourism-driven economies. Although it has been on the rise over the past few years, the debt is mostly domestic and denominated in local currency; current levels are not too concerning (yet). For these reasons, the risks to debt sustainability have been classified as moderate by the IMF's Article IV consultation (IMF, 2020a).

Caribbean countries are also extremely vulnerable to natural disasters and adverse effects of climate change due to their geographic location,

which imposes an additional layer of volatility. These climate shocks have become more frequent and require additional (unplanned) government spending, which results in higher debt. Tourism-driven economies are, generally, more vulnerable due to their smaller (economic, geographic, and population) size and dependency on their infrastructure to maximize tourism exports. It is for these reasons that COVID-19 has had very large fiscal impacts on the Caribbean economies, as explained below.

### **SOEs under the Magnifying Glass**

SOEs play an important role in the Caribbean economies, as they address market failures and provide basic services to the population. They have a strong presence and operate across a wide variety of sectors, though they tend to be more concentrated in the key sectors of energy and natural resource extraction. A large wave of privatization occurred between the 1980s and '90s, but it slowed down during the early 2000s and came to a halt with the financial crisis. Despite their relevancy, and a strong history of mismanagement and poor service provision, the existing data are insufficient to study SOE performance.

One of the main contributions of the present book is an original dataset on CCB6 SOEs, manually extracted from the companies' financial statements, called the IDB CCB6 State-Owned Enterprises Database. Although incomplete, this database provides the most up-to-date data available and is sufficient for the identification of overall trends and main performance issues. This section will provide some descriptive statistical analyses and historical evidence of the fiscal impact of SOEs. For a complete depiction of SOE performance over time and across countries, see Chapter 2.

The number and nature of SOEs varies widely by country. Suriname, an economy with a very strong state presence, has over 140 SOEs that participate in nearly every sector. There is no public list of the SOEs, one of many indicators of the lack of transparency and accountability surrounding these companies. The government, which accounts for 40 percent of Suriname's total employment, uses the SOEs to redistribute revenues from extractive activities. Current expenditures are extraordinarily high, mostly due to payroll expenses, and pose significant fiscal risks (World Bank, 2018).

Trinidad and Tobago has about half as many SOEs as Suriname, which is still a significant number. The vast majority provide services, mostly financial, but also related to health, education, sports, transportation, and tourism. SOEs also operate in the agriculture, manufacturing, and energy sectors. The government established SOEs in key sectors, like oil and gas, in the early 1960s as part of an import-substitution strategy. Guyana, on the other hand, currently has only six SOEs, a product of the significant privatizations that started in the 1990s and continue to the present day. The SOEs are in sugar,

oil, energy, communications (2), and tourism, and the state also has a minority stake in two bauxite mining companies.

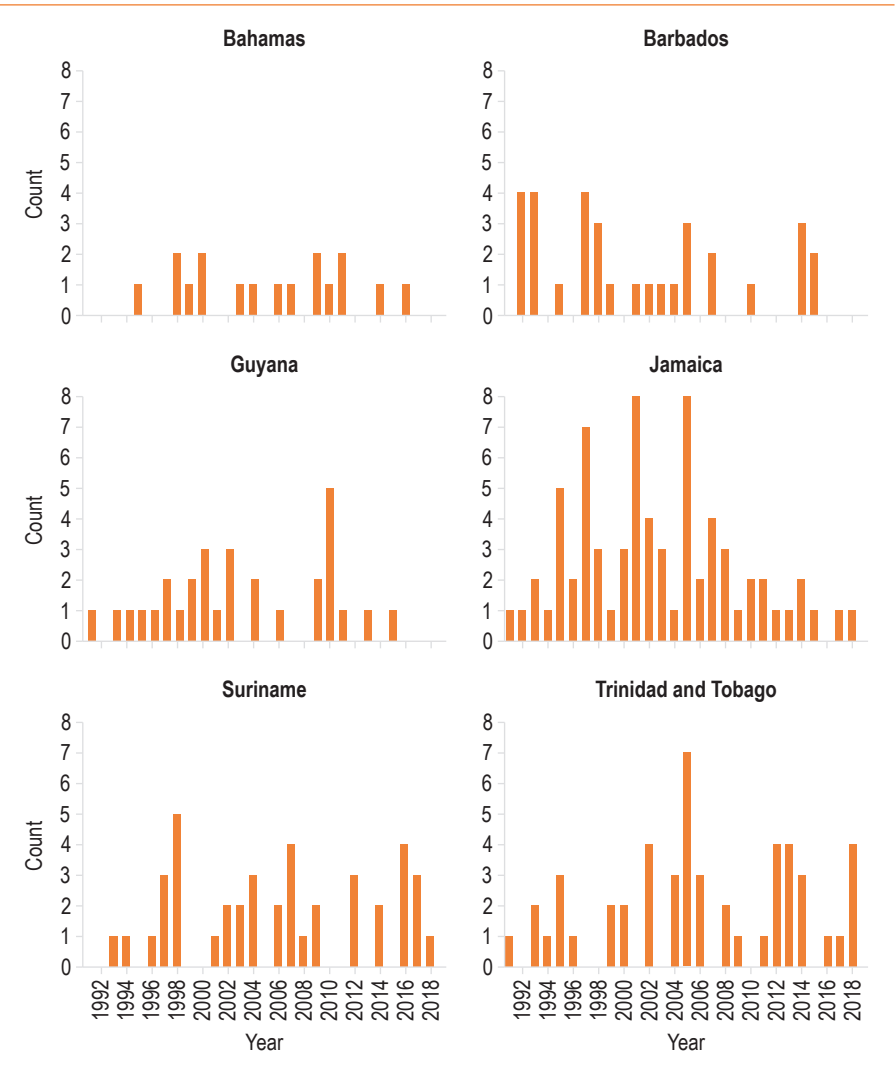
Perhaps most surprising is the case of Jamaica, with 195 public bodies—the most in the Caribbean. Interestingly, Jamaica has more SOEs than Trinidad and Tobago (almost three times as many), even though the latter has a larger economy in terms of GDP. Jamaica's SOEs cut across 13 sectors of the economy and fulfill select public functions (quasi-fiscal operations) in some cases. The underperformance of most of them (losses and high debt), combined with their large sizes, raises concerns about fiscal risk exposure and overall fiscal sustainability. Lastly, Barbados has 63 SOEs, a substantial number given its small population size (around 300,000 people), while the Bahamas currently has only 25 SOEs, mostly operating in utilities and services (health, education, tourism).

In all cases, SOEs are inefficient, too large, and too dependent on government transfers; they have become a fiscal burden for the CCB6 economies (see Chapter 2). In addition, private companies complain about unfair competition and market distortions (e.g., in airline routes). This book presents the SOE problem in the Caribbean not as just poor-performing companies but rather as the result of deep institutional flaws that govern fiscal behavior. In other words, the CCB6 are stuck in an SOE fiscal trap: during good times governments spend on SOEs (oftentimes unnecessarily), which end up becoming government dependencies and absorbing a lot of resources.

Figure 1.12 shows the evolution of SOEs by year of establishment. After a sustained growth in the number of SOEs in the 1980s (not shown), there is a collapse in the number of new SOEs during the early 1990s, coinciding with the reformist and privatization agenda of that time. We observe overall persistent creation of SOEs over time and a clear procyclicality bias. For commodity exporters (which includes Jamaica), SOE creation increases gradually and peaks in the years between 2005 and 2010, coinciding with the commodity boom. Across the region as a whole, we see almost no SOE creation after the global financial crisis. All this evidence suggests that SOEs are created in periods of abundance and used as vehicles for public policy targeting employment, job creation, and subsidies.

Finally, a note regarding the role of SOEs during times of crisis (like the COVID-19 pandemic). It has been argued that public companies could help overcome the implementation challenges (due to deficient financial services and existing market failures) regarding the distribution of social assistance. Lazzarini and Musacchio (2020) discuss the pros and cons of state involvement and classify different policy instruments within state-owned organizations according to their likely effectiveness. They argue that the state apparatus can play a major role in aiding remote and critical areas which the private sector does not serve due to high marginal costs of service provision. These potential areas range from medical treatments and testing to capital injections and the expansion of critical

Figure 1.12. Creation of State-Owned Enterprises over Time in the CCB6



Source: IDB CCB6 State-Owned Enterprises Database.

infrastructure.<sup>7</sup> Lazzarini and Musacchio also advocate for horizontal rather than vertical industrial policies (e.g., all financially tight SMEs regardless of their sectors).

<sup>7</sup> For example, SOEs could help with the temporary disruptions in supply chains and the short-term liquidity problems caused by COVID as nonessential businesses were required to close temporarily in many countries. State-owned development banks could provide credit lines for households and SMEs, and even grants to help alleviate the payroll burdens of temporarily closed businesses and to cushion the effects on employment.

## The Economic Impacts of COVID-19 in the CCB6

The very rapid spread of COVID-19 globally starting in early 2020<sup>8</sup> led many countries to adopt strict isolation measures (like lockdowns) to relieve pressure on the health system and help “flatten the curve” (i.e., distribute the number of positive COVID-19 cases over a greater period of time). The idea was to keep the rate of contagion low enough (by restricting human interaction) so that the health-care system’s capacity would not be overwhelmed. The high contagion rates led most CCB6 economies to impose either full or partial social distancing measures.

Economically, flattening the curve has proven to be very expensive. The lockdowns imposed in an effort to contain the virus provoked an initial domestic supply shock. Additionally, it was amplified by disruptions in the supply chain as well as through domestic and external demand shocks that led to a massive recession.<sup>9</sup> Guerrieri et al. (2020) show that a supply shock, when concentrated in certain sectors (e.g., lockdowns of nonessential businesses), can lead to higher contractions in demand than the original supply shock. This results in firm exits, layoffs, and subsequently less spending. There is also a reduction in demand due to increased caution. People (and firms) delay consumption and investment due to health concerns (e.g., when ordering food from a restaurant) and uncertainty about the future.

In addition to the shocks mentioned above, LAC economies faced a severe trade shock as their exports of goods and services collapsed, while imports of personal protective equipment (PPE) and medical supplies soared. All Caribbean countries have suffered declines in remittances. On top of that, the commodity-driven economies have seen large reductions in output due to historic lows in demand for oil<sup>10</sup> and other commodities. Tourism-driven Caribbean economies, dependent mostly on North American and European tourism, suffered the most because tourism originating from these regions came to almost a complete halt for most of 2020, with the lowest hotel occupancy rates and international flights on record.<sup>11</sup>

<sup>8</sup> By early March 2020, the virus had been identified in at least 115 countries and became the first coronavirus to be declared a pandemic. Since then, the number of positive cases has grown exponentially, reaching 180 million total cases as of June 2021. These numbers likely undercount the real number of cases because most countries have failed to test a representative sample of their populations. See <https://coronavirus.jhu.edu/map.html>.

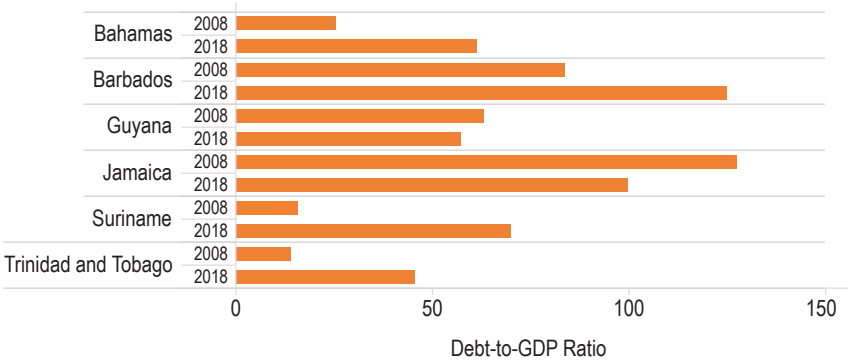
<sup>9</sup> This was not specific to the CCB6. Unemployment claims in the United States reached a record high of 7 million in March 2020, more than 10 times higher than during the peak of the 2008–09 financial crisis (U.S. Bureau of Labor Statistics, n.d.).

<sup>10</sup> U.S. oil futures turned negative in April 2020, for the first time ever, with shrinking demand and storage space at full capacity (U.S. Energy Information Administration, n.d.).

<sup>11</sup> See <https://www.statista.com/statistics/206546/us-hotels-occupancy-rate-by-month/>.

Perhaps the key to understanding COVID-19’s deep economic impacts in the CCB6 is to analyze the shocks within the regional macroeconomic context. This chapter has described the economic model of the Caribbean as one of procyclical spending, driven partly by efforts towards employment creation in the public sector and through SOEs, and high external debt. In fact, there has been a dramatic increase in external debt, particularly compared to pre-financial crisis levels (see Figure 1.13).<sup>12</sup> As a result of high and rising debt, these countries have been characterized by constrained fiscal space even in the best of times. Together with poor governance practices, this has made it very hard for governments to deploy funds and resources to fight the pandemic and accompanying economic crisis.

**Figure 1.13. Debt to GDP (2008 vs. 2018)**



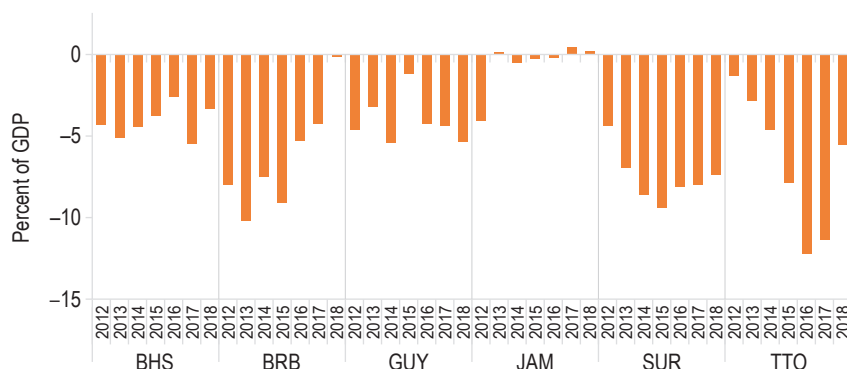
Source: Authors’ calculations based on IMF (2020b).

**Twin Deficits**

**Fiscal Deficit**

With the end of the commodity boom, the commodity-driven CCB6 economies saw a sharp rise in fiscal deficits and debt. Something similar happened to the tourism-driven economies after the 2008–09 global financial crisis. Due to concerns about sustainability, many countries began to move towards fiscal consolidation (as seen in Figure 1.14). For instance, Barbados and Jamaica, both under IMF programs, have significantly reduced their fiscal deficits in recent years—Jamaica even achieved a surplus—in an attempt to lower their high debt ratios. While lower ratios were indeed achieved in 2018 and 2019, these countries still have less fiscal space to implement

<sup>12</sup> There has been a dramatic increase in debt for all but Guyana (whose levels have stayed about the same) and Jamaica. The latter managed to reduce debt to GDP, but levels are still very high (close to 100 percent).

**Figure 1.14. Fiscal Deficit in the CCB6**

Source: Authors' calculations based on IMF (2020).

measures than others with more moderate debt levels. Additional expenses are thus harder (more expensive) to finance, which has led to a slower recovery from the COVID-19 shock. Furthermore, by slowing economic activity, the pandemic has dramatically reduced tax revenues, further constraining fiscal space.

During the global financial crisis, most Caribbean economies were able to respond by increasing public spending to foster aggregate demand. Though the average fiscal stimulus package was around 3 percent of GDP in LAC (it varied significantly depending on debt levels), this proved to be sufficient for the objective. This time around, however, things have been different. First, as COVID-19 hit as more of a supply shock rather than a demand shock, it is unclear whether fiscal policy is the right tool this time. On the one hand, Guerrieri et al. (2020) argue that, while the fiscal multiplier is lower because some sectors are shut down, fiscal policy is still optimal. On the other hand, the current fiscal position of the Caribbean is much weaker than in 2009 and debt levels are higher. Thus, fiscal sustainability presents a challenge to the regional economies: the required spending levels exceed the current fiscal space. Box 1.1 describes the fiscal measures undertaken in 2020 by each of the CCB6 countries.

### **Balance of Payments Deficit**

The small Caribbean islands are among the world's economies most dependent on travel and tourism, with shares of GDP significantly above the world and LAC medians of around 3 percent and 5 percent, respectively. Figure 1.15 shows the direct contribution of tourism to the CCB6 economies. The shares of tourism in GDP are very high for the Bahamas, Barbados, and Jamaica, between 10 and 20 percent, and are even higher for the smaller islands like

**BOX 1.1. FISCAL POLICY RESPONSES TO COVID-19**

Despite their financial constraints, all CCB6 countries have undertaken several fiscal measures in response to the COVID-19 pandemic. The main ones have been a new (or increased) budget for health expenses and transfers to households. The latter have taken the form of social security (mostly unemployment) benefits paid in cash or in kind (e.g., food stamps), but in some cases they even cover extraordinary health expenses and transfers to nationals that could not repatriate due to travel bans. Deferrals in tax filings have also been widely adopted. Other popular policy responses have been credit lines and stimulus grants to SMEs (e.g., for salary compensation), tax reductions, and tax and debt deferrals. Barbados is even granting tax benefits to foreigners who can work remotely while in Barbados as a way to attract travelers and foster private spending. Table 1.2 summarizes the measures taken by each country through 2020.

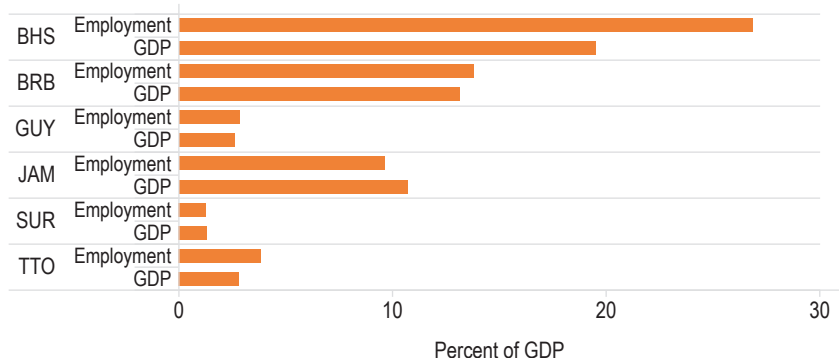
**Table 1.2. 2020 Fiscal Policy Responses in CCB6 Countries**

	Containment measures				Recovery measures		
	Health fund	Transfers to households	Tax deductions or deferrals	Debt deferrals	Grants/loans to SMEs	Infrastructure investment, others	Estimated budget
Bahamas	√	√ (B\$4 million+)	√	√	√ (B\$20 million+)	x	B\$65.7 million (0.6% GDP)
Barbados	√	√ (BBD\$2.7 million+)	√ (BBD\$40 million)	x	√ (BBD\$260 million+)	√ (BBD\$325 million+)	~6% GDP
Jamaica	√	√ (J\$10 billion)	√ (J\$15 billion)	x	√	x	J\$25 billion+ (1–2% GDP)
Guyana	x	x	√	x	x	x	Not available
Suriname	√	√	x	x	x	x	~1–2% GDP
Trinidad and Tobago	√	√	x	√	√	x	Not available

Source: Authors' elaboration based on IMF (n.d., "Policy Responses") and EY (n.d.) data.

It has become evident that Caribbean governments are facing higher spending needs but have a lower spending capacity than in previous crises. Part of the current spending is for emergency purposes (health systems), but mostly it is for economic stimulus. The dilemma facing the CCB6 has been what the optimal size of the package should be considering both the limited fiscal space and the lower efficiency of a fiscal channel. A stimulus of 3 percent of GDP (like that of the global financial crisis) has been considered too small for the current crisis. In fact, several countries have already spent substantially more than that. However, 3 percent of GDP today is too large for the current debt ratios. In addition, the main challenge is not fiscal sustainability but rather how the countries are going to finance the extra spending.



**Figure 1.15. Travel and Tourism's Direct Contribution to Caribbean Economies (2019)**

Source: Authors' calculations based on World Bank (n.d., "Travel and Tourism") data.

Aruba or the British Virgin Islands (over 25 percent, not pictured). Most striking perhaps are the shares of tourism in domestic employment, reaching 27 percent in the Bahamas. Note that the total contribution of tourism is likely even higher, as it also benefits local businesses that are not directly tourist oriented.

In this context, the severe drop in tourism demand, remittances, and the plunging commodity prices driven by diminished global demand implied a widening of the balance of payments deficit for most Caribbean economies. Several of them were already running current account deficits by the end of 2019, and while the economic recession has also prompted a concurrent fall in imports, it will not be enough to close the gaps. This means that on top of the fiscal deficit, capital is leaving these countries. Furthermore, the downward shock to oil prices has been a big hit to oil exporters like Trinidad and Tobago, where it introduced to the market an additional layer of volatility that generated short-term uncertainty (as reflected in futures options), thus negatively affecting profitability. Oil also tends to be an important source of government revenue for these countries. Moreover, while low oil prices would normally benefit the importers, it fails to compensate for the decline in overall economic activity. Therefore, the already weak economies of the Caribbean region are now facing sharper deficits.

### Fiscal Struggles: Can We Do Better?

The macroeconomic indicators and time trends depict a clear picture of the Caribbean region. The global financial crisis has had a deep negative effect on exports, especially in tourism-based economies because they depend

on arrivals from the United States, Canada, and Europe. The response of fiscal policy and debt levels varied according to the structure of the economy.

### Countercyclical Fiscal Policy, Only During the Crisis

In tourism-based economies, public spending increased (from already relatively high levels) to mitigate the negative effects on GDP growth rates, and subsequently caused debt levels to spike up dramatically. By 2017 debt to GDP in Barbados surpassed 150 percent (see Figure 1.11). While public spending also increased in the commodity exporters, and in even larger proportions, the high and increasing commodity prices (especially of oil) were sufficient to finance this public spend. The commodity-based countries managed to reduce their debt-to-GDP ratios during the boom, but as fortunes reversed so did the ratios. In fact, both Trinidad and Tobago and Suriname reverted to 1990s debt ratios soon after 2014.

Over the past five years, exports have slowly begun to rise, though they remain at early-2000s levels. GDP has remained flat and government expenditures have continued to rise in an effort to revive the domestic economies, which pushed debt-to-GDP ratios upward. As a result, the CCB6 countries are trapped in a high debt-low growth spiral: high debt started as a consequence, but is now also a cause, of low economic growth. But this is not new. The Latin American debt crisis of the 1980s should pose a clear warning about the perils of rapid increases in debt-to-GDP ratios.

### The Cycle and the Exchange Peg

As described in the previous section, the long-term trends of fiscal and debt policy tend to be procyclical. Tourism-based economies increased their debt levels during the commodity boom, and even an oil exporter like Suriname had exited the boom with higher debt levels than in the period preceding the commodity boom.

These trends are exacerbated by the fact that most of the economies in the region have fixed exchange rates. Barbados and the Bahamas have hard pegs and Guyana, Suriname, and Trinidad and Tobago have soft exchange pegs. Jamaica is the exception, with a flexible exchange rate. Having a fixed exchange rate tends to exacerbate macroeconomic adjustments during a commodity boom because the exchange rate cannot be used to adjust to a new equilibrium after a large movement in the terms of trade. Instead, the adjustment variable is internal prices in the medium term and quantities in the very short term. As a result, riding a commodity boom with a fixed exchange rate amplifies macroeconomic volatility. On the plus side, if the peg is credible and is maintained after the commodity boom is over, the country can avoid the usual cycle of stop-and-go that tends to arise when a large portion of the debt is denominated in foreign currency and the country adjusts its exchange rate.

### The Debt Glass Ceiling

Empirical evidence reveals an inverted U-shaped relationship between debt and economic growth for developing economies, also known as the Debt Laffer Curve.<sup>13</sup> At low debt levels, the incoming capital can help to stimulate the economy (e.g., when used for productive purposes) and foster growth. Once debt levels reach a (relatively high) threshold, interest payments and sustainability begin to take a toll on output by increasing volatility and often-times reducing growth. The main channel for reducing debt is through a crowding out of private investment (since interest rates increase) and the expectation of a tax hike in the near future. Evidence for advanced economies is more mixed and has been widely debated since the Reinhart and Rogoff (2010) controversy.

Regarding Caribbean countries, several studies emerged in the late 1980s to understand the debt crisis and its relationship with output. Bourne and Nicholls (1990) found that increased debt obligations in Barbados and Trinidad and Tobago significantly reduced growth. Boamah and Moore (2009) found that debt is sustainable below 63 percent of GDP. They suggested that lower benchmarks should be considered, as the estimated limit assumes good institutions, low inflation, and a solid fiscal stance. Similarly, Greenidge et al. (2012) found the threshold debt-to-GDP ratio for Caribbean economies is between 55 percent and 56 percent. They also found faster growth when debt is below 30 percent of the GDP, but it declines rapidly as that lower limit is passed.

There are multiple channels through which debt might affect economic growth. First, high debt crowds out private investment, both domestic and foreign. As investors anticipate higher future taxes to repay the debt, investment is discouraged, thus reducing growth. It could, additionally, crowd out public investment if debt obligations are large enough that governments are not able to undertake productive projects due to tight finances. Moreover, high debt to GDP limits a country's degrees of fiscal freedom due to the need to guarantee debt sustainability. This means that they might only be able to implement procyclical policies, which could be suboptimal in times of crisis. Finally, high debt to GDP could also increase rollover risks as investors will demand higher interest rates in times of financial distress.

Close examination of debt trends in the Caribbean region shows that procyclical fiscal policy combined with the macroeconomic cycle has resulted in a secular increase in general indebtedness as a fraction of GDP. The global financial crisis only aggravated this situation, especially for the subset of countries whose export of tourism services is concentrated in the United States, Canada, and the United Kingdom.

<sup>13</sup> See Claessens (1990) for estimates and discussion.

## Fiscal Rules

Fiscal rules have recently become very popular, especially for developing economies after crisis episodes, as an attempt to be better prepared for future crises. They impose persistent restrictions (rules) on fiscal policy with the objective of correcting behavior (such as overspending in good times) and promoting fiscal responsibility. In the Caribbean countries, fiscal rules would help curb procyclical spending, improve transparency and accountability of public bodies, and stabilize the debt trajectory. In fact, various IDB reports and IMF Article IV consultations have strongly recommended the use of rules for fiscal discipline.

Of the CCB6 economies, only the Bahamas, Barbados, and Jamaica have adopted fiscal rules. Jamaica's Fiscal Responsibility Framework (FRF) was approved in 2010 with two rules (a balanced budget rule and a debt rule) and objectives to be achieved by 2016. However, a new rule was added in 2014 to bring the debt-to-GDP ratio below 60 percent by 2025 (see Box 1.2 for further details). The 2016 objectives were not met, and the target debt ratios seem unlikely to be achieved given the current levels.

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### BOX 1.2. FISCAL RULES IN JAMAICA

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Jamaica, the largest and most populated of the CCB6 economies, has been among the worst performers in the region since the mid-1990s. Annual GDP growth rates were below 3 percent prior to 2008, and have dropped to near 1 percent since. The global financial crisis significantly affected Jamaica's growth trajectory and led to a deep recession that lasted until 2014. Furthermore, debt levels in Jamaica are significantly higher than in the rest of the Caribbean and constitute a major source of concern. Jamaica's debt levels were already high (above 70 percent of GDP) in the 1990s, but in the early 2000s, the debt-to-GDP ratio quickly escalated and remained around 120 percent, helped in part by the global financial crisis.

These are the outcomes of fiscal mismanagement, more specifically of procyclical spending in the good times and countercyclical spending in the bad times (with increases in debt). In the Jamaican case, the debt trigger was completely domestic: a banking crisis in the mid-1990s and the bankruptcy of large public companies. When debt levels are too high, however, interest payments take a toll on public finances, crowd out private investment, and thus have a negative effect on economic growth. The global financial crisis left high unemployment, public debt surpassing 140 percent of GDP, and a persistent fiscal deficit driven partly by massive interest payments. With no signs of international trust or access to credit markets following a debt exchange in 2010, it was imperative for Jamaica to get back on the debt sustainability path in order to stabilize the economy and achieve medium- to long-term growth.

The Fiscal Responsibility Framework (FRF) was adopted in March 2010 through the passage of legislation that, among other things, amended the long-

*(continued on next page)*

**BOX 1.2. FISCAL RULES IN JAMAICA** *(continued)*

standing Financial Administration and Audit (FAA) Act and the Public Bodies Management and Accountability (PBMA) Act. In spring 2013, with debt levels at a historic high, Jamaica reached an agreement with the IMF for an Extended Fund Facility (EFF). There was much skepticism, given the country's long history of failed IMF programs, but civil society demanded a commitment to reforms. The FRF was revised in 2014 and an economic program oversight committee (EPOC) was formed, with stakeholders from various sectors including government and academia), to monitor and evaluate progress. According to Nigel Clarke, Jamaica's Minister of Finance and Public Service: "What began as an 'IMF program' became 'Jamaica's program' with IMF support" (Clarke, 2019).

The FRF promulgated the structural reform of fiscal management and financial sector regulation, through a balanced budget rule and a debt rule. Specifically, it set a floor for fiscal balance (expected to be zero by 2016) and aimed to bring debt down to 100 percent of GDP or less by 2016 (2010 FRF) and 60 percent of GDP or less by 2025–2026 (2014 revision). These two fiscal rules were complemented by targets to rationalize public sector employment (and reduce public sector payroll as a share of GDP), tighter controls on SOE expenditures, and reforms to the tax administration. Overall, the FRF incorporated budgeting, timelines, and fiscal rules that limited public spending (with emergency budgeting clauses in the case of natural disasters) by imposing appropriate monitoring and controls.

In the end, Jamaica was able to reverse its fortune, showing substantial improvements in public debt-to-GDP ratios, fiscal deficit reductions, and the accumulation of foreign reserves. Consequently, in 2016 the new government signed a new agreement with the IMF (a Stand-By Arrangement) that provided an extra push for further improvement. By 2019 debt was well below 100 percent of GDP and the country had run an average primary surplus of 7 percent of GDP for six consecutive years. In addition, unemployment dropped to a historic low of 8 percent and growth rates had slowly started to rise again. Other structural reforms to public finances (e.g., tax administration) and the financial sector have also taken place with technical assistance from the Inter-American Development Bank (IDB) and other multilateral organizations.

Jamaica is a great example of how fiscal rules can work. But the country's history of many failed reform programs also showcases that having rules is not enough; there needs to be commitment, monitoring, and ex post accountability. In Jamaica's case, the involvement of all relevant stakeholders was key, highlighted by the fact that the policies and reforms continued under a different (and opposing) political administration.

The Bahamas passed the Fiscal Responsibility Law in October 2018, establishing specific numeric rules for fiscal policy: a ceiling for budget deficit (0.5 percent of GDP), current expenditures (4 percent of GDP), and

government debt (50 percent of GDP). The targets are expected to be met in 2021, 2022, and 2025, respectively. It also introduced new reporting requirements to improve transparency. Barbados has recently adopted a fiscal rule for the primary surplus, as part of a large fiscal reform that includes changes in tax policy, public finances, transfers to SOEs, and capital expenditures.

## Other Considerations

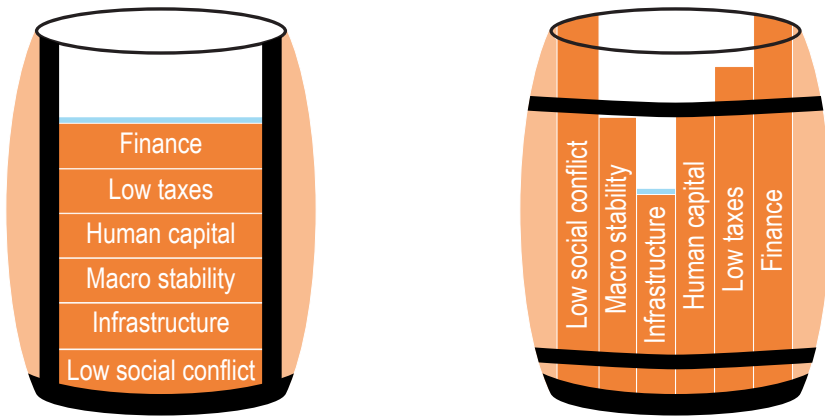
This chapter has attempted to provide a clear and complete depiction of the fiscal struggles in the Caribbean. However, it is important to acknowledge that macroeconomic policy does not take place in isolation but rather within and in response to country- or region-specific ecosystems. This section aims to identify those aspects of the ecosystem that pose the largest barriers to economic growth and that may be guiding some of the fiscal behavior. In other words, procyclical fiscal policies applied within a context rife with structural constraints to growth generate the high debt–low growth environment described previously.

Economic growth is a central driver to improved standards of living within a region. In order to achieve a sustainable growth path, economic and social reforms must be appropriately prioritized. A common mistake has been to create long lists of structural reforms, yet they are not made actionable due to a lack of a clear roadmap and order of implementation. Reform efforts must be evaluated in terms of impact, feasibility, and resource requirements. In addition, policy recommendations should provide answers to concrete problems in the local context. Universal or best practice reforms, when attempted without this assessment and adaptation, rarely succeed in LAC, as Section II of this book will illustrate.

What is happening to growth in the CCB6? Figure A1.5 in the appendix to this chapter shows the lackluster evolution of productivity growth, as measured by total factor productivity (TFP) over a five-year period. Barbados and Jamaica have had no growth since the early 1990s, the latter showing a remarkably flat pattern. Trinidad and Tobago, the largest of the CCB6 economies, experienced positive TFP growth only until the global financial crisis. Since 2010, TFP has dropped 7 percent, followed by an additional drop of 11 percent after the end of the commodity boom.

## Growth Diagnostics

The approach of growth diagnostics takes into consideration the local context and surfaces risks and opportunities from a local perspective. According to Hausmann, Klinger, and Wagner (2008), all developing economies have different factors holding them back. Suppose that the factors that impact economic development are like staves on a wooden barrel (as depicted in Figure 1.16). The total volume of water that can be held in a barrel represents

**Figure 1.16. Factors of Production as Staves in a Barrel**

Source: Hausmann, Klinger, and Wagner (2008).

output in an economy. In the first barrel, the amount of water it can hold depends on the total width of all the staves. Though their width varies, their lengths are equal (they extend the full circumference of the barrel), which implies that they are (perfect) substitutes. In the second barrel, on the other hand, the staves are vertical, so volume is determined by the length of the shortest one, regardless of the others' lengths. This implies that the relevant factors are complements, rather than substitutes.

The growth diagnostics methodology recognizes that the real world lies somewhere between these two paradigms: not all factors of production affect economic growth equally. The impact of a change in the length of a slat will be positive if that factor is a binding constraint to economic growth. It will also depend on the distance between that slat and the next constraint (e.g., the second shortest slat). What matters, therefore, is the relative performance of these economic factors. Even if all the slats are short, the key is to find the one that is disproportionately binding (i.e., the shortest one). The objective then is to identify the shortest staves, which will be the barriers to growth or active restrictions to the growth of Caribbean economies. This framework uses a Bayesian approach to identify constraints based on their different symptoms (signals); binding constraints are determined using four main criteria.<sup>14</sup> The following sections demonstrate a simplified growth

<sup>14</sup> As defined by Hausmann, Klinger, and Wagner (2008): First, a constraint is binding if the shadow price of the factor is high. The second criterion is that movements in the availability of the factor produce movements in the target variable. Third, agents that are less intensive in the factor usage are more prone to prosper. And finally, economic agents try to actively overcome the barrier.

diagnostics approach to identifying binding constraints to economic growth in the CCB6 based on observable characteristics.

### Identifying Binding Constraints

The usual suspects when it comes to explaining sluggish growth are poor infrastructure (physical capital), little or no access to financial markets, and low educational attainment (human capital). For tourism-driven economies, infrastructure is crucial to improve competitiveness and capture a larger market share in tourist activities. In addition, Caribbean countries are highly vulnerable to natural disasters, damages from which require massive funds for infrastructure rebuilding and repair. The Bahamas only recently approved a disaster relief fund (in the 2018 Fiscal Responsibility Act). In addition, island economies rely heavily on sea and air transport for connectivity and trade. These modalities require higher investment in maintenance and upgrades than land modes.

The Introduction of this book showed the time series for gross fixed capital formation (GFCF) and SOE creation in the CCB6 countries and argued that the two are unrelated (and thus it is unlikely that SOEs contribute to capital formation). There are two additional trends worth noting, that are also replicated in the time series of investment (see Figure A1.6 in the appendix to this chapter). First, since the 2000s, capital formation in these economies has been relatively high, with shares exceeding 20 percent of GDP. These are higher than the Latin American and European averages of 18 percent and 20 percent, respectively.<sup>15</sup> Second, the commodity-driven economies invest a significantly larger share of GDP (over 30 percent) in infrastructure (physical capital) than the tourism driven (20 percent). For Suriname, this exceeded 40 percent even before the global financial crisis.

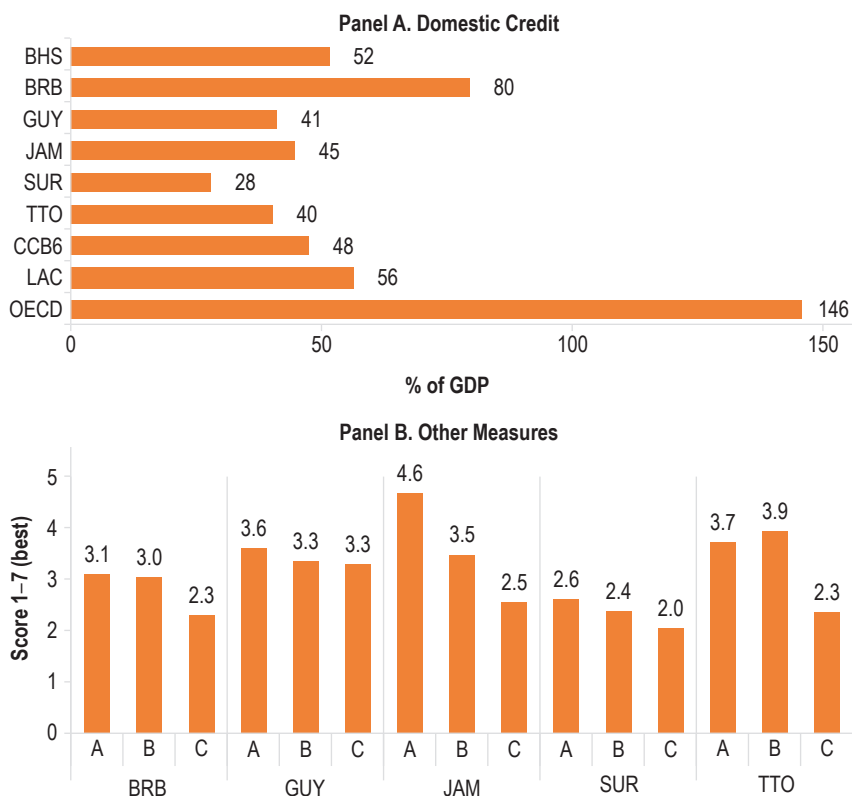
Access to credit for the private sector seems, nevertheless, quite limited. Financial markets in the CCB6 are small and fragmented, which is usually blamed on excessive and deficient regulation. Their weak status is also considered to be one of the main reasons behind the underdevelopment of the private sector economies in the region. Panel A of Figure 1.17 shows that domestic credit as a share of GDP is low in the CCB6, except for Barbados. The regional average (48 percent) is lower than LAC's (56 percent) and lags much further behind the shares for advanced economies, which tend to be above 100 percent of GDP (the OECD average is 146 percent).

Despite the small size of the financial sectors, overall access to domestic credit does not seem to be a barrier for firms. Panel B of Figure 1.17 shows three other measures of financial depth: financing through the local equity market, ease of access to loans, and availability of venture capital. They are

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<sup>15</sup> In fact, European countries exhibit a constant decline of these shares over time, from over 30 percent in the 1970s to less than 20 percent lately (World Bank, n.d., "WDI").



**Figure 1.17. Financial Markets in the CCB6**

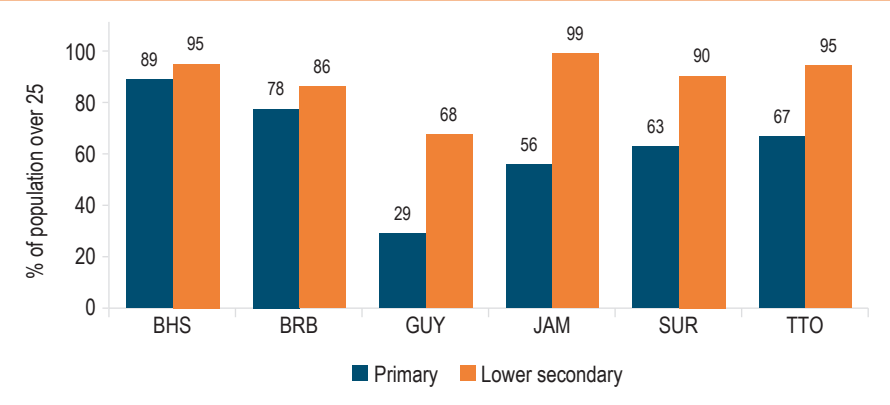
Source: Panel A: IMF (n.d., “IFS”); Panel B: WEF (2019).

Note: Data is for the latest available year, spanning from 2015 to 2019. In Panel B, A = financing through local equity market; B = ease of access to loans; C = venture capital availability.

presented as scores from 1 to 7 (7 being the best), based on data for the latest available year between 2015 and 2019. While venture capital activity in the Caribbean is negligible, domestic lending seems to be relatively accessible. This suggests that the small ratios of domestic credit might respond to scarce demand rather than limited supply. In fact, the costs of financial intermediation, as measured by interest rate spreads, are not significantly higher (7.7 percent) than LAC (7.1 percent) and world (5.5 percent) averages (IMF, n.d., “IFS” 2017-2019).

Regarding infrastructure, the 2019 and 2020 Global Competitiveness Reports reveal that the quality of infrastructure is not an issue (at least relative to other things) for the region (WEF, 2019, 2020). In fact, Barbados and Trinidad and Tobago lead the region, with relatively high infrastructure scores. They rank 30 and 54, respectively, out of 138 economies in the world. Jamaica’s infrastructure is one of the least problematic factors in terms of

**Figure 1.18. Share of the Population Age 25+ with Primary and Lower Secondary Education**

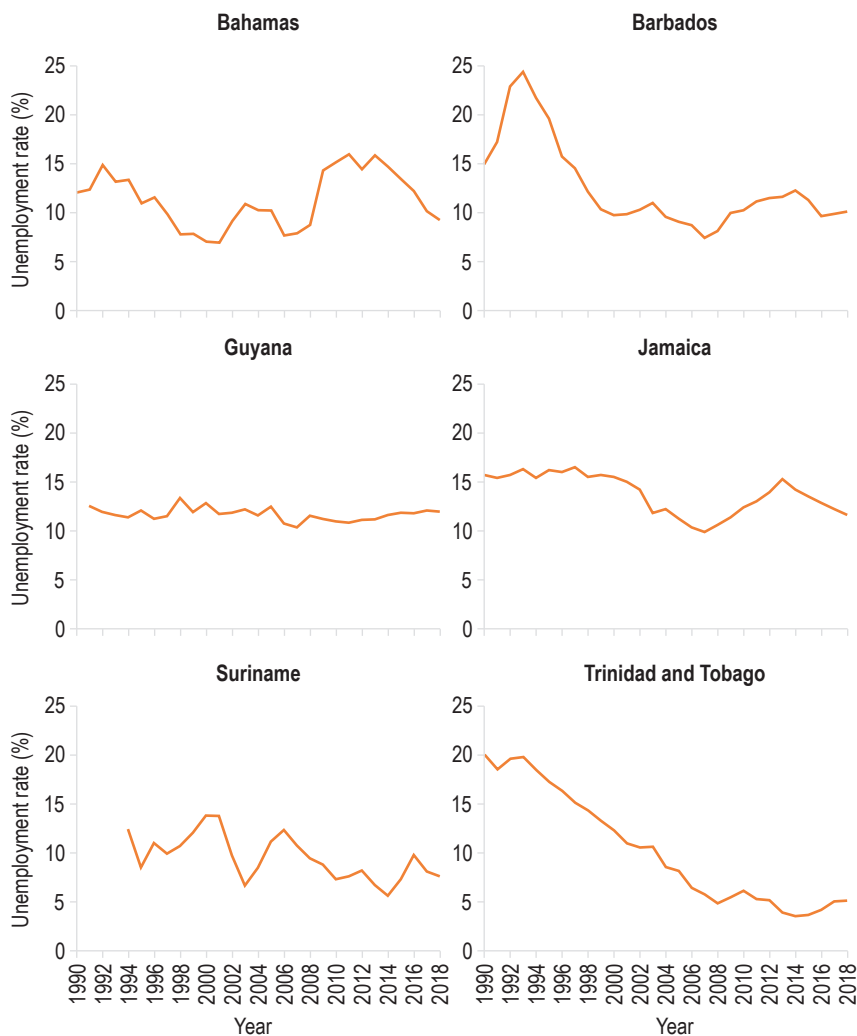


Source: World Bank (n.d., “WDI”).  
Note: Data corresponds to last available year.

competitiveness and doing business. It has an average infrastructure score well above LAC, even though the overall country competitiveness is relatively worse. While there is no infrastructure score information on the other three economies of the CCB6, there are no reasons to suspect that they would perform very differently. Infrastructure, therefore, does not seem to be a binding constraint in the CCB6 economies.

Human capital is one of the main drivers of growth in the neoclassical theory and helps explain differences in development across countries. Given its complementarity with physical capital, low education attainment could be restricting productivity (for example, if the workforce is inadequately educated or trained). Figure 1.18 shows that, except for Guyana, educational levels are not low in the region at all; in fact, they are among the highest in LAC. Almost the entire population over 25 years of age has primary education and most of them also have lower secondary education. In the beginning of the 2000s, several governments in the region invested significantly in increasing primary and secondary enrollment rates, introducing universal coverage for both. As a result, average years of schooling went up.

Furthermore, if education was in fact a binding constraint to growth for the Caribbean economies, we would expect to see a price effect: high returns to schooling. Patrinos (2016) shows that returns to education in LAC are around 9 percent, lower than those in Africa, advanced economies, and the global average. In addition, Aedo and Walker (2012) and Ferreyra et al. (2017) run a series of Mincer regressions by country. They find that returns are lower for the Caribbean economies (vis-à-vis the Latin American economies) when looking at overall years of education, completed primary, and

**Figure 1.19. Unemployed as a Percentage of Population**

Source: IMF (2020).

completed secondary. Since higher education does not prove sufficient to generate higher returns to education in the CCB6, human capital does not appear to be a binding constraint in the region.

If education is not a binding constraint in the Caribbean, then what is the driver of the stagnating (or even falling) TFP growth? Despite an average of almost 11 years of schooling, young people entering the workforce still struggle to find employment. Figure 1.19 shows the evolution of unemployment rates in the CCB6 economies. These rates are high, on average, but

vary significantly across time. Both general trends and some country-specific ones are evident.

The tourism-driven economies had very high unemployment rates during the 1990s, with Barbados reaching almost 25 percent in 1993. However, all three countries experienced sharp declines and reached their lowest rates in 2007 (around 7 percent for the Bahamas and Barbados and 10 percent for Jamaica). Rates have since gone up again, spurred on by the global financial crisis and a very slow recovery. In the Bahamas, unemployment doubled between 2007 and 2011. In Barbados and Jamaica, it rose steadily until 2014. Current rates are above 10 percent.

The commodity-driven economies have lower unemployment rates than the tourism-driven economies, but their trajectories differ significantly from the other group. Trinidad and Tobago had 20 percent unemployment in 1990, which declined steadily until reaching 5 percent in 2008 and has remained fairly constant since then. Suriname's unemployment rate peaked in 2000 at 14 percent and has remained below 10 percent since 2008. Finally, Guyana has maintained an unemployment rate between 10 and 14 percent since the early 1990s; it has remained slightly below 13 percent since 2008.

Parra-Torrado (2014) provides an exhaustive description of unemployment in the region, highlighting three key facts. First, unemployment is very persistent, lasting for over a year in many cases. Second, the unemployment rate is higher for females, and the gap widens with age. And finally, youth unemployment is much higher than total unemployment. In the Bahamas, Jamaica, and Trinidad and Tobago, youth unemployment in 2010 was almost 2.5 times total unemployment. In Guyana, it was twice the rate of total unemployment. More recent data is unavailable, but there are no reasons to suspect that anything has changed since. In fact, for all CCB6 countries except the Bahamas, total unemployment is currently at 2010 levels. While high youth unemployment is a current worldwide problem, the Caribbean has among the highest rates (after the MENA—Middle East and North Africa—region). While youth unemployment has been on the rise around the world since the global financial crisis, the high, persistent rates for the Caribbean economies are worrisome.

Likely a consequence of the high unemployment rates, there is significant brain drain in the CCB6. The latest surveys of living conditions for Caribbean economies show that all country's emigrants are significantly more educated than residents who remain local. For instance, in Guyana over a third of the emigrants in 2017 had tertiary education versus 9 percent of the locally residing citizens. In Barbados, the ratios were one-half versus one-third. But this phenomenon is not new. Between 1965 and 2000 the Caribbean lost, on average, 70 percent of its skilled (tertiary educated) workforce to the OECD countries. The numbers are higher for the commodity-driven economies: Trinidad and Tobago and Guyana lost 79 percent and

89 percent respectively (Ruprah, Melgarejo, and Sierra, 2014). In addition, according to the WEF's Global Competitiveness Index, the CCB6 countries have a low capacity for retaining talent. Suriname ranks the worst of the six, with a score of 2.8 out of 7. Unsurprisingly, the same index indicates little entrepreneurship and risk taking across the region (e.g., Barbados ranks 123 out of 141). This might also explain why venture capitalism appears to be absent from the region.

The brain drain effect is the result of tiny,<sup>16</sup> undiversified economies reliant on activities that require mostly unskilled labor (commodities and tourism). In addition, the high exposure to outside shocks (due to a very small internal market that cannot cushion against these) makes overall employment more volatile, so there is little job security and much lower tenure than in other economies. Even when countries invest in education, the marginal gains are small. There is a structural supply-side problem in the labor market; when negative shocks hit, skilled labor will emigrate. This is also the result of a (too) small private sector, often crowded out by a (too) large public sector that creates underperforming and mismanaged SOEs.

## Conclusion

The lack of diversification within the Caribbean economies makes them very vulnerable to shocks. The resulting volatility and dependence on the global macroeconomic cycle, combined with procyclical policymaking, pose important challenges to the economic welfare of the region. This has become very evident with COVID-19; since the Caribbean economies depend more on external than internal demand for goods and services, the recovery of the region is likely to lag behind the rest of the world. It is also still too early to know whether the effects will be temporary or permanent.

The approach to SOEs in the Caribbean follows a unique pattern that will be further explored in Chapter 2. In general, in prosperous times, such as a commodity boom, policymakers invest in the growth of SOEs, while bad times expose the financial vulnerability of many of these firms and industries. Both history and empirical evidence teach that particular caution is needed in fiscally exuberant countries: increases in public spending need to be fiscally sustainable.

Using macroeconomic data from the region and microeconomic data from the SOEs, a diagnostic was conducted of the economic problems of the region, with a particular focus on the dynamics of SOEs. The sample was split into two subgroups: commodity exporters and tourism-based economies. Commodity exporters ride export booms, increasing their GDP and government spending—part of it in SOE creation—while reducing the load

<sup>16</sup> In CCB6 the domestic markets are much smaller than foreign ones.

of debt over GDP. The same dynamic was true for tourism-based economies until the global financial crisis of 2009. After the crisis, tourism-based economies reach a plateau in terms of GDP growth, exports, and levels of indebtedness. Commodity exporters do not suffer from this plateau since commodity prices are still high. As a result, they have managed to reduce their debt levels and to increase exports and GDP over time. Of course, the COVID-19 shock exacerbated existing issues regarding fiscal sustainability and paralyzed economic activity, leaving CCB6 economies with few tools to finance economic recovery.

Finally, a growth diagnostic was run to identify the main binding constraints of the region. The lackluster growth of TFP was identified as one of the main symptoms holding back the region in terms of GDP growth and management of their SOEs. The usual suspects of low investment and low educational levels do not seem to be present in the Caribbean region; with the exception of Guyana, educational levels seem to be high. Investment and levels of capital formation also seem to be high in the Caribbean region. The region, however, has suffered historically from brain drain due to a lack of economic opportunities to live, prosper, and invest in the region. The historically high unemployment levels in the region were identified as a binding constraint to growth and prosperity.

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## CHAPTER 2

# Exuberance, Inefficiency, and Fiscal Risk in the SOE Sector in the Caribbean

### Introduction

The previous chapters have discussed the troublesome fiscal dynamics in CCB6 countries (Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago). The CCB6 countries have small open economies, dependent on tourism and natural resources, and exposed to external shocks such as natural disasters, commodity price volatility, or, more recently, a global health crisis. The region has a long history of increased fiscal spending during booms, which has resulted in limited fiscal space during downturns and led to a strong dependence on external credit for stabilization. These procyclical overspending patterns are closely related to the creation of state-owned enterprises (SOEs) in the CCB6. This chapter will examine the contribution of SOEs in the CCB6 to the region's fiscal risk, structural reasons for this, and why SOEs continue to proliferate in the CCB6 despite evidence arguing for reform. As discussed in Chapter 1, SOEs are created during economically prosperous times and serve as a vehicle for employment and public policymaking. With unreliable performance records, however, SOEs add little in terms of fiscal income, yet produce a significant burden in terms of fixed costs for the government.

Despite the massive wave of privatizations that took place between the late 1980s and the late 1990s, SOEs continue to have a strong presence in Latin America and the Caribbean (LAC). Governments use SOEs for the provision of key public services and to address market failures in key sectors including water, gas, electricity, transportation, and the extraction of natural resources (oil, gas, and mining). SOEs also play an important role

in public policymaking due to their connection to the ministries that oversee them. Over the past couple of decades, however, there has been an increasing concern regarding SOE sustainability stemming from multiple scandals involving a long history of mismanagement of the largest SOEs in the region. Rather than focus on the optimal allocation of existing resources, SOEs appear to seek rents or political gains that ultimately undermine their financial performance and the financial stability of their respective governments.

While these trends hold true across Latin America, in the Caribbean they are exacerbated. SOEs are too numerous, too large, and too dependent on government transfers and subsidies. First, the CCB6 countries have the highest number of SOEs per capita in the Western Hemisphere, surpassing even Venezuela, which has nationalized hundreds of firms over the last two decades. While in most Latin American nations SOE creation dropped considerably after the 1990s, it remains high in the CCB6. Second, SOEs in CCB6 countries are extremely large relative to their domestic economies. Considered too big to fail, they constitute a major source of fiscal risk. Finally, limited to nonexistent monitoring contributes to consistent underperformance in SOEs, which then require frequent cash injections and subsidies from the treasury budget to operate.

This dependence on government transfers and subsidies is due to the fact that SOEs in CCB6 economies are neither productive nor profitable. Beyond the fact that most newly created SOEs are noncommercial (e.g., tourism boards), these public companies have not contributed to any major driver of economic growth, such as increasing total factor productivity (TFP) growth, gross fixed capital formation (GFCF), or labor productivity. In regard to financial performance, average aggregate SOE income is very small and even negative for some countries. This is likely due to exorbitant payroll costs, a result of both high salaries and overstaffing. In addition, SOEs are often mismanaged and susceptible to corruption given the close ties they have with politicians. Underperformance may also be a result of the limited competition SOEs in the region face inside their countries, resulting in their operating as (natural) monopolies and having almost no incentive to improve efficiency.

If SOEs are not productive and lose money, why do governments continue to create them? Mostly because they serve a political need. Governments use these public companies to perform quasi-fiscal operations, such as boosting employment, providing public services, and supplying key inputs at subsidized prices. For instance, SOEs may sell basic services like fuel, water, or electricity below market price, and sometimes even below production costs. Conducting quasi-fiscal operations drives SOEs to spend beyond their budget constraints, ultimately hurting their financial performance and translating their uneven or negative performance into fiscal risk.

Despite the temptation to launch SOEs to *address social needs* in CCB6 nations, their creation has mostly materialized during boom years. Our research shows that new SOEs tend to appear during episodes of current account

surpluses, regardless of political cycles. Far from temporary spending, however, these SOEs exist as permanent fixtures of the governments of the region. New SOEs, therefore, have lasting consequences on the economy, as the fiscal burden on the government accumulates over time. In other words, SOEs expand (i.e., new companies are born) during economic booms, yet in bad times SOEs do not contract and their high fixed costs become a source of fiscal risk.

Given that SOEs are sources of fiscal burden and fiscal risk, it is useful to examine further the causes and consequences of the poor financial performance of SOEs in CCB6 nations. The aim is to provide quantifiable measures for an adequate diagnosis of economic problems. Due to limited data availability, the few existing studies about SOEs in the region rely mostly on qualitative methods. The present study is based on an original dataset of financial statements of SOEs in the CCB6 over the period 2010–2017 to evaluate the SOEs' fiscal impact. This new dataset, the IDB CCB6 State-Owned Enterprises Database, allows for measures of financial performance across firms, countries, sectors, and time, and provides a reliable benchmark for future analyses.

The rest of the chapter is organized as follows. The first section describes the current state of the SOE sector in the CCB6 economies (sector size, sector growth rate, organizational types, and governance) and compares it to the Latin American SOE sector. The second section assesses the economic performance of SOEs in CCB6 and the main implications for the overall economy, and the third section addresses the elephant in the room: given the evidence provided, why do governments continue to create SOEs? The fourth section looks at the macroeconomic consequences of SOE creation, and the final section provides concluding comments.

## **The Anatomy of the SOE Sector in CCB6 Economies**

### **There Are Too Many SOEs**

Ranging between 26 and 70 SOEs per million people, CCB6 countries have an extremely high number of SOEs, especially considering the small size of their respective populations and economies. Comparable figures for Latin America are at five or below (except for Venezuela). Note, however, that due to data availability these figures correspond only to commercial SOEs. Commercial SOEs are defined as those that sell products or services for which there is or could be a market price (i.e., firms that provide public services like health care or that act as regulatory agencies are excluded).<sup>1</sup> Table

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<sup>1</sup> Also excluded from this analysis are financial firms, such as development banks, development trusts, and the like, which are plentiful in CCB6 nations. Some of the firms counted as noncommercial SOEs may have revenue that they get from fees (e.g., tourism boards), but their business is not selling a product or service per se, but to support private firms by providing regulations and guidance.

**Table 2.1. Number of SOEs in Latin America and the Caribbean**

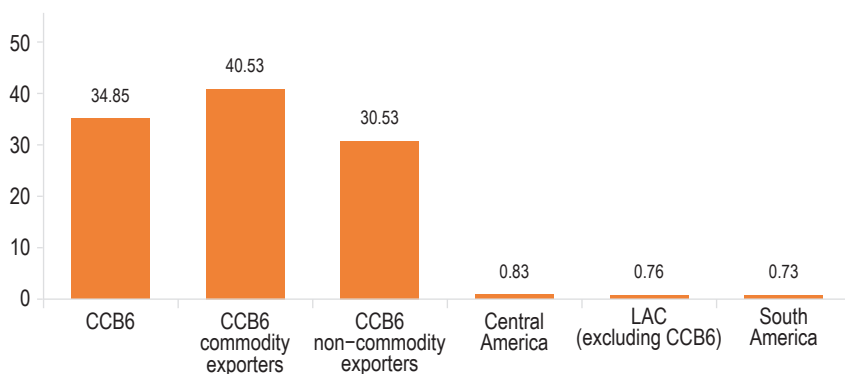
	Number of commercial SOEs 2010–2016 (average)	Number of commercial SOEs per billion of constant GDP of PPP (2015)	Number of commercial SOEs per million people (2015)
<b>CCB6 Economies</b>			
Suriname	40	4.94	70.81
Barbados	17	3.63	59.48
Bahamas	16	1.46	42.34
Trinidad and Tobago	45	1.05	32.67
Guyana	25	4.60	32.41
Jamaica	76	3.27	26.15
<b>Other Latin American Economies</b>			
Venezuela	582	1130.72	19.5
Costa Rica	25	0.35	5.1
Uruguay	17	0.25	4.96
Peru	31	0.08	4.57
Bolivia	26	0.37	2.36
Ecuador	32	0.18	1.94
Nicaragua	11	0.36	1.74
Panama	7	0.08	1.73
Argentina	62	0.07	1.42
Chile	25	0.06	1.37
El Salvador	7	0.16	1.1
Honduras	8	0.21	0.86
Colombia	37	0.06	0.77
Guatemala	10	0.08	0.6
Mexico	73	0.03	0.59
Paraguay	13	0.18	0.42
Brazil	36	0.01	0.17

Source: Created using the IDB CCB6 State-Owned Enterprises Database. Data for Latin America is taken from Musacchio and Pineda Ayerbe (2019; Table 1) and World Bank (n.d.). To make data comparable the average number of SOEs from 2010 to 2016 is used for all countries in this table.

Notes: PPP = purchasing power parity. The data for Argentina most accurately reflects 2016 according to reports from the Jefatura de Gabinete de Ministros (2017); in the case of Venezuela, the constant GDP of PPP is from 2014. Data on SOEs for Venezuela comes from Vendata (n.d.) and PDVSA (n.d.).

2.1 shows the average stock of commercial SOEs in CCB6 and Latin American economies between 2010 and 2016, both in absolute and per capita terms. Noncommercial companies are particularly abundant in the CCB6 countries, so the divergence between the number of SOEs in each region is expected to be even more pronounced for that category. Suriname is

**Figure 2.1. SOEs per Million People in the CCB6 vs. Rest of Latin America (2010–2016)**



Source: World Bank (n.d.); IMF (2020b); Musacchio, Pineda Ayerbe, and García (2015); IDB Database on State-Owned Enterprises in Latin America; and own calculations. Data on Venezuelan SOEs is not included.

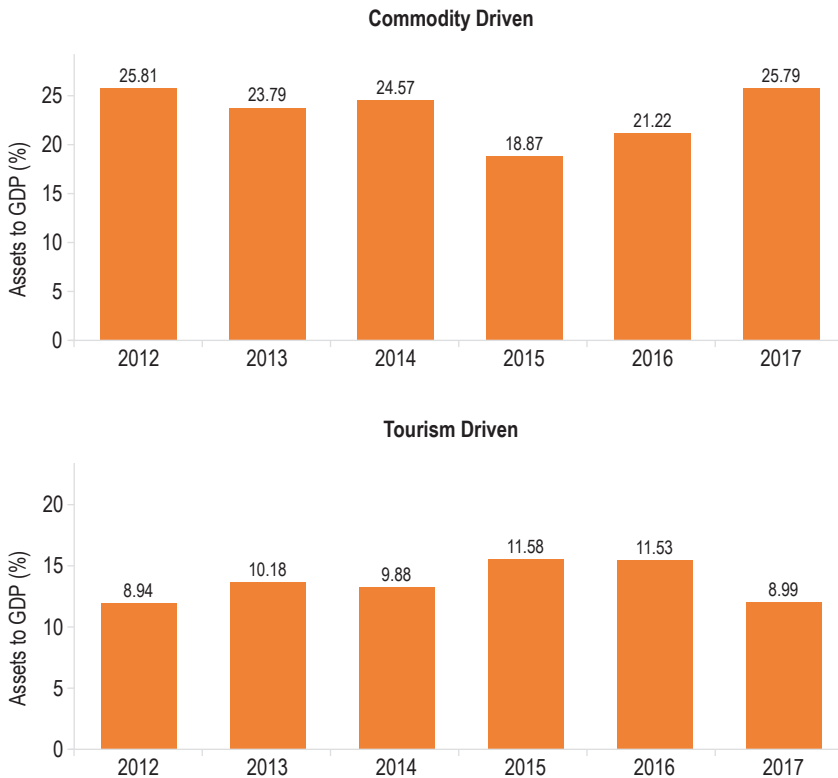
estimated to have more than 140 SOEs, which account for a third of public sector employment.

Comparing the number of SOEs in the CCB6 with those in Latin American countries might seem unfair because in the latter, provincial and municipal governments also have commercial SOEs (e.g., most electricity and water/sewage companies in Colombia and Brazil are run by provincial governments). However, when the comparison is narrowed to Central American nations, which are also small and where there are only a few provincial or municipal SOEs, the number of SOEs per million people in the CCB6 still appears extremely large (see Figure 2.1).

There is also heterogeneity within the CCB6 that is worth mentioning. If the countries are divided into commodity exporters (Guyana, Suriname, and Trinidad and Tobago) and non-commodity exporters or tourism driven (Jamaica, the Bahamas, and Barbados), the number of SOEs is higher for the commodity exporters. Figure 2.1 shows that commodity exporters have an average of 40.53 SOEs per million people, while nonexporters have 30.53—still more than 30 times the number of SOEs in Latin American countries.

### Commercial SOEs Are Too Large

SOEs in the CCB6 are not only numerous, but they are also too large relative to their respective domestic economies, with assets-to-GDP ratios averaging 16.5 percent for the period 2012–2017. This is only slightly higher than the Latin American average of 16 percent, but the numbers are likely understated since commercial SOEs in CCB6 countries are underreported in the dataset. The average, however, masks large differences based on each

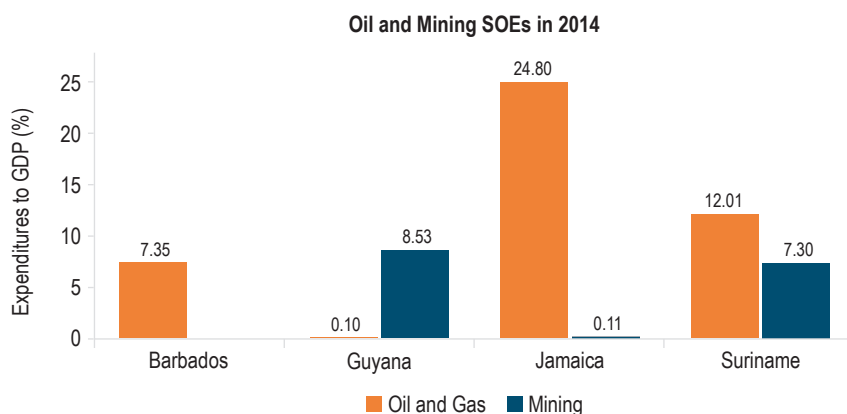
**Figure 2.2. SOE Assets to GDP**

Source: IDB CCB6 State-Owned Enterprises Database.

Note: The figures are averages for all countries in each group over the period 2012–2017.

country's main economic activity (see Figure 2.2). In tourism-driven economies, commercial SOEs are modestly sized with assets of about 10 percent of the GDP during this period. Assets-to-GDP ratios demonstrated slow growth during the period, peaking in 2015 and 2016 before going back to 2012 levels. On the other hand, SOEs in commodity-driven economies are immense, with assets-to-GDP ratios averaging over 20 percent almost every year. The ratios contracted in 2015, largely due to the collapse in oil prices, but have since recovered. Currently, assets surpass 25 percent of GDP.

The largest SOEs are in the oil and gas and the mining sectors, so it is natural to assume that the differences in the sizes of SOEs in tourism-driven economies versus commodity-driven economies are due to their respective economic structures. A closer look at the country-specific data, however, reveals incongruities in this seeming difference: (i) oil SOEs are among the largest even in some tourism-driven economies (e.g., Jamaica), and (ii) in both groups the average size of SOEs is driven by a single country. Jamaica

**Figure 2.3. Expenditures of SOEs in Extractive Industries in CCB6 Nations**

Source: IDB CCB6 State-Owned Enterprises Database.

has the largest SOEs of the tourism-driven economies, with assets exceeding 10 percent of the country's GDP for all years in the period 2012–2017. The largest public company is Jamaica Public Service Company (JPS Co.), an electric utility. Amongst commodity exporters, the large average size of SOE assets to GDP is driven upward by Suriname. The public sector in Suriname employs 60 percent of the formal workforce, with SOE employment representing over 70 percent of GDP. Finally, Jamaica and Trinidad and Tobago also have large SOE sectors but larger economies, so their SOE assets-to-GDP ratios are around 4 percent, similar to those of Barbados and the Bahamas (see Figure A2.1 during the appendix to this chapter).

Another indicator that SOEs are concerningly large is how much they spend to cover costs relative to national output. Total SOE expenditures in the CCB6 economies are very high, even compared to Latin American standards—which tend to be lower than 15 percent of GDP, surpassing 25 percent of GDP at times. The largest share of these expenses comes from oil and gas SOEs, regardless of the main economic activity of the country. Figure 2.3 shows the expenditures of oil and gas and of mining SOEs relative to GDP in 2014 (right before the decline in commodity prices).

Interestingly, Jamaica has had the highest expenditure-to-GDP ratios due to its public oil companies, Petrojam Limited and Petroleum Corporation of Jamaica (PCJ), which spend around 13 percent of GDP (each).<sup>2</sup>

<sup>2</sup> Petroleum Corporation of Jamaica was closed in 2019 due to its financial instability, as part of a rationalization plan of public bodies. Debates about the future of Petrojam, and the possibility of turning it into an import terminal, are still ongoing (see Cameron and Stanley, 2017).



Suriname's Staatsolie N.V. is also a big spender, accounting for 12 percent of the country's GDP. Together with the public mining company, Rosebel, these two SOEs spend almost 20 percent of Suriname's GDP to cover their costs. The oil and gas SOEs in Barbados have more moderate expenses, though still high relative to the size of the economy (8 percent of GDP on average). Similarly, the biggest spender in Guyana is Gold Board, the country's mining SOE, which spends over 6 percent of GDP per year.

### The Evolution of SOEs in the CCB6

Even more worrisome than the high number and large size of SOEs in CCB6 countries is the continued proliferation of SOEs over time. While most countries in the world have been winding down their SOE sector since the 1970s or converting their SOEs into government majority- and minority-owned enterprises, the CCB6 nations have continued to increase the number of wholly state-owned enterprises at an accelerated pace (see more detail in Box 2.1).

The evidence suggests that SOE creation in the Caribbean was not a temporary policy experiment of the post-WWII period, but rather has

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#### BOX 2.1. SOE CREATION IN THE CCB6 VIS-À-VIS BRAZIL

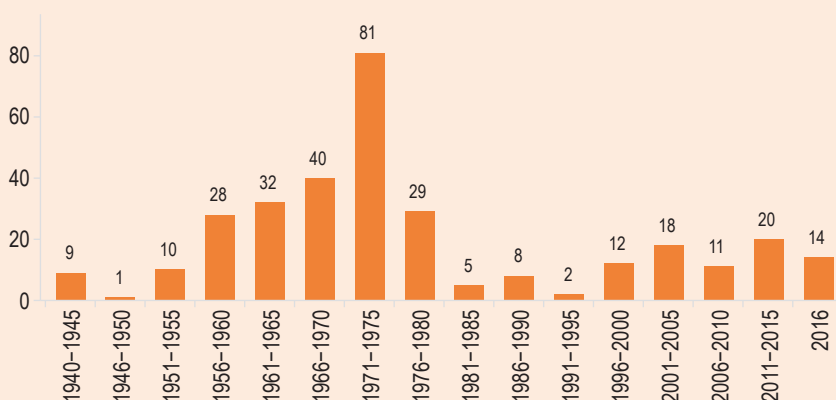
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One way to gauge how substantive the trend of SOE creation is in CCB6 countries is to compare it with that of Brazil, a country with a large state-owned enterprise sector and in which the number of SOEs established did not stop completely in the 1990s (Musacchio and Lazzarini, 2014).

Figure 2.4 shows SOE creation over time in Brazil, plotting the number of federal SOEs established since 1940 in five-year intervals. There was an explosion of the federal SOE sector in the early 1970s, followed by rapid deceleration in SOE creation. The wave of privatizations, as well as the closure of many inefficient SOEs, in the 1980s and 1990s reduced the number of SOEs drastically. This trend of divestitures reversed in the late 1990s, when the Brazilian government resumed SOE creation, and picked up in the 2000s though remaining below the pace seen in the era of state capitalism during the 1960s and 1970s.

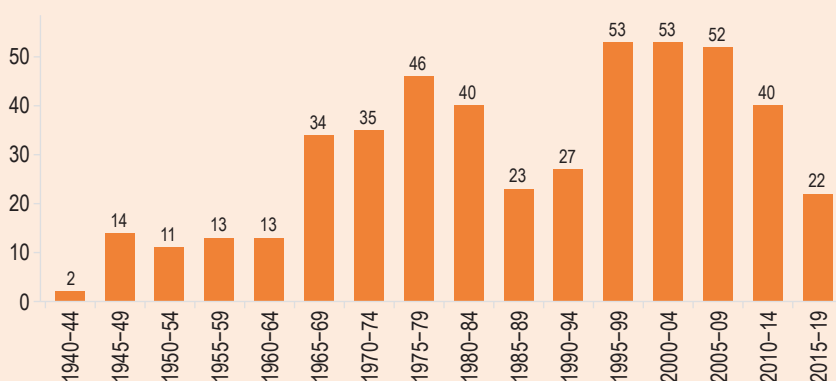
The case of CCB6 nations contrasts with the Brazilian trend. The number of SOEs established per year in the Caribbean peaked twice, once before the 1990s and once after 1995. In fact, SOE creation in the late 1990s exceeds levels observed in the past (see Figure 2.5). In the post-colonial period, the pattern of SOE creation closely follows that of other Latin American nations. Yet, what is striking about the graph is that the largest number of SOE creation happened after 1995 and continued up to the 2010s (with over 50 SOEs appearing in the region every five years). Figure A2.2 in the appendix to this chapter shows that this pattern holds at a country level, and in cases such as Trinidad and Tobago or Suriname the number of SOEs created remains high after 2010.

*(continued on next page)*

**BOX 2.1. SOE CREATION IN THE CCB6 VIS-À-VIS BRAZIL** *(continued)***Figure 2.4. SOEs Established per Quinquennium in Brazil (1940–2016)**

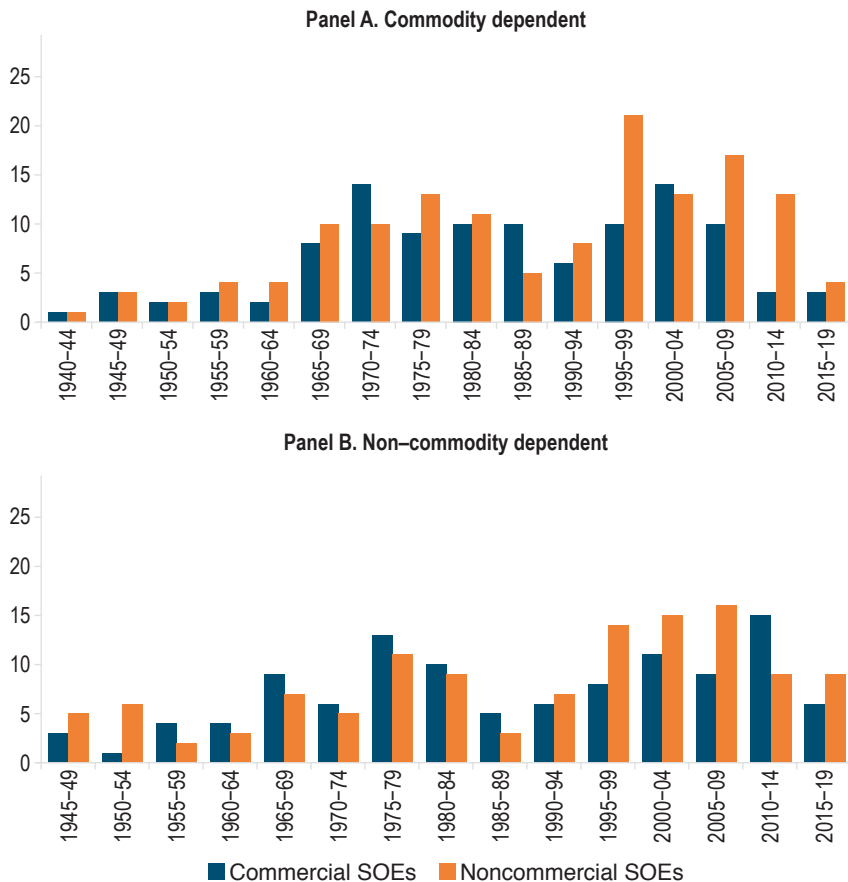
Source: Created with data from Musacchio and Lazzarini (2014) and data after 1980 from the Secretaria do Planejamento (n.d.).

Note: The figures include the subsidiaries of financial and nonfinancial SOEs as well but excludes firms in which the government is a minority shareholder.

**Figure 2.5. SOEs Established per Quinquennium in CCB6 Countries (1940–2019)**

Source: IDB CCB6 State-Owned Enterprises Database.

become a favorite instrument in governments' policymaking toolkits, particularly as a way to create jobs. Take, for instance, the case of Suriname, where employment and business cycles have depended heavily on commodity prices, especially bauxite/aluminum and gold. The Surinamese

**Figure 2.6. Commercial and Noncommercial SOEs Established (five-year periods, 1940–2019)**

Source: IDB CCB6 State-Owned Enterprises Database.

government has established new SOEs (both commercial and noncommercial) closely following the business cycle, and, in turn, commodity price fluctuations.

One salient characteristic of the SOE proliferation is that, since the late 1990s, most of these companies have been noncommercial (see Figure 2.6). That is, they do not produce goods or services but rather provide public services, technical assistance, or act as regulators. A few examples are government health providers, regulatory agencies, tourism boards, and foundations. This pattern is clearer in commodity-exporting nations, in particular Trinidad and Tobago and Suriname. These two countries have been utilizing SOEs as a source of job creation, in an effort to compensate for the decline in commodity export revenues. In fact, as will be discussed in

greater detail later, there is a clear correlation between the decline in current account surpluses and the creation of new SOEs in these countries. As will be discussed in following sections, the expansion of the SOE sector has serious implications for fiscal sustainability.

One problem with this type of company (i.e., the noncommercial SOE) is that they usually have no revenue other than the fees from beneficiary users (e.g., in highway administrations), which are usually not enough to cover their expenses, and instead rely upon government transfers. In other words, the new SOEs created in CCB6 nations have limited to no sources of revenue, yet still add to fixed operating expenses in the government budgets—most requiring continuous budget transfers to survive.

### **(Under)Performance of SOEs**

So far, we have established that the CCB6 countries have too many SOEs—yet the sector continues to grow—and that these SOEs are too large relative to their respective countries' GDPs. The optimal number and size, however, should be evaluated against SOEs' contribution to the domestic economy. Do they generate sufficient revenues or fees to sustain their operations? Do they contribute to increases in labor or TFP? Do their investments contribute to the capital stock of the country in a way that can be conducive to future growth?

#### **SOEs Are Not Productive**

The opening sections of this book discussed the relationship between the recent waves of SOE creation in each CCB6 country, and their correlation with productivity, proxied by gross capital formation and TFP. The evidence suggests that new SOEs have not contributed to TFP growth and, in fact, might even have worsened it. Table A2.1 shows that there is barely any correlation between GFCF over GDP and the number of SOEs established (from 1990 to 2018), confirming that SOEs have not resulted in productive investment either.

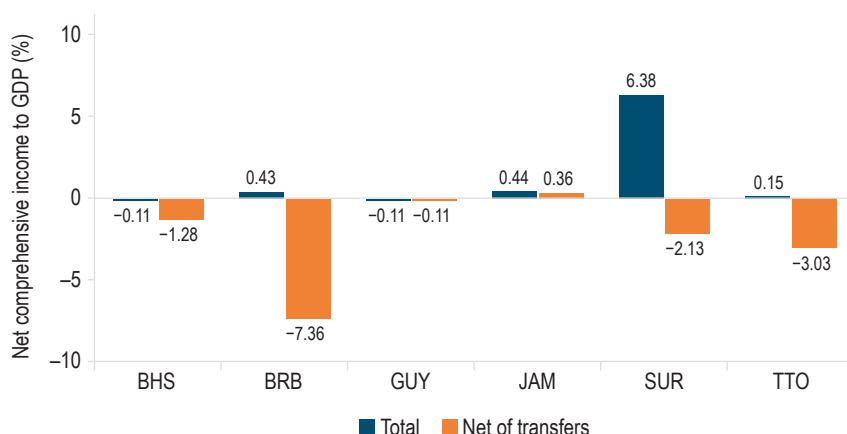
Here the analysis is extended and shows that SOE creation is not correlated to other productivity measures. Figure 2.7 presents trends in unemployment and its relation to SOE creation for each CCB6 country. These graphs show that unemployment in most CCB6 countries has been stagnant over the last two decades, only improving (i.e., declining) in Trinidad and Tobago and, to a lesser extent, in Suriname. Besides these two cases, unemployment figures do not improve as new SOEs are created. This does not infer that SOEs do not have positive employment effects; it just shows that they do not have a strong enough effect to reverse negative unemployment trends. Similarly, Figure A2.3 in the appendix to this chapter does not indicate a correlation between SOE creation and labor productivity gains.

**Figure 2.7. Trends in Unemployment and SOE Creation (CCB6 countries)**

Source: IDB CCB6 State-Owned Enterprises Database; IMF (2020b).

### SOEs Are Not Profitable

SOE creation in the CCB6 has accelerated over the past 20 years, expanding primarily in the noncommercial realm over the past decade. Unfortunately, this expansion does not correlate to strong financial performance within the sector. To the contrary, most SOEs have operated with financial losses. This section looks at two key financial performance indicators for SOEs: income to GDP and debt to total assets using the new dataset on SOE performance in CCB6 nations, the IDB CCB6 State-Owned Enterprises Database.

**Figure 2.8. Net Comprehensive Income to GDP (2010–2017)**

Source: IDB CCB6 State-Owned Enterprises Database; IMF (2018a, 2018b, 2019a, 2019b, 2019c, 2020a).

Note: The amount of government transfers to SOEs as a share of GDP was obtained for every year available and the period average computed; that average was subtracted from the period average of net comprehensive income.

During the period 2010–2017, over a third of the SOEs in the sample experienced net comprehensive losses. Comprehensive income takes into account net income and unrealized gains (or losses). Comprehensive losses peaked in 2015 as 46 percent of the firms registered losses.<sup>3</sup> Figure 2.8 shows the average net comprehensive income to GDP for the period 2010–2017, depicting both total and net of government transfers. Except for Suriname, average comprehensive income is small relative to the size of CCB6 economies, and even negative for the Bahamas and Guyana. In Guyana, the average is dragged down by a single underperforming company. The state mining company, Guyana Gold Board, is the worst performer of the sample with losses of up to 1.6 percent of national income. When government transfers are removed, the picture is even more stark: Guyanese SOEs average losses of up to 7.3 percent of GDP.

In addition, SOE performance exhibits great volatility across time. Comprehensive income in some countries goes from positive one year to negative the following year and then back to positive. The magnitudes of these reversals are also quite large. In the case of Suriname, for example, income goes from 5.4 percent of GDP in 2014 to –0.23 percent in 2015 then to 2 percent in 2017—more stable SOE sectors in the Western Hemisphere have overall income between +0.5 and –0.5 as a percent of GDP. The problem with

<sup>3</sup> While the sample is incomplete, there are no reasons to suspect that it is biased in any way towards the worst-performing firms. In fact, one would expect that financial statements are available for the most transparent and/or best-performing ones.

volatility is that it generates uncertainty, which leads to a misallocation of federal funds, as the possibility of a bailout is always present (even with gains). Income variation is higher in the SOE sector of commodity-driven economies as their public companies are more concentrated in volatile industries.

The primary contributing factor to low income levels in SOEs is high fixed costs, mostly in the form of bloated payrolls. SOE wages can be influenced by government policy, for example, if the government approves an increase in public sector salaries. This payroll burden is exacerbated by the fact that SOEs in the Caribbean are usually overstaffed. Just one example: in 2017, the annual payroll for Petrotrin, Trinidad and Tobago's state oil refinery, constituted nearly half of the organization's operating expenses. While during boom times the SOE may be able to cover these expenses from its own revenues, and if not, then the government may be able to afford these

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#### **BOX 2.2. SOE EMPLOYMENT IN EXTRACTIVE INDUSTRIES: THE CASE OF PETROTRIN**

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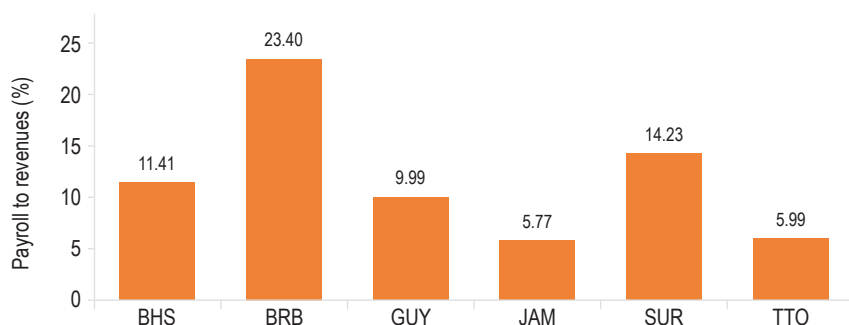
Trinidad Petroleum (formerly known as Petrotrin) is one of the two wholly owned public companies in the oil and gas industry in Trinidad and Tobago, accounting for 50 percent of the country's total oil production (around 82,000 barrels per day). Petrotrin was established in 1993 and operated in exploration, development, and extraction of oil until 2018. The refinery shut down after years of substantial losses and debt accumulation.

In 2017, Petrotrin had almost 5,000 workers that made up for 50 percent of its operational expenses: an annual wage bill of US\$1.9 billion. Since 2013, the company had been involved in wage negotiations with the Oilfields Workers' Trade Union (OWTU). The union demanded salary increases that were unattainable for the company given its poor financial standing, especially in a context of declining oil prices. After multiple negotiation rounds and strikes, a collective agreement of a 5 percent increase was reached, subject to productivity improvements. As part of the benefit packages, employees were provided with medical services and a generous retirement package, formally established in the Petrotrin Pension Act of 2010. Unable to support its cost structure, Petrotrin was compelled to cut dividends.

With the closure of the refinery in 2018 all employees were terminated and compensated by the government, which also continues to support their pension plan. Additionally, lands have been granted to former employees as part of termination benefits through Petrotrin's land distribution program. In 2019, the refinery was sold to the union workers for a US\$700m purchase price with a deferred payment agreement—three years' moratorium on the purchase price plus interest and up to 10 years to pay—and has been broken down into four new companies.

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*Source:* Cameron and Stanley (2017).

**Figure 2.9. Payroll to Revenues (2010–2017)**

Source: IDB CCB6 State-Owned Enterprises Database.

Note: The ratio of payroll to revenues is computed for each public company and then averaged over the period 2010–2017 for each country.

expenses, during recessions these expenses are fixed costs that then must be covered by fiscal transfers from the government.

According to official sources (Office of the Prime Minister of Trinidad and Tobago, 2017), the payroll ratios for CCB6 nations are high even for the case of SOEs in the oil and gas sector—which tend to be sectors with more inflated payrolls in oil-exporting countries. An audit revealed that Petrotrin was employing 30 percent more workers than the average Latin American refinery. Outrageous in its own right, this figure is even more worrisome given that refineries in the benchmark countries were also most likely overstaffed. Figure 2.9 shows the average ratio of payroll to operating revenues by country over the period 2010–2017. Payroll expenses are a substantial share of revenues, especially in Barbados and Suriname.

It is worth noting that high variance is evident even within subsectors of countries. For example, in the same year, the payroll of Barbados National Petroleum Corporation (NPC) was 37.5 percent of expenses, while the payroll of Barbados National Oil Company Limited (BNOCL) was only 1 percent of expenses. High ratios of payroll to operating revenues in SOEs should be of concern, as they increase the fiscal risk to governments. They are a sign of inefficiency in firms, indicative of failures to optimize properly and potential exposure to losses. In such an instance, losses are often recurrent, and result in a constant need for cash transfers from the government to cover the SOE's payroll expenses.<sup>4</sup> Very high payrolls may also reflect political use of the SOEs, such as creating jobs for social or political purposes.

It should be noted that SOE payroll expenses in CCB6 economies are a fixed cost to governments (see Figure 2.9). SOE creation increases during

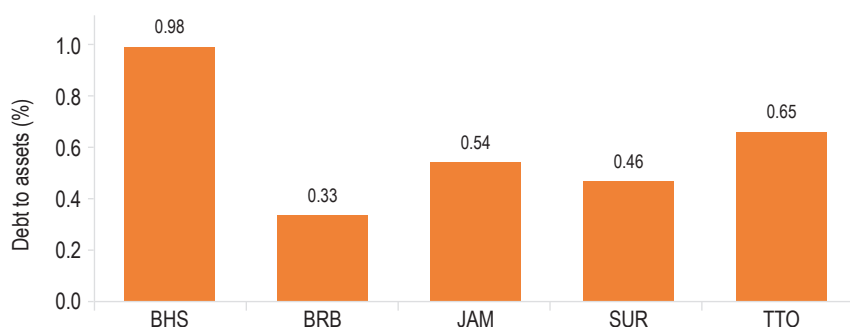
<sup>4</sup> See Musacchio and Pineda Ayerbe (2019).



good times (as explained later), which means that labor costs rise when there is liquidity. However, Lazzarini and Musacchio (2018) show that SOEs neither close down nor shrink during downturns, as governments provide them with cash injections to cover the losses. The exception is when a country enters a restructuring program. Barbados significantly cut employment in overstaffed SOEs, including its Transport Board, as part of the IMF-approved Barbados Economic Recovery Transformation (BERT) program. Similarly, Guyana's GuySuCo, the Bahamas' Bahamasair, and Jamaica's Jamaica Urban Transit Company (JUTC) had to dramatically reduce their overstaffing to facilitate restructuring. However, layoffs in SOEs are not common during downturns (Lazzarini and Musacchio, 2018). This is clear in the aggregate results of SOEs presented in this book's Introduction, which showed significant losses sustained during downturns, particularly for commodity-exporting CCB6 countries. This means that any increases in payroll-to-revenue ratios are rather permanent. During recessions, these expenses become a quasi-fiscal operation and add significant fiscal pressure (and risk) to the governments in the region.

Another way of assessing the health of SOEs is to look at their total debt (current and long-term liabilities), specifically the debt-to-assets ratio. We use this over other measures of financial leverage, such as assets to equity—the leverage ratio—or debt to equity because many SOEs have been undercapitalized for years and therefore exhibit negative equity, which distorts these particular ratios. The total debt-to-assets ratio showcases the firm's long-term financial position and the ability to meet all its financial requirements. Figure 2.10 shows the CCB6 average total debt-to-assets ratio for the period 2010–2017, for the five countries with data availability. The ratios are high for all countries, Barbados being the only one with total debt below 50 percent

**Figure 2.10. Total Debt to Total Assets by Country (2010–2017)**



Source: IDB CCB6 State-Owned Enterprises Database.

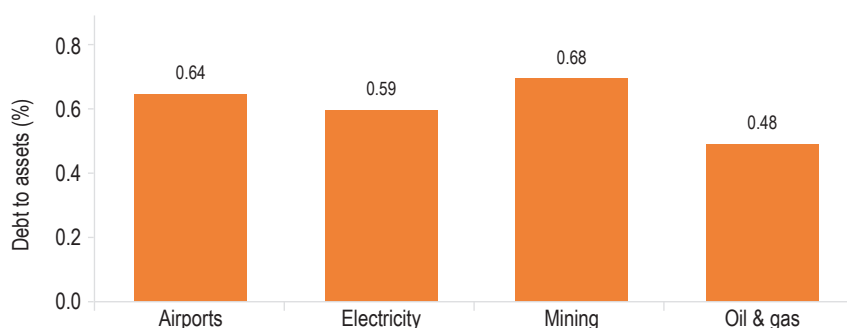
Note: Total debt is calculated as long-term debts plus current liabilities, averaged for each country over the period 2010–2017. There were many companies with negative net worth in the Bahamas; for this graph it is assumed that those have zero equity.

of total assets. In summary, SOEs in the CCB6 economies are highly leveraged and thus have more exposure to financial risk.

The cases of Suriname and the Bahamas are particularly worrisome, given 80 percent and 100 percent of their assets, respectively, are financed with debt. Perhaps more telling is their evolution over time: these ratios have remained consistent since 2010, implying that the growth of these companies is still very much dependent on debt. Given that most of the SOE debt in the CCB6 countries is implicitly, if not explicitly in all cases, guaranteed by their respective governments, highly leveraged SOEs increase the public sector's overall debt profile. SOE contingent liabilities in the Bahamas are currently around 9 percent of total government debt (down from 11 percent in 2015), with over 50 percent corresponding to just two companies.<sup>5</sup> In Barbados, even after reducing the amount of debt guaranteed by the central government, SOE debt still accounted for 10 percent of the overall debt in 2017.

The composition of debt varies across countries. For the Bahamas and Barbados, most of their total debt is long-term (93 percent and 68 percent, respectively). Thus, there is a high risk of bankruptcy if cash flows decline. For Jamaica and Suriname, total debt is half current and half long-term liabilities. For Trinidad and Tobago, total debt is mostly current liabilities. The sectoral breakdown of total debt to total assets, shown in Figure 2.11, reveals that mining has the highest ratio (around 0.7). Interestingly, the ratio is the lowest for oil and gas, the most capital-intensive sector. It is most likely that during the oil price boom these companies used the increased margins to pay off their debts. In addition, the lower ratios might be a result of counting reserves as assets. Finally, in terms of the ratio of debt to GDP, it is the highest in Suriname and the lowest in Trinidad and Tobago.

**Figure 2.11. Total Debt to Total Assets by Sector (2010–2017)**



Source: IDB CCB6 State-Owned Enterprises Database.

<sup>5</sup> The Bahamas Telecommunication Corporation and Bahamas Mortgage Corporation.

## Explaining the Dependency on SOEs

This chapter has demonstrated that there is a concerning high number of SOEs in CCB6, and that these firms are too large, not financially viable, and dependent on government transfers, and that they fail to contribute to economic gains. Yet SOEs exist in every country in the world. Why? Meant to create public value by addressing market failures, SOEs are commonly natural monopolies and/or operate in infant industries. In many countries, they provide essential resources like water or electricity, which may be difficult or unprofitable for the private sector to provide. Due to the lack of competition, however, SOE performance tends to be weaker than that of private companies (Estrin and Pelletier, 2018; Megginson and Netter, 2001). Musacchio and Pineda Ayerbe (2019) use matching techniques to compare SOEs in LAC to a set of similar private counterparts and find that the former are less solvent and more leveraged, and have lower returns, than the comparable private firms.

While there appear to be substantial reasons to halt the creation of SOEs in Latin America, these arguments have not been applied in the case of CCB6 nations. This is because SOE creation in CCB6 economies depends on both (political) incentives and (financial) feasibility. We argue that the incentives stem from the political economy of the region and that the current account cycles determine the budget constraints. In other words, there are political motives behind the creation of additional SOEs, but those are only realized during economic booms. This means that SOE creation is yet another element of the Caribbean procyclical spending pattern and adds to the already large fiscal burden described in previous chapters.

Regarding the political incentives, CCB6 governments have historically used SOEs as vehicles for public policy. While SOEs depend on their respective central governments as their main lender and financier, the central governments use the enterprises to perform quasi-fiscal operations. SOEs' dependence on regular fiscal transfers grants governments *de facto* dominion over the resources and governance of these companies. Given that it is very hard to identify when SOEs are deviating from their normal operations to perform quasi-fiscal activities, governments have strong incentives to control these companies.

Governments in LAC have historically instructed SOEs to subsidize prices, mostly for political or social purposes, by pricing fuel, electricity, or water below market rates (and occasionally below costs). In fact, it should not come as a surprise that the largest SOEs in the Caribbean are energy related. These quasi-fiscal operations are usually not included in the financial reports and are thus considered "hidden expenditures."

Until its closure in December 2018, Petrotrin was required to sell liquefied petroleum gas (LPG) cylinders for much less than the international price. In Guyana, the government has for years subsidized Guyana Power and Light (GPL) and other power suppliers in order to keep tariffs low. The Surinamese people also

receive electricity at subsidized rates as Staatsolie delivers fuel to EnergieBedrijven Suriname (EBS) to generate power at a rate below the cost of production. The government of the Bahamas has also acknowledged that there has been no increase in the rate at the Water and Sewage Corporation (WSC) since 1999, and as a consequence the WSC is very reliant on government subventions.

Governments also use SOEs to provide employment, either to strategic actors like members of powerful unions (like the case of oil refineries in Mexico) or more widely as a social policy. The case of Suriname is a perfect illustration of the latter. The government redistributes the natural resource revenues through public spending, half of which corresponds to wages. The central government is the main employer in the economy, as it provides over 60 percent of formal jobs. A third of those are accounted for by more than 140 SOEs (most of which are noncommercial). As a result, the government operates in all sectors of the economy and has crowded out the private sector, which remains underdeveloped and dominated by small (usually family-owned) firms that sell nontradable services.

As explained in Box 2.3, SOE creation in the CCB6 economies corresponds to procyclical spending behavior. During economic booms, such as

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### BOX 2.3. DETERMINANTS OF SOE CREATION IN CCB6 COUNTRIES

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While SOEs serve political and social purposes, SOE creation in CCB6 countries is strongly tied to procyclical spending. Below we estimate the effects of political cycles and external sector fluctuations on the number of SOEs established per year. The panel consists of yearly data for each of the CCB6 countries—the Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago—between 1982 and 2018. The estimating equation is:

$$y_{ct} = f(X_{ct} \beta, c, t) + \varepsilon_{ct},$$

where  $y$  is a dummy indicating SOE creation in a specific country  $c$  and year  $t$ , the  $X$  matrix includes lagged values (for one and two years) of a dummy variable for general elections in each country as a proxy of the political cycle, and the contemporaneous and lagged variations of the current account balance—as a percent of GDP—as a proxy of the external sector. In addition, we control the model with the contemporaneous and lagged values of the real growth rate of the GDP.

Table 2.2 shows the results of the generalized Poisson regression model estimated by maximum likelihood (ML).<sup>a</sup> We find that the Caribbean governments introduce more SOEs when they have current account surpluses (both contemporaneous and in the recent past) and tend to open fewer SOEs when their exports of commodities or services are not doing well. When we split the sample

(continued on next page)

**BOX 2.3. DETERMINANTS OF SOE CREATION IN CCB6 COUNTRIES** *(continued)*

between commodity exporters and non-commodity exporters, we see that the result holds only for the former. That is, in this exercise we uncover that fluctuations in the current account balance explain the pattern of SOE creation for commodity-exporting countries only. This finding is consistent with the idea that commodity-driven economies increase fixed expenditures during good times, increasing fiscal stress in down cycles. In other words, SOE creation follows the current account cycles. Note also that general elections and real GDP growth are not statistically significant after controlling for the current account fluctuations. In the appendix to this chapter we present a robustness check using a negative binomial model (see Table A2.2).

**Table 2.2. Generalized Poisson Regression of the Number of State-Owned Companies Established by CCB6 Countries per Year (with country and time fixed effects, 1982–2018)**

VARIABLES / Incidence ratios	CCB6 Countries	CCB6 Commodity-Dependent Countries	CCB6 Non-Commodity-Dependent Countries
General elections (t-1)	0.909 [0.174]	0.733 [0.214]	1.318 [0.322]
General elections (t-2)	1.249 [0.224]	1.115 [0.253]	
D.Current account balance to GDP (t)	1.026* [0.014]	1.045** [0.018]	0.977 [0.032]
D.Current account balance to GDP (t-1)	1.038*** [0.014]	1.055*** [0.016]	1.032 [0.032]
Real GDP growth (t)	0.992 [0.021]	0.974 [0.026]	0.997 [0.043]
Real GDP growth (t-1)	0.986 [0.021]	0.964 [0.026]	0.993 [0.042]
Constant	0.0917 [0.098]	0.394 [0.296]	0.025*** [0.566]
N	222	111	111
Deviance	305.9	112.3	83
Pearson	286.1	95.31	76.94
Deviance (p)	4.62e-09	0.000333	0.0898
Pearson (p)	2.98e-07	0.0106	0.190

Note: Robust standard errors in brackets, \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

<sup>a</sup> ML estimation is used to avoid two common problems of using ordinary least squares when the dependent variable is a count outcome. First, the presence of many zero-values would prevent the log transformation into a normal distribution. Second, the regression model probably would predict some negative values of the dependent variable, which are theoretically impossible. The Poisson regression model assumes that the errors follow a Poisson distribution, which is skewed, rather than a normal distribution.

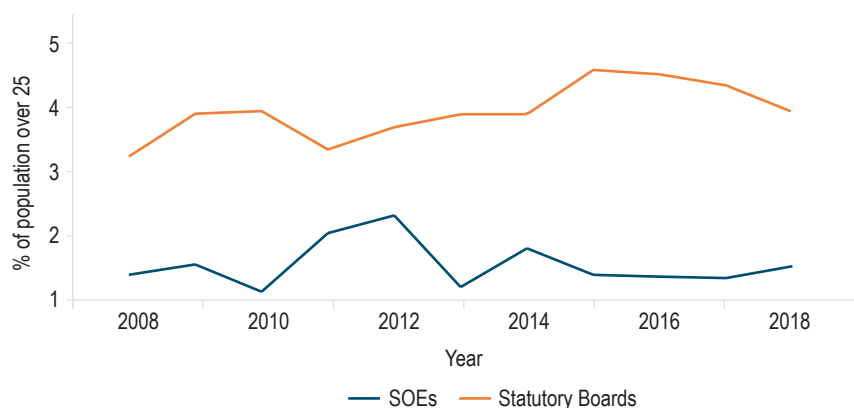
years of high commodity prices, governments spend more and create more SOEs. However, as described further in the next section, the full price will be paid only in future years.

## Fiscal Risk and the Consequences of SOE Creation

This chapter has shown that SOEs are not productive and have very high fixed costs, and thus lose money and end up relying on government transfers to survive. Maintaining inefficient public companies constitutes a waste of national resources, and SOE underperformance, especially on a recurring basis and in large companies, is dangerous as it constitutes a major source of fiscal risk. In particular, negative shocks (even small ones) will leave these companies exposed and in need of a bailout. The larger the SOE, the larger the *bailout risk* for the government, and also the harder to actually implement such a bailout. As a consequence, these companies end up being “too big to fail” and also “too big to be bailed out.” Commodity-driven economies are more vulnerable to external shocks that affect SOEs directly (through movements in international commodity prices) and are thus more exposed to bailout risk. They also have larger SOEs, raising the bailout costs, and they often provide basic services to firms and society (like electricity) so denying a bailout would be too costly politically for governments.

Furthermore, the quasi-fiscal operations conducted by public companies, primarily in the form of subsidies, magnify their financial losses and disrupt incentives for efficient operations (as losses seem inevitable). As a result, SOEs create *cash-flow risk* to governments by spending beyond their budget constraint. They request capital injections from the government to cover their losses, avoid default, or complete an important project. The risk stems from the uncertainty (in timing and amount) of these funding requests, which makes budgeting very hard for governments. For instance, in the case of the public oil companies that provide subsidies, the losses and subsequent government transfers are subject to current oil prices (which have shown to be quite volatile).

It is important to stress that governments inject funds in most public companies, not just those that subsidize basic services. SOEs can start new large projects at their discretion, with very limited (or no) accountability, use resources from other government agencies, and in some countries even issue debt freely. In addition, since SOEs operate in key economic sectors that provide essential inputs, governments find it too politically costly to deny the funds. As a result, these companies end up taking on too much risk and mismanaging their resources. Operating on tight margins or at a loss, which is frequent in CCB6 SOEs, increases the cash-flow risk considerably since the companies will require constant fiscal transfers in order to operate.

**Figure 2.12. Government Transfers in Trinidad and Tobago**

Source: IDB CCB6 State-Owned Enterprises Database.

While government transfers are meant to support SOE operations, they distort incentives and create a large fiscal burden that accumulates over time. Figure 2.12 shows government transfers in Trinidad and Tobago. Between 2008 and 2018, transfers to SOEs averaged 1.6 percent of GDP, while transfers to statutory boards averaged about 4 percent of GDP. Combined, for any given year, transfers have oscillated between 5 and 6 percent of GDP. While the figures are less dramatic for some countries than others, some SOEs depend entirely on government funds including Barbados' International Business Promotion Corporation (Invest Barbados) and Transport Authority, Guyana Power and Light, GuySuCo, and Jamaica Urban Transit Company (JUTC), among many others.

To sum up, government involvement in SOEs is very problematic. Instead of maximizing revenues, these firms have a set of objective functions driven by political interests. This also produces governance issues, including corruption practices (like bribery) and politically appointed managers and directors that are not suited for their positions.<sup>6</sup> Many of these abuses have taken place in public contracting and privatization processes. As a result, they deviate from the optimal allocation of resources and compromise long-term growth. Changes in state enterprise appointments that stem from a change in political regime also limit the long-term sustainability of these organizations due to disruptions in future planning.

<sup>6</sup> There is vast anecdotal evidence of cases of mismanagement of SOEs in LAC, like the Petrobras corruption scandal in Brazil (Operation Car Wash), or the downgrading of Pemex in Mexico due to excessive debt.

## Conclusion

This chapter has examined the SOEs in the CCB6 economies and their value add. SOEs are numerous, rarely productive, frequently loss-making, highly leveraged, and dependent on transfers from their respective governments. The latter use these companies for political purposes, and as has been shown, tend to create SOEs following current account cycles. When there is excess capital in the region, it is spent poorly. But when the region is experiencing a downturn, the real consequences of sustaining large, inefficient public companies becomes evident, both in terms of small fiscal risks year-on-year and large bailout risks over time.

Part of the problems described here could be eliminated if the fiscal governance of SOEs were addressed, making it harder for them to request fiscal transfers, while also constraining the government's capacity to use SOEs for quasi-fiscal operations. Such changes would require a major overhaul of the legal regime for SOEs, of the corporate governance of these firms, and of the monitoring agencies. Section II of this book will examine these solutions in depth, from the historical evolution to current practices, and provide benchmarks in the legal regime, corporate governance, and monitoring agencies.



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## **SECTION II**

# **The Origins of SOEs and Their Problems**



## CHAPTER 3

# The Evolution of the Role of SOEs in the Caribbean: The Cases of Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago

### Introduction

Section I of this volume looked into the macroeconomic context of the CCB6 economies, stressing the economic effects of the COVID-19 shock, and the financial performance of state-owned enterprises (SOEs). It argued that these aspects, together, intensify the fiscal problems of these countries. Moreover, it portrayed these small open economies, highly dependent on either tourism or commodities, as being highly vulnerable to climate and external economic shocks, while having little to no fiscal room to face them. It also portrayed them as having a history of high debt levels, low economic growth, and procyclical fiscal spending. There is also evidence that in CCB6 countries the creation of new SOEs happens during good times and most likely is related to the need to create employment.

This chapter aims to weave a historical narrative of the origins of these problems in CCB6 nations. The chapter argues that fiscal imbalances and the underperformance of SOEs are not a product of the colonial institutions or the identity of their colonizer, but a consequence of the post-colonial catching up these countries have had to do on public goods, especially education and health care. This focus on social needs stands in contrast with the focus on infrastructure expenditures that

benefited local elites during colonial times. Moreover, given the democratic nature of the institutions of these countries in the post-independence period, for most of their post-colonial period governments have used fiscal policy to create employment, to a large extent via SOEs and government jobs.

The chapter examines the evolution of SOEs and fiscal policy over five periods: the period before independence, the period immediately following independence, the crises of the 1980s, the rationalization of the state-owned sector of the 1990s, and the reversal of the 2000s. Case study examples from the CCB6 countries—the Bahamas (BHS), Barbados (BRB), Jamaica (JAM), Guyana (GUY), Suriname (SUR), and Trinidad and Tobago (TTO)—are included throughout.

The conclusion is that during times of high demand for services in the tourism-based CCB6 economies or during times of high demand for commodities in the exporting CCB6 economies (as in the 1970s), expenditures and SOE creations have been procyclical. This has ultimately led to a high level of fixed expenditures, which coupled with the inefficiency of SOEs has led to severe fiscal imbalances, in the 1980s and continuing to this day.

During times of crisis or significant external shocks (such as in the 1980s), the system ground to a halt and structural reforms were desperately needed. A privatization drive and structural reform effort followed in the 1990s. Yet, the dependency of CCB6 governments on fiscal expenditures and SOEs to create jobs, and the trends observed in the 1970s and 1980s, repeated in the 2000s, first with a cycle of current account surpluses and then with a decline in tourism and commodity prices. Puzzlingly, SOE creation accelerated in the 2010s in CCB6 nations, despite the persistent fiscal and current account deficits. If the history of the CCB6 can serve as a guide, the facts and structural issues described in this chapter should serve as a warning to governments that a major crisis is on the horizon and restructuring of the current model of development may be urgently needed.

## Colonial Origins versus Post-Colonial SOE Creation

There is a temptation in the Caribbean countries to excuse their fiscal troubles as resulting from the way they were colonized, the institutions that were introduced during colonial times, and the long-lasting consequences of colonization in the region. For instance, some explanations focus on the difference between British sugar colonies and other British non-sugar colonies (Dippel and Khadan, 2018). Others have focused on differences in the political institutions within the British Caribbean over the long run, for instance comparing Barbados with its long, uninterrupted tradition of parliamentary practices to Guyana, which was colonized by the Dutch and the British, was geographically fragmented until 1831, and had a more violent independence movement. Yet, despite some of the differences across these countries, the

long-run fiscal profiles and the abuse of SOEs for employment purposes remain similar across the former British colonies and even in former Dutch colonies (i.e., Suriname). That is, fiscal deficits, large debt burdens, and a high number of SOEs per capita are common features of CCB6 countries, regardless of their colonial institutions.

A large body of research originating at the University of the West Indies divided the evolution of public expenditures in the former British colonies into roughly three periods: the traditional, the transitional, and the post-colonial periods. This characterization is developed by Odle (1975), but also developed in detail for Jamaica, Barbados, and Trinidad and Tobago by Howard (1992). In the traditional period (mostly before 1960), the tax system and the allocation of public expenditures was mostly destined to aid the operations of the colonial plantations. A large portion of the budget was allocated to pay for infrastructure, such as roads, ports, and harbors, which mostly benefited plantations and their owners. In contrast, expenditures on public goods that would benefit the majority of the population, such as education or health care, were extremely low. In the 1930s, the plantation export system became less attractive for the British after the United States introduced quotas and reduced its imports from the British Caribbean colonies. After the Colonial Development and Welfare Acts of 1940 and 1945, the public good expenditures increased but were still relatively low (Howard, 1992).

The transitional period took place between the 1950s and independence (1969–1976). During this period there was an increase in self-governance, with governments in the region promoting industrialization using tax incentives while also reducing their reliance on plantation agriculture. In this period, expenditures on public goods for citizens and infrastructure to support national enterprises increased. For instance, in Barbados expenditures on education increased more rapidly during this period, and the government paid for a major port, water works, and road projects that would benefit a broader part of the population. All over the Caribbean, statutory corporations began to be established in larger numbers, “including development boards and marketing and financial corporations” (Howard, 1992, 41). This began to change the fiscal profile of these countries, increasing public expenditures.

The post-colonial period began with the independence of Guyana and Barbados in 1966 and was characterized by rapid increases in government expenditures. Independence had two effects. On the one hand, nationhood required more expenditures to pay for new ministries and to increase the defense budget (i.e., to pay for the administrative responsibilities that were previously paid out of colonial transfers). On the other hand, independence also forced governments to spend on public goods that were neglected during the colonial time, especially secondary and tertiary education and health. To pay for all of these new expenses, governments in the Caribbean changed



the structure of taxation, replacing import duties as the main source of revenue with income taxes (Howard, 1992). Furthermore, in most of the countries the new states created a large number of commercial SOEs as they nationalized foreign firms or aimed to replace multinationals.

Table 3.1 provides a generalized overview of the CCB6 economies in the immediate decades following independence. The average growth rate for the 1960s was 5.6 percent and the average number of SOEs formed was eight. In the 1970s, the average growth in these Caribbean countries continued to be buoyant and an increase is visible in the number of new SOEs formed (from 8 to 13). However, in the 1980s when average economic growth in the CCB6 countries fell, so too did the number of new SOEs formed. The exception was in Suriname, where the number of SOEs established increased by 17 (a large increase given the low numbers until then). In the 1990s, economic growth in the CCB6 improved, and alongside it the average number of SOEs formed. In the 2000–2009 and 2010–2019 periods, a similar pattern is observed.

There are two important facts that come out of the data in Table 3.1. First, the number of SOEs increases rapidly *after* independence. That is, the overreliance on SOEs is not a colonial phenomenon, but a post-colonial development linked to both nationalization of foreign companies and the subsequent formation of new SOEs, as mentioned earlier in this book. Second, the increase in SOE creations has not been accompanied by improvements in real GDP growth or any productivity indicator, as discussed in Chapter 2.

**Table 3.1. Average Annual Growth and Number of SOEs Formed in CCB6 Economies**

	BHS	BRB	GUY	JAM	SUR	TTO	Average growth
1960s	9.85	2.1	3.66	4.38	8.47	4.97	5.6
1970s	2.31	3.77	1.67	1.22	3.24	4.64	2.8
1980s	4.04	1.76	-2.8	1.73	-0.34	-1.4	0.5
1990s	1.64	0.47	4.7	2.16	0.29	5.22	2.4
2000s	1	1.41	1.87	0.93	4.65	6.46	2.7
2010s	0.75	-0.02	4.08	0.68	1.15	-0.14	1.1
<b>Number of SOEs Formed</b>							
1960s	1	6	4	17	11	8	7.8
1970s	8	9	14	29	10	9	13.2
1980s	3	6	5	27	17	5	10.5
1990s	4	17	13	24	11	11	13.3
2000s	8	9	12	38	17	22	17.7
2010s	5	6	8	11	8	17	9.2

Source: IDB CCB6 State-Owned Enterprises Database.

That is, SOEs were initially intended as part of national development plans but failed to be engines of growth and turned instead into vehicles of patronage that created employment in the CCB6 by taking advantage of resources obtained from the export of commodities or from tax revenues from the tourism industry.

This chapter explains the evolution of this quasi-rentier system in the Caribbean. More specifically, it will look at how economies dependent on exports of goods (commodities in Guyana, Suriname, and Trinidad and Tobago) or services (tourism in the Bahamas, Barbados, and Jamaica and financial services in the Bahamas) have used the rents obtained from those industries to create new SOEs, for the purposes of increasing employment for nationals, on an almost continuous basis between the 1970s and the 2010s.

### SOEs after Independence

In the period following World War II (particularly in the late 1940s and 1950s), the population of the British Caribbean colonies became increasingly agitated due to economic imbalances and inequities in the ownership and distribution of resources. Governors in the colonies were appointed by the Crown, and locals could only vote if they met property qualifications (i.e., if they were land or property owners). Administrative guidance of the colonies came through the Colonial Office. Economic activity in the colonies was guided by the hand of the “mother country,” and all major decisions were made in London and executed by British administrators and local white elites stationed at the Colonial Office (Knight, 1997). During the 1950s, the role of the state, represented by the Colonial Office, was to provide economic infrastructure, but in practice was limited to oversight as the owners of the main industries, including utilities and other production facilities, in the region were foreigners. In many regards, the economic well-being of the colonies was exogenously determined, as decisions regarding the allocation and employment of resources were determined outside of the country. Moreover, after 1945, the British Ministry of Colonial Affairs tried to create a West Indian Federation, membership in which was a precondition for colonies in the Caribbean—including Belize and Guyana—to join the Commonwealth. The Federation was eventually created in 1958, without Belize or Guyana, only to fail a couple of years later.

After the failure to keep a unified West Indies as part of the Commonwealth, independence movements became more prominent. Since the end of World War II, the colonies of the Caribbean increasingly raised their concerns about poverty levels and the distribution of income and clamored for their independence. With the emergence of the nationalist consciousness, the agitation for independence became more aggressive over time. In the end, they forced Britain to consider divesting of its interests in the region

as the colonies were becoming an economic drain on UK coffers, already indebted due to post-war recovery efforts. Independence was granted to British colonies in the 1960s and 1970s, starting with Jamaica on August 6, 1962. The remaining Caribbean colonies received “associated state” status, which gave them military protection and access to British aid, in exchange for a degree of subordination to the Crown.

The Dutch government granted a similar level of autonomy to Suriname in 1954. After World War II, a series of Round Table Conferences led the Kingdom of the Netherlands to declare (in 1954) that “it consisted of three equal partners, namely the Netherlands, Suriname, and the Netherlands Antilles” (Meel, 1990, 76). This allowed the government of Suriname to attend to its own affairs, while still sharing some governmental responsibilities with the Netherlands, particularly foreign relations, defense, legal matters, and the protection of human rights and liberties. Suriname became independent from the Kingdom of the Netherlands in 1975.

Around this time, a regional ideological movement also emerged. Initially, there was appreciation for the work done by Sir Arthur Lewis, who recommended that the economies of the Caribbean follow after the example of Puerto Rico in industrializing by inviting large foreign firms with capital and established markets to set up operations within the region. Lewis noted that “It is hardly possible for the islands to break into the market in competition with existing suppliers. Breaking into a market involves great expenditure on sales promotion to establish new trade channels, and this will hardly be worthwhile for the limited amount of trade that the islands would do. The moral of this is that what should rather be done is to try to persuade existing suppliers, with established distribution channels.... to open factories in the islands to supply their trade” (1950, 31).

Lewis’s strategy recommendations were implemented but with limited success, prompting the rise in popularity of another group of economists, including Lloyd Best, who promoted “taking over the commanding heights of the economy” (Best, 1971a, 7). Specifically, Best stated that it was necessary “to create a framework within which the Caribbean economy would be able to make effective decisions about development. In terms of action, this means a transformation of the character of the corporations and a drastic revision of the terms of their participation” (Best, 1971b, 33).

As the region became independent of the metropole, the various colonial administrative and regulatory entities were transformed into domestic organizations controlled and operated by nationals. In Jamaica, for example, the Urban Development Corporation (UDC) was formed in 1958 with the express responsibility to lend administrative support to the Town and Country Planning Department (TCPD). The government at that time believed that a collaborative approach among the TCPD, the UDC, and the private sector could spark development.

In the case of Jamaica, SOEs were distinct from other public bodies, and as such it was necessary to enact legislation to establish each SOE. The various government ministries, departments, and agencies in the country established SOEs to assist in the execution of specific governmental mandates and objectives. That is, from the beginning, SOEs played an important role in either the nationalization of industry or in the creation of new organizations to promote development within a specific sector.

In the former British colonies, the 1970s can be regarded as the era of local developmentalism as several of the newly independent countries sought to take over the leading industries of their various economies in an effort to direct the economic development process locally. This rise in nationalization was at least partially linked to the increasing prominence of economists such as Lloyd Best. In the case of Guyana, during the late 1950s and into the 1960s, the local elites and the government administration, which supported foreign ownership, began to change their stance on foreign investment and began to implement a more nationalistic development agenda. The bureaucracy not only expanded, but it also took over sectors as part of the “commanding heights” approach (Best, 1971a). A commingling of the local public administration with private investors resulted in new profitable economic groups in the country. The growing size of the local bureaucracy, however, was not associated with an improvement in the efficiency of public sector operations.

An important instrument to transfer control of “the commanding heights” to the locals was the nationalization of multinational enterprise assets. This nationalization wave was part of a larger wave of nationalization taking place in developing nations around the globe. In Africa, Asia, and most of Latin America, the 1970s saw a major wave of nationalization of former colonial or multinational enterprises as a way to ascertain independence and as a form of autarkic development. In this type of nationalist development, referred to as developmentalism or import-substitution industrialization, politicians saw SOEs as possible solutions to market failures and as an important tool to deal with natural monopolies (Kobrin, 1984).

Caribbean former colonies and developing countries were not alone in pursuing that economic agenda. Toninelli (2000) noted that in Western Europe the main waves of nationalization occurred in France, Austria, Great Britain, and the Netherlands with the intention of achieving industrial democracy. Further, while privatization was widespread in Latin America in the period immediately after World War II, significant nationalization and hence an expansion of the public sector took place in the 1960s and 1970s.

The overarching thinking in the Caribbean at this time was that the state should take responsibility for allocating resources and distributing wealth equitably—taking control of the “commanding heights” was perceived to aid in this process. The thrust in the Caribbean may have been influenced by similar

efforts occurring in the rest of the world. According to Howard, “the British nationalization precedent gave impetus to the few Caribbean nationalizations during the colonial post-war period, as well as to the establishment of state-owned corporations and enterprises” (1992, 56). Barbados nationalized the gas industry prior to independence, yet most nationalizations took place after independence was granted (e.g., in Trinidad and Tobago and Guyana). Indeed, Norman Girvan explicitly argued that nationalizations in Chile, Cuba, Egypt, Mexico, and Zambia should provide guidance for the Caribbean (Howard, 1992).

In the case of the islands of the Bahamas, a new constitution was proposed in 1963 at a conference in London, where it was agreed that the colony should transition to full internal self-governance, retaining the post of the governor only for specific foreign affairs, defense, and security matters. The new constitution came into force officially in 1964, with complete self-governance achieved in 1969. This transition to self-governance included strict government ownership of business enterprises, particularly regarding public utilities, and the replacement of foreign staff by locals. This thrust continued through the decade and beyond, even after independence was achieved in 1973.

In 1970, Guyana established its political ideology of “cooperative socialism,”<sup>1</sup> which promoted larger government participation in the economy and a more active role for the public sector as the engine of growth. Thus, the government of Guyana moved vigorously to take control of the economy. Prime Minister Burnham proclaimed that the country would continue to welcome foreign investors but that the government would own at least 51 percent of any enterprise operating in Guyana (Merrill, 1992). Major foreign companies resisted the idea of shared ownership, which resulted in the government taking complete control of companies, eliminating both foreign ownership and foreign management. The government nationalized the private U.S. and Canadian bauxite holdings as well as the holdings of Booker McConnell companies in Guyana, which included sugar plantations, light manufacturing, and commercial enterprises (see Table 3.2).

In the early history of SOEs, management was entrusted to a board appointed by the line minister. Loans could be raised by a corporation only with the express approval of the line minister. In this context, public enterprises in Guyana more than quadrupled from 1977 (18 SOEs) to 1980 (80 SOEs) and represented government interests in sectors such as mining and sugar. In the late 1970s and early 1980s, however, world commodity prices declined, reversing earlier economic gains.<sup>2</sup>

<sup>1</sup> “Cooperative republic” was the term used on February 23, 1970, when Guyana cut all ties to the British monarchy. The governor general was replaced as head of state by a ceremonial president. Also, Guyana became a force in the Nonaligned Movement.

<sup>2</sup> Economic activity declined persistently as demand for sugar and bauxite fell but government spending did not, and Guyana was forced to begin borrowing from abroad (Merrill, 1992). This challenge was hallmarked by the magnitude of the debt and the inability of the

**Table 3.2. Companies Nationalized in Guyana during the 1970s**

Demerara Bauxite Company (Demba)	1971
Reynolds Bauxite Company	1974
Jessel Securities	1975
Booker McConnell	1976

Source: Lee (2000).

In Guyana, public enterprises were and continue today to be utilized for a variety of purposes, including developing the country's infrastructure base, channeling government investment, building local management and technical skills, and generating economic activity. As these public enterprises became entrenched in the country's political and economic landscape, they became predominant channels through which the government could implement its economic policies. As a result, the income generated and expenditure incurred by these enterprises during the 1970s had an important bearing on the government's overall financial situation.

Trinidad and Tobago experienced an oil boom in the 1970s that generated rapid economic growth. Oil prices went from US\$1.80 in 1970 to US\$31.61 by 1979. This boom facilitated economic policies necessary to heal the colonial social shortcoming. Trinidad and Tobago had only gained independence in 1962. In 1970, there were massive street demonstrations as part of the Black Power Movement,<sup>3</sup> protesting rising unemployment and growing discontent for the presence of "foreign control over the commanding heights of the economy" (Best, 1971a). The state at first proceeded cautiously as it did not have adequate resources to respond to citizens' concerns, but as economic rents began to accumulate during the oil boom government action became more targeted and deliberate. The windfall gains were immediately utilized to fund several activities, including the purchase of majority interests in several companies. In 1972, a white paper was prepared that highlighted the role of the state in the public sector, industrial, and commercial activities. This

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government to service it. Since becoming independent in 1966, Guyana sought out avenues of foreign aid. At the end of 1970, loans had been contracted from the United States, Canada, and multilateral agencies like the International Bank for Reconstruction and Development and the International Development Association. During the late 1960s, external loan utilization was primarily for social development and economic infrastructural purposes. In 1971, the external public debt stood at 83.4 percent of GDP. By 1977, Guyana's external debt had increased by 408 percent over 1970's total to US\$404.4 million (G\$84.6 billion).

<sup>3</sup> The Black Power demonstrations took place in Trinidad and Tobago between February 26 and April 21, 1970. On April 21 a state of emergency was declared. The demonstrations were carried out mainly by young black urban unemployed youths protesting domination of the business sector by a ruling white minority (While similar in some of the demands made, the movement in Trinidad and Tobago had no connection to the Black Lives Matter movement that began in the 2010s in the United States.)

white paper was used to rationalize state-led economic activity and outlined the mechanisms that could be used for securing private assets (Ryan, 1977). In 1973 and 1975 additional white papers articulated public participation in the economy. The general objectives of the government, as highlighted in these papers, were to: (i) localize selected sectors in the economy by transferring the control of foreign-owned assets to local players, (ii) encourage and support new local industries, and (iii) maintain employment.

Specifically, prior to 1972, part of the industrial and development activity practiced by the government of Trinidad and Tobago was to save the jobs of some workers in bankrupt companies. The white papers emphasized, however, that this type of rescue intervention by the state would not be long term. The state's involvement deepened in 1969 when the government took over the domestic assets of British Petroleum. In 1974 the government also purchased the domestic holdings of Shell and in 1983 it purchased the non-marine assets of Texaco and in so doing gained control of a large element of the commanding heights of the economy. As oil revenues expanded, the state set about becoming the prime mover in the economy.

Table 3.3 lists acquisitions by the government of Trinidad and Tobago during this time.<sup>4</sup> Note that the majority of these took place during the 1970s and early 1980s. The table includes the year in which the asset was nationalized or acquired, the sector in which the company operated, the reason for the acquisition, and the ultimate share of equity controlled by the government.

In 1974, the Jamaican government declared its political ideology to be “democratic socialism,” which underscored a strategy of taking over the leading industries in the economy. Accordingly, Jamaica began to invest heavily in a system of SOEs which would be responsible for recruiting staff from the general civil service. The size of the core civil service declined in terms of both quantity and quality as many civil servants joined SOEs, which were deemed a better alternative to the Jamaican public sector. One of the main sectors represented by public enterprises in Jamaica was sugar. The state-led public corporations did afford the government some flexibility and quicker turnover times for decisions as it became the conduit through which policies would be implemented. These enterprises were also used to develop capacity of locals in terms of technology and managerial expertise. A successful example of this is the National Housing Trust (CaPRI, 2016; Knight, 1997).

During the 1970s in Barbados, the role of the state remained limited to maintaining the status quo of the local whites and elites who exercised a disproportionate influence in politics and decision making (Beckford, 1972). Thus, “the government instituted statutory corporations in areas where the state could provide impetus to private development ... or in sectors in which

<sup>4</sup> Specific data on acquisitions as compared to enterprises created by the state was not immediately available from the Ministry of Finance.

**Table 3.3. Companies Acquired by the State in Trinidad and Tobago (1958–1984)**

Year	Company	Economic sector	Reason for acquisition	% state shareholding
1958	Angostura Bitters Co.	Manufacturing	Strategic	6.9
1965	Trinidad and Tobago Mortgage Finance Company Ltd.	Finance	Development	60
1968	Trinidad and Tobago Telephone Co. Ltd.	Communication	Localization	100
1968	Agriculture Development Bank	Finance	Development	53
1968	Arts and Crafts Export Ltd.	Services	Development	N/A
1969	Orange Grove National Co. Ltd.	Agriculture	Localization	100
1969	Trinidad-Tesoro Petroleum Co. Ltd.	Petroleum	To save jobs	50.1
1969	NAMUCAR	Transportation	Development	N/A
1969	Trinidad and Tobago External Communication Company Ltd.	Transportation, Storage & Communication	Localization	51
1970	National Commercial Bank of T&T Ltd.	Finance	Localization	51
1970	Trinidad and Tobago Development Finance Co.	Finance	Development	94.2
1971	Allied Innkeepers (Holiday Inn)	Hotel	Development	35
1971	Trinidad Cement Ltd.	Manufacturing	Localization	100
1971	Trinidad and Tobago Printing and Packaging Ltd.	Manufacturing	To save jobs	100
1971	Trinidad Bagasse Products Ltd.	Manufacturing	Development	N/A
1971	National Brewing Co.	Manufacturing	Development	1.16
1971	Trinity Garment Manufacturers (IDC)	Manufacturing	Development	N/A
1972	National Broadcasting Service of T&T Ltd.	Communication	Localization	100
1972	Neal and Massy Holdings Ltd.	Finance	Strategic	3.12
1972	National Fishers Co. Ltd.	Manufacturing	Development	96.3
1972	National Flour Mills Ltd.	Manufacturing	Localization	100
1972	Trinidad and Tobago National Petroleum Marketing Co. Ltd.	Petroleum	Localization	100
1973	Trinidad and Tobago Lime Products	Agriculture	Development	100
1973	Trinidad and Tobago Television Co.	Broadcasting	Localization	100
1973	Workers Bank T&T Ltd.	Finance	Development	26.5
1973	Maritime Life (Caribbean) Co. Ltd.	Finance	Localization	18
1973	Trinidad and Tobago Electronics Ltd.	Manufacturing	Development	100

*(continued on next page)*



(continued)

**Table 3.3. Companies Acquired by the State in Trinidad and Tobago (1958-1984)**

Year	Company	Economic sector	Reason for acquisition	% state shareholding
1974	Caribbean Investment Corp.	Finance	CARICOM	N/A
1974	CARICOM Corn and Soya Bean Co.	Manufacturing	CARICOM	49.2
1974	Trinidad Nitrogen Co. Ltd.	Petroleum	Development	51
1974	Trinidad and Tobago Oil Co. Ltd.	Petroleum	Localization	100
1974	LIAT (1971) Ltd.	Transportation	CARICOM	18.2
1975	Caroni	Agriculture	Localization	100
1975	Trinidad and Tobago Export Credit Insurance Co. Ltd.	Finance	Development	100
1975	Reinsurance Co. of T&T Ltd.	Finance	Development	60
1975	Iron and Steel Co. of T&T	Manufacturing	Development	100
1975	National Gas Co. of T&T Ltd.	Petroleum	Development	100
1975	Trinidad and Tobago (BWIA International) Airways Corp.	Transportation	Localization	100
1976	Forres Park Ltd.	Agriculture	Localization	100
1976	Non-Pareil Estate Ltd.	Agriculture	Other	100
1976	National Agro Chemical Ltd.	Manufacturing	Development	100
1976	National Feed Mills Ltd.	Manufacturing	Development	100
1976	Shipping Corp. of T&T Ltd.	Transportation	Development	100
1976	West Indies Shipping Corp.	Transportation	CARICOM	40
1976	Point Lisas Port Development Co. Ltd.	Transportation, Storage & Communication	Development	98
1977	Fertilizer of T&T Ltd.	Petroleum	Development	51
1978	Trinidad and Tobago Meat Processors Ltd.	Manufacturing	To save jobs	100
1978	Trinidad and Tobago Forest Products Ltd.	Manufacturing	Development	100
1978	Lake Asphalt	Petroleum	To save jobs	100
1979	Food and Agriculture Corp. of T&T Ltd.	Agriculture	Development	100
1979	National Quarries Co. Ltd.	Agriculture	Development	100
1979	Caribbean Hotel Development Co. Ltd. (Crown Reef)	Hotel	Development	91
1979	Farrell House Ltd.	Hotel	Other	100
1979	Metal Industries Co. Ltd.	Manufacturing	Development	6.81
1979	Universal Metal (IDC)	Manufacturing	Development	22
1979	Caribbean Food Corp.	Manufacturing	CARICOM	N/A
1979	National Energy Corp. of T&T Ltd.	Petroleum	Development	100

(continued on next page)

(continued)

**Table 3.3. Companies Acquired by the State in Trinidad and Tobago (1958–1984)**

Year	Company	Economic sector	Reason for acquisition	% state shareholding
1979	Secondary School Maintenance, Training and Security Co. Ltd.	Services	To circumvent bureaucracy	100
1979	CARICARGO	Transportation	CARICOM	50
1980	Polymer (Caribbean) Ltd. (IDC)	Manufacturing	Development	11.9
1980	National (Secondary Roads) Development Co. Ltd.	Services	To circumvent bureaucracy	100
1980	School Nutrition Co. Ltd.	Services	Other	100
1980	Sea Island Development Co. Ltd.	Transportation	Development	32.9
1981	Arawak Cement	Manufacturing	CARICOM	49
1981	National Hospital Management Co. Ltd.	Services	To circumvent bureaucracy	100
1983	National Poultry Co. Ltd.	Agriculture	Development	100
1984	Trinidad and Tobago Solid Waste Management Co. Ltd.	Services	To circumvent bureaucracy	100

Source: Adapted from Sergeant and Forde (1992).

private sectors were unwilling” (Howard, 1992, 58). Still, despite the limited state ownership, Barbados invested in SOEs like Caribbean Airways, Arawak Cement, and Caribbean Air Cargo (Caricargo, a joint venture between the governments of Barbados and Trinidad and Tobago), which required continuous transfers of fiscal resources, leading the Barbados government to have a persistent budget deficit (see Figure 3.4). Indeed, the IMF Article IV consultation of Barbados for 1982 showed that in the late 1970s the Caribbean nation had persistent current fiscal deficits and transfers to nonfinancial public enterprises that grew from US\$6.15 million in 1976/77 to US\$8.1 million in 1979/80 (IMF, 1982). Some public enterprises received more subsidy support than others, with the major ones being the Transport Board, Water Authority, the National Housing Corporation, and the Industrial Development Corporation. Indeed, the IMF (1982, 18) noted that the operating deficit of the nonfinancial public enterprises grew from about 0.5 percent of GDP in 1977/78 to 1.4 percent of GDP in 1979/80.

In the post-colonial period, and in particular since 1973 when the United Kingdom joined the European Union, the Caribbean region benefited from foreign aid; however, this aid was mainly directed through the financial support facilities offered to the African, Caribbean, and Pacific (ACP) countries. On average, Caribbean economies received less than 10 percent of available aid, with Asian and African economies receiving the lion’s share (Lockley, 2015). These aid funds to the Caribbean were used mainly for building capacity of the government sector.

For Suriname, development aid was still accessible after independence from the Netherlands, with the only condition of disbursement being that there had to be agreement between the local government and the Hague on the various benefiting interventions. Aid from the Netherlands to Suriname represented the largest proportion of aid per capita globally in 1976 (Mhango, 1991). Specifically, all development projects had to be approved by the Commission for Development Aid. Further, all projects had to include a small contribution from the government of Suriname. Aid funds were used to build up the infrastructure base of Suriname, contributing to improving food security, domestic savings, and the health and education systems. These interventions were executed through foundations, state enterprises, and government institutions and ministries.

Regionally, a key characteristic of the state enterprise sector during the 1970s was that while it was used to implement government policy, these institutions became the channel through which patronage and the recruitment for political supporters and quasi-fiscal operations were undertaken. Specifically, in Guyana, Jamaica, and Trinidad and Tobago, localization was widespread in the insurance and banking sectors. The regulatory mechanisms to protect public interest that were in place when the companies were privately owned no longer had control over these newly localized firms. Even further, the regulatory agencies were also now under the purview of the state. This worsened the oversight and monitoring of the operations of state enterprises in the former colonies. It should be noted, though, that Trinidad and Tobago maintained its Public Utilities Commission but in Jamaica a similarly established commission had not been utilized since the early 1970s (Knight, 1997). In several Caribbean states, the post of ombudsman was established to lodge public complaints against state companies and the wider public service, but this mechanism too became overloaded and eventually failed (Knight, 1997).

It is hard to do an overall evaluation of the post-colonial economic model and the burden it placed on the public finances of CCB6 nations. In the early 1980s, R. P. Short, an IMF economist, collected information from the Article IV consultations for SOEs around the world to calculate their importance and the burden they were placing on the budget of each country. For the Caribbean few countries were tracked, but the data available for CCB6 nations is compiled in Table 3.4. Panel A provides some figures that show the importance of SOEs for the economy, especially the prominent role they played in financing gross capital formation in the Bahamas, Barbados, Guyana, and Jamaica. In the latter two countries, over a third of capital formation was undertaken by SOEs. Panel A also shows that the overall surplus/deficit of SOEs to GDP was negative and sizable, ranging from 2 to 4 percent of GDP and reaching even 7 percent in Guyana, where the state had a heavier presence in the economy.

**Table 3.4. Importance of SOEs and Their Budgetary Burden in the Bahamas, Barbados, Guyana, and Jamaica (1973–1981)****Panel A. Overall Importance of SOEs (all data as a percent of GDP)**

Country	Years	Output to GDP	As % of gross capital formation	Overall deficit/surplus	Net deficit/surplus (w/o transfers)
Bahamas	1975–77	N/A	20.4	–1.9	–2.7
Bahamas	1978–79	N/A	31.6	–1.7	–2.1
Barbados	1975–77	N/A	9.6	–1.8	–2.8
Barbados	1978–79	N/A	11.4	–2.1	–3.4
Guyana	1973	12.7	26.6	–3.7	–4.4
Guyana	1974–77	22.8	38.3	–6.6	–7.7
Guyana	1978–80	37.2	35.1	–1.4	–2.5
Jamaica	1976–77	N/A	40.1	–4.3	–4.5
Jamaica	1978–81	N/A	27.4	–3	–4

**Panel B. Budgetary Burden of SOEs**

Country	Years	Subsidies	Budgetary burden of SOEs	Government surplus/deficit	% of deficit that can be attributed to SOE fiscal transfers and loans
Bahamas	1975–77	0.8	3	–1	100%
Bahamas	1978–79	0.4	2	–0.6	100%
Barbados	1975–77	1	3.8	–5.8	66%
Barbados	1978–79	1.3	3.8	–3.7	100%
Guyana	1973	0.7	1.4	–12.5	11%
Guyana	1974–77	1.1	1.5	–15	10%
Guyana	1978–80	1.1	3.8	–23.4	16%
Jamaica	1976–77	0.2	1.9	–17.5	11%
Jamaica	1978–81	1.1	3.9	–14.2	27%

Source: Short (1984).

Note: The budgetary burden of SOEs includes subsidies, fiscal transfers to cover losses, and loans.

Panel B of Table 3.4 shows the fiscal burden of SOEs in these four countries. We can see the size of subsidies and the overall fiscal burden (which includes subsidies, fiscal transfers to cover losses, and total credit to SOEs from the government). The figures of the overall fiscal burden can be alarming, requiring over 3 percent of GDP in some years. The last two columns of Panel B show that these CCB6 countries had consistent and extremely large budget deficits and calculations of how much of the budget deficit can be attributed to the overall fiscal burden of SOEs. In most cases the fiscal deficit is to a large extent attributable to the fiscal needs of SOEs. In Guyana and Jamaica, the percent of the deficit attributable to SOEs is

lower, but the deficits are also larger. Thus, we can conclude that the post-independence economic model of the CCB6 countries already showed the fiscal imbalances and the SOE underperformance and fiscal risks that observed today.

### 1980s: Crisis in SOEs in the Caribbean

In the early 1980s Europe, the United States, and most of the developing world suffered a severe recession. Initially, tourism-based economies like the Bahamas and Barbados suffered, but they recovered by the mid-1980s. In contrast, commodity-exporting countries suffered more in the later part of the decade as the demand for commodities slowed down. Consequently, growth in the Caribbean ground to a halt in the early 1980s and remained negative in commodity-exporting countries for most of the decade (see Table 3.1).

The large increase in fiscal expenditures of the 1960s and 1970s was, for the first time, met by a severe downfall in revenues. According to Howard (1992), public expenditures in the post-colonial period had increased dramatically in secondary and tertiary education, health, and infrastructure. As such, most CCB6 countries were slow to cut those expenditures during the 1980s and, as a consequence, fiscal deficits as a percent of GDP increased rapidly. In fact, most countries in the region experienced consistent fiscal deficits throughout the 1980s, with the Bahamas showing the lowest figure (around 1.5 percent of GDP) and Guyana showing dramatic two-digit deficits as a percent of GDP. As fiscal deficits deepened, it became necessary to immediately and aggressively reverse the inefficiencies of the state sector. The downfall of the socialist experiment in Guyana led to the most severe recession in the early part of the 1980s. As a consequence of the dire situation, the IMF assisted various CCB6 countries during the crisis.

Worsening economic realities compounded the relevance and role of the public sector. SOEs subsequently were subject to heavy scrutiny as the performance of the sector deteriorated due to declining profitability of public utilities. The World Bank (1986) attributed the decline in performance of these companies to poor management practices, the inadequate maintenance of physical infrastructure, insufficient market size to experience economies of scale, low productivity relative to wages, pricing constraints, rising costs, and nonpayment of arrears by the government. The challenge of declining profitability, especially for what were deemed essential utilities, was remedied by government subsidies which eventually became a necessary fiscal burden on the national budget—a situation which still exists today. While it has been acknowledged that some reorganization has been attempted through regulations, a critical shortcoming observed has been the inability of the government to transition away from subsidized tariffs for services of SOEs. This stasis puts a burden on SOEs and creates fiscal risk

for the government budget. The governments need to face the challenge and transition towards a tariff level which is sustainable in the long run.

In 1980, SOEs in Guyana accounted for about 48 percent of GDP and 50 percent of gross fixed capital formation (Knight, 1997). In the 1980s, state enterprises' output accounted for approximately 80 percent of local economic activity and 90 percent of the country's exports. This sector became so important to the overall economy that between 1984 and 1985 the sector was reorganized to make it more productive and efficient (World Bank, 1986). However, during the latter years of the 1980s, the increasingly poor performance of SOEs contributed to the near collapse of the Guyanese economy. Knight (1997) and Nicholls (1997) explained that these corporations suffered from political interference in their management, as well as poor administration and limited financial resources. The lack of resources impeded SOEs from acquiring new capital and from maintaining equipment effectively, thereby further weakening their capacity to produce goods and services in an efficient manner. The underperformance of SOEs underscored the thrust towards privatization, which followed in the 1990s.

Trinidad and Tobago, the only oil-exporting economy in the region at the time, experienced windfall gains during the 1970s and early 1980s, which enabled it to capture a leading role in development in the Caribbean as a lender to some of its less fortunate neighbors. Guyana was one of the main recipients of assistance from Trinidad and Tobago. The government of Trinidad and Tobago, however, was forced to make several changes when production and prices of crude oil fell after 1982. The state, as a major component of the transformation process, accessed the facilities on offer from the IMF, IDB, and World Bank. But the financial support from the IMF and the World Bank was associated with conditionalities which included the privatization of some state holdings and rescheduling of some of its outstanding public sector debt repayments. In 1987, the government of Trinidad and Tobago appointed the Rampersad Committee to guide policy on the restructuring of the economy. In its report, the committee noted that many of the SOEs were inefficient and had high debt service payments and, as reported by Sergeant and Forde (1992), extensive privatization was recommended. More specifically, in considering the varying levels of ownership (wholly owned, majority, and minority) the state held, the Rampersad Committee recommended that the government divest of all minority shareholdings (Sergeant and Forde, 1992, 190).

In Barbados the situation in the 1980s was also dire. There, the government and its SOEs started to borrow heavily from the domestic banking system. Table 3.5 shows credit to the government and SOEs as a proportion of GDP for Barbados, which increased by 50 percent in the later part of the 1980s to over 10 percent of GDP. The Bahamas is included as a benchmark to show that this increase in borrowing from banks was not a trend there. The

**Table 3.5. Credit to Government and State-Owned Enterprises as a Percentage of GDP (1980–1989)**

Year	Barbados	Bahamas
1980	7.63	4.08
1981	7.66	4.22
1982	8.60	4.89
1983	8.17	4.72
1984	9.16	4.22
1985	9.33	3.37
1986	10.26	3.30
1987	10.55	3.17
1988	10.87	4.20
1989	8.81	4.42

Source: FRED (n.d.).

growth in this indicator for the Bahamas was modest, increasing from 3.37 percent in 1985 to 4.42 percent of GDP in 1989.

In Barbados, SOEs required outsized transfers from the government during the 1980s, even though the economy recovered from the recession by 1983. Still, despite these problems, Nicholls (1997) noted that in the public sector in Barbados spending on SOEs was more selective compared to other economies such as Jamaica. Nicholls noted that “Barbados avoided the high volatility of relative outlays on economic infrastructure experienced by Jamaica because of the narrower intervention in ownership and a more cautious fiscal policy” (1997, 67). Specifically, the government managed the breadth of public sector participation more prudently, focusing on public goods such as roads and pipe-borne water as well as mass passenger transportation. These sectors were heavily subsidized by the government and remain so today.

Some of the SOEs in Barbados incurred severe losses. For instance, prior to 1955, public transportation in the country was provided via a series of concessions on various routes. On August 24, 1955, the Transport Board was established and legislated under CAP297 of the Laws of Barbados, and the board has persistently depended on transfers from the government. Table 3.6 shows the fiscal operations of this SOE in the latter part of the 1970s; a persistent increase in the operating subsidy from the government and in expenditures is evident over the defined period (eventually up to 185 percent).

Across the CCB6, the 1980s saw an entrenchment of the role of SOEs in development even as economies experienced worsening economic performance. These institutions became the key conduits through which government policy was implemented.

**Table 3.6. Barbados Transport Operations (in millions of US\$)**

	1976/77	1977/78	1978/79	1979/80
Current Revenue	5.2	7	8.95	12.5
Operating Subsidy from Government	(1.85)	(2.3)	(2.25)	(3.8)
Current Expenditure	4.4	6.2	8.7	12.5
Surplus/Deficit	0.8	0.8	0.25	0

Source: IMF Article IV Consultation Reports for Barbados, various years.

## 1990s: Rationalizing the State Sector

At the start of the 1990s several CARICOM economies were experiencing low growth and persistent fiscal deficits. The CCB6 experienced growth with three of the economies increasing the number of new SOEs formed (see Table 3.1).

In the 1990s the prevailing ideology in the Caribbean was influenced by global trends towards more liberalized economies in which the role of the state was deliberately diminished. Regional economies therefore began to liberalize and privatize their respective public sectors. In Jamaica privatization started in the late 1980s and continued well into the 1990s, such that by the mid-1990s most of the holdings of the National Commercial Bank had been privatized (Knight, 1997).

In Guyana, over the period 1989–1992, 11 SOEs were selected for divestment. The primary objective of the government's privatization program was to liquidate, wherever possible, unprofitable enterprises and to privatize specific public entities, including the Guyana Telecommunication Corporation, Livestock Development Company, National Paint Company, Guyana Leathercraft Limited, Muneshwar Limited, and Guyana Transport Services Limited. The results of privatization varied widely. For example, the financial performance of the Guyana Telephone and Telegraph Company, Guyana Nichimo Company Ltd., and Muneshwar Limited improved. In April 1992, the government privatized the Livestock Development Company (LIDCO) but retained a 25 percent stake. After an initial profit of G\$9.5 million (US\$84,974) in 1991, LIDCO's financial performance deteriorated significantly between 1992 and 1994. The company recorded losses of G\$8.5 million (US\$68,000) in 1992, which worsened to G\$57.2 million (US\$410,000) by 1994. The company claimed that the poor financial performance was due to the dumping of cheaper imports on the local market, the higher cost of production following the depreciation of the Guyanese dollar, and the elimination of government grants. Despite poor profitability during this period, the net cash flow of the company had remained positive, so the government made the decision to terminate financial subsidies to the company and remove exemptions from taxes and import duties/levies.



Privatization positively impacted employment within LIDCO, with staff increasing from 128 in 1991 to a high of 169 in 1993 and leveling off at 142 between 1994 and 1995. The increase in employment was accompanied by an improved compensation package. Despite LIDCO's poor financial performance, positive contributions were made from the perspective of foreign exchange earnings and savings, lower price levels (on livestock), and infrastructure development. The pricing policy of the company has contributed to lower food prices and hence a lower inflation rate in the country.

On July 4, 1990, Guyana's National Hardware Limited bought the privatized assets of Guyana Nichimo Company Ltd. (Nichimo). At the time of this privatization, the old machines at Nichimo were only useful for the production of trawler nets, which were not in demand (Ganga, n.d.). National Hardware purchased the assets because Nichimo was unable to obtain foreign exchange to purchase new equipment and raw materials. The financial performance of the company improved considerably after divestment, in the 1992-1994 period. This resulted from an initial investment of G\$2.6 million (US\$20,000) in four machines to restore production of more marketable nets. Sales increased after 1992 and net cash flow was positive by 1994. The company paid an estimated G\$1.2 million (US\$10,000) annually in taxes to the government during the 1992-1994 period. The revamp in operations led to an increase of 50 percent in employment from 1991 to 1994. In addition to this increase in employment, workers received a 250 percent increase in wages and salaries between 1992 and 1994. The recommencement of the local production of fishing nets also resulted in a decrease in the importation of polyethylene fishing nets and hence foreign exchange savings.

A second privatization phase began in Guyana in the mid-1990s and was focused on 30 commercial SOEs which had remained in the hands of the state. The objective was to broaden ownership, promote efficiency among these SOEs and subsequently liberalize the economy, and promote competition and private sector development. About 15 of the SOEs were either fully or partially privatized. Guyana Power and Light (GPL) was re-nationalized following a failed privatization attempt. Revenue accruing to the government from the second phase of privatization amounted to G\$23 billion (US\$160 million), a significant amount considering it is about 50 percent of GDP for 1990 or 30 percent for 1994.

Despite privatization and efforts to improve the efficiency of SOEs in the CCB6, fiscal imbalances and SOE deficits were still sizable in the 1990s. Table 3.7 shows government and SOE borrowing from banks in the 1990s. In the Bahamas and Barbados (notably tourism-based economies) borrowing increased, although less dramatically in the Bahamas. In Barbados, government credit increased from 10.63 percent of GDP in 1990 to 14.86 percent of GDP by 1999, peaking at 19.56 percent in 1997. This indicates that government imbalances and SOE underperformance required more and more

internal credit, most likely displacing private investment in the process. In fact, SOEs in Barbados continued to represent a drain on public funds during the 1990s. The IMF (2000) mission to Barbados recommended moving towards economic rates for the services offered by these public enterprises to reduce their dependence on the state.

In the 1990s, the Trinidad and Tobago economy experienced significant economic challenges as its energy rents-motivated consumption and expenditure patterns continued to display signs of inertia even after the price of oil fell in 1982. From 1991 to 1995, the government introduced a more private sector-oriented set of policies, prompted no doubt by the conditions of the structural adjustment associated with financial support from the World Bank and IMF in 1987.

One of the companies that was privatized during this period was the Iron and Steel Company of Trinidad and Tobago (ISCOTT); it was subsequently rebranded as Arcelor Mittal. The government emphasized that it was not renouncing objectives such as employment creation but reassured that these had to be pursued in light of the changing dynamics of the 1990s.

In addition to these privatizations, there was a concerted effort to allow market forces to control utility generation wherever possible. The government sold off the power generation component of Trinidad and Tobago Electricity Commission (T&TEC) to the Power Generating Company of Trinidad and Tobago (POWERGEN). Additionally, Severn Trent of Britain was contracted to manage the restructuring of the other SOEs, such as the Water and Sewerage Authority (WASA), and the rationalization of two local oil companies, TRINTOPEC and TRINTOC, which were merged to form Petrotrin (Henry, 1999).

The 1990s were also associated with extensive public sector reform initiatives in Jamaica. The Public Sector Modernization Program was launched

**Table 3.7. Bank Credit to Government and State-Owned Enterprises as a Percentage of GDP (1990–1999)**

Year	BHS	BRB	TTO
1990	5.61	10.63	N/A
1991	6.50	10.88	N/A
1992	6.45	14.19	N/A
1993	8.21	14.51	N/A
1994	6.86	13.96	N/A
1995	6.73	16.12	N/A
1996	6.64	19.36	8.28
1997	6.87	19.56	12.97
1998	8.58	16.32	8.40
1999	8.42	14.86	7.71

Source: FRED (n.d.).

in 1996 and resulted in the establishment of the Public Sector Modernization Unit. This unit was responsible for rationalizing the operations of the public sector. The unit's objectives included strengthening procurement processes and training public sector staff. With this new management approach, the government of Jamaica was able to divest its remaining shares in Cable and Wireless and to privatize Jamaica Public Service Company Limited (JPS Co.). Other measures included mergers among public bodies such as the Caribbean Finance Housing Corporation and the National Housing Corporation, which became the National Housing Development Corporation (Atkinson, 2006). The Forestry Industries Development Company was closed.

Upon review of the public sector of Suriname, the IMF (2003) found that the central government accounts were the only financial records available for the public sector. As a result, coherent information about the 108 existing public enterprises was unavailable. What was known, though, was that the sector employed about 15,000 people and that these SOEs were fully subsidized by the national budget. The report concluded that extensive technical assistance was required to support an audit and a subsequent restructuring of the public and civil service in Suriname. At the time of the report, the country's relationship with the World Bank was being renewed, after a 10-year lapse, in order to pursue these types of support facilities.

Overall, the 1990s saw a return to the more facilitative role of the state, particularly in the form of reduced economic participation. Governments across the CCB6 attempted to rationalize their state sectors and improve efficiency of operations as the region came under closer scrutiny by multilateral institutions.

## 2000–2020: Reversal of Fortunes

In the period 2000–2010 in particular, the role of the SOEs in the Caribbean remained bound by the region's historical pattern of economic prosperity being accompanied by a rise in the number of SOEs in the CCB6 economies (as seen in Table 3.1). In particular, SOEs continued to provide strategic services in key sectors, revenue for the state in terms of dividends and taxation, and employment, but were also conduits through which quasi-fiscal operations occurred with soft budget constraints. In fact, as demonstrated throughout this volume, the number of SOEs in CCB6 economies increased dramatically during the commodity price supercycle of the early 2000s.<sup>5</sup>

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<sup>5</sup> Commodity price supercycles are extended periods during which commodity prices are well above or below their long-run trend. They are expected to last much longer than business cycles, which, in Canada and the United States, have lasted six years on average in the post-war period. Note that the CCB6 economies benefited from increased crude oil prices starting in 2000, which remained buoyant until 2014. Gold prices rose from 2000 and peaked in 2012. Aluminum prices peaked in 2014 and rice prices in 2012. Tourism inflows have improved fairly constantly since 2000.

**Table 3.8. Credit to Government and State-Owned Enterprises as a Percentage of GDP (2000–2017)**

	BHS	BRB	GUY	JAM	SUR	TTO
2000	7.18	17.50	N/A	N/A	N/A	5.37
2005	8.93	22.58	N/A	22.67	N/A	10.93
2006	8.52	18.37	N/A	20.46	N/A	7.58
2007	8.29	18.32	N/A	19.03	N/A	7.10
2008	11.40	18.77	N/A	16.71	N/A	6.05
2009	12.88	21.03	N/A	17.28	N/A	15.50
2010	20.23	N/A	N/A	15.92	N/A	15.18
2011	20.10	N/A	N/A	14.93	N/A	12.44
2012	19.75	N/A	N/A	15.93	N/A	15.29
2013	23.10	N/A	N/A	14.28	N/A	14.56
2014	22.67	N/A	10.72	12.04	N/A	17.53
2015	24.87	N/A	10.86	11.96	4.83	N/A
2016	25.69	N/A	10.29	12.53	N/A	N/A
2017	N/A	N/A	9.65	N/A	N/A	N/A

Source: FRED (n.d.).

Another piece of evidence that the increase in the number of SOEs and fiscal imbalances continued during the post-2000 period is the trends in borrowing from banks. As Table 3.8 demonstrates, based on bank credit to the government and SOEs (as a percent of GDP), the 2000s and 2010s have been some of the worst decades for CCB6 countries. This table shows that in the cases of the Bahamas, Barbados, and Trinidad and Tobago, bank credit to the government and SOEs as a percentage of GDP increased dramatically over this period, especially after the global financial crisis (2008–2009). In Barbados, borrowing from banks surpassed 20 percent of GDP, and in the Bahamas it reached 25 percent of GDP (tripling from the 1980s). In Trinidad and Tobago, credit from banks to the government and SOEs started around 5 percent of GDP at the turn of the 21st century and ended up closer to 20 percent in 2014. In Jamaica, the only country to undertake significant structural reforms, government and SOE borrowing from banks as a percent of GDP declined from 22.67 percent in 2005 to 12.53 percent in 2016—still a large number when compared to Suriname and the Bahamas, which are below 10 percent of GDP.

This information and the data presented throughout this volume reinforce the idea that the CCB6 nations did not properly correct course in the 1990s with privatizations and structural reforms, and, with the exception of Jamaica, have actually worsened their reliance on SOEs as policy instruments, resulting in SOEs taking a significant toll on public finances.

## Conclusion

In the Caribbean region, public enterprises such as SOEs play a significant role in the delivery of goods and services. The legacy of colonization provided a framework for state-led economic activity, and indeed forms the foundations of the contemporary SOE sector in the region. These enterprises seemed to be instrumental in stabilizing employment and promoting economic activity and have been a conduit through which government expenditure is used to provide opportunities and transfers to the population. Over the last few decades, however, the policy position, pricing, and employment systems of SOEs have been used for tunneling and political patronage and as a political instrument to secure tenure for politicians. Mismanagement in terms of governance, compounded by economic and environmental shocks, has resulted in SOEs more often than not becoming a financial burden to the national budget.

This chapter shows that despite efforts to reform the SOEs of CCB6 nations, some of the vices and mismanagement problems inherent in the public enterprise system persist and have actually compounded as the number of SOEs exploded in the last two decades. Yet it also implicitly shows that when reform efforts had political commitment, like in the privatization programs of Guyana and Trinidad and Tobago or in the recent structural reform efforts of Jamaica, the results are significant in a short amount of time. Thus, the historical experience suggests that the large SOE sector and the fiscal pressures experienced by these young nations are not historically ingrained and may be susceptible to change. The recent economic shock of the COVID-19 pandemic may provide a window to reform like that of the 1980s and 1990s that should not be allowed to go to waste.

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## CHAPTER 4

# Corporate Governance Institutions for Sustainable SOEs in the Caribbean

### Introduction

As discussed in the preceding chapters, the CCB6 countries—the Bahamas (BHS), Barbados (BRB), Jamaica (JAM), Guyana (GUY), Suriname (SUR), and Trinidad and Tobago (TTO)—have a tremendous number of state-owned enterprises (SOEs) that regularly resort to public funding to fill their budgetary gaps, triggering systemic fiscal risk. It has been well documented elsewhere that the pursuit of unclear goals by managers and owners of SOEs prompts firms' poor economic performance, which leads to demand for public funds that ends up draining the respective countries' fiscal reserves. Facing strained financial resources, many countries have taken actions to turn the situation around and avoid fiscal crisis—that is, they have made institutional changes that support SOE reform. This chapter provides an overview of contemporary SOE reform practices, comprising international best practices for SOE corporate governance and fiscal monitoring. The aim is to illustrate how these standards may help to avert fiscal crisis and to improve SOEs' economic performance for CCB6 countries.

The principal-agent incentive structure, believed to be behind SOEs' underperformance (Vickers and Yarrow, 1991), has, at times, induced SOE reform. However, it should be noted that contemporary SOE reform means something quite different from what it implied decades ago. In the 1980s and early 1990s, SOE reform equated to divestiture and privatization (Ramamurti, 1992; Galal and Shirley,

1995<sup>1</sup>; Chong and López-de-Silanes, 2005). Later in the 1990s, governments began to include private parties in the provision of public services using privatizations as well as different forms of contractual arrangements, including what are currently known as public-private partnerships (PPPs). In some cases, the latter involve SOEs.<sup>2</sup> During this time, SOE reform also began to include a focus on setting adequate corporate governance standards for such companies, either in view of prospective divestiture or to improve the existing operating framework of SOEs remaining in government portfolios,<sup>3</sup> and on developing and improving frameworks for fiscal monitoring of SOEs.<sup>4</sup> Despite the different applications reform may take, the motivation for SOE reform has remained relatively unaltered since the 1980s: to ensure the desired outcome expected of SOEs (the efficient provision of public services to citizens) is achieved and to reduce systemic fiscal risk.<sup>5</sup>

The slow pace of divestitures within the developing world and criticism that emerged in response to the World Bank's position on SOE reform in the 1990s (Cook and Kirkpatrick, 1997) paved the way for new approaches to SOE reform in the 2000s. Seeking to improve SOEs' economic performance without resorting to divestiture has led to renewed focus on forms of public ownership that can work to reduce principal-agent problems. Governments reaffirmed the view that SOEs are separate and autonomous entities from government administrations. However, it also became clear that they are different from private companies and require unique and specific guidelines and monitoring systems to reshape SOE ownership practices and avert mismanagement and fiscal risk.

The risk of mismanagement of SOEs arises not only through a misalignment of the incentives of SOE managers with those of SOE owners, but also when SOE owners lack sufficient incentives for maintaining a financially healthy SOE or a satisfied customer base (citizenry). When the agency executing

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<sup>1</sup> The 1995 book by the World Bank did not explicitly identify the authors of its chapters, except in the description about the report team disclosed on p. viii, which was used for the citation and reference in this chapter.

<sup>2</sup> For a discussion of the different forms of PPPs see Yescombe (2007), Delmon (2011), and Reyes-Tagle (2018). Siqueira, Reyes-Tagle, and Park (2018) discusses PPPs linked to SOEs.

<sup>3</sup> For transition economies, see Aoki (1995) and Rosenbaum, Bönker, and Wagener (2000).

<sup>4</sup> For example, many contemporary fiscal regulations for SOEs were introduced in Chile in the early 1980s.

<sup>5</sup> Although the World Bank did acknowledge possibilities other than divestiture in the 1980s and early 1990s, Galal and Shirley (1995, Figure 1) clarifies that these alternatives were conceived when privatization was deemed infeasible or the possibility of entering into management contracts with the private sector was ruled out. In these exceptional cases, SOE reform took the form of holding managers responsible for the SOE's results while also allowing them the freedom to make necessary changes in the firms.

ownership of SOEs faces no incentive to have a financially healthy SOE and when there is opportunity to use the SOE for patronage or other political purposes, these conditions of fiscal risk will inevitably transform into a fiscal crisis.

At present, SOE reform is concentrated on fiscal monitoring practices and new conceptions of corporate governance of SOEs. Fiscal monitoring initiatives have tied SOEs more closely to central government oversight, while new corporate governance practices allow SOEs in specific domains to be treated more in line with governance rules and norms of the private sector. Fiscal monitoring has emerged to mitigate the risks of SOE mismanagement that impacts general fiscal objectives of government, while improved corporate governance regulation has helped enable governments to act more responsibly as owners. Both aspects of reform work to mitigate the principal-agent distortions that have facilitated persistent SOE mismanagement in the past.

Corporate governance reform seeks to outline the various duties of SOE owners and to define how best to conduct them across portfolios of diverse SOEs. Fiscal monitoring reform seeks to define the monitoring practices and regulations necessary to mitigate unforeseen fiscal repercussions of SOE operations. Enacting these reforms may require modifying the manner through which governments exercise ownership of SOEs by establishing appropriate corporate governance institutions, such as centralized agencies that execute ownership duties and conduct appropriate monitoring practices. All these practices are necessary to ensure accountability among SOEs and their managers and to reduce the potential fiscal risk they generate. In summary, contemporary SOE reform has devised an institutional setup, in the form of centralized SOE oversight agencies, that can strike a healthy balance between the autonomy and managerial flexibility required of SOEs with adequate fiscal control and public accountability.

Since 1998, multilateral agencies worldwide—including the Organisation for Economic Co-operation and Development (OECD), World Bank, International Monetary Fund (IMF), and the Inter-American Development Bank (IDB)—and academics have come to a consensus on best practices for fiscal monitoring and corporate governance of SOEs. Best practices for fiscal monitoring have been advanced by the IMF, World Bank, and IDB.<sup>6</sup> For corporate governance of SOEs, the OECD introduced guidance in 1998 and has revised it several times, eventually releasing specific guidelines.<sup>7</sup>

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<sup>6</sup> See, for instance, Chapter 5 in World Bank (2014). For the IMF, see IMF (2016) and Medas and Ralyea (2020); for the IDB see Ter-Minassian (2017) and Musacchio and Pineda Ayerbe (2019b).

<sup>7</sup> In 1998 the OECD published the proceedings of a conference on corporate governance for SOEs. In 2005, the OECD offered a comparative analysis of the practices used by different country members. In 2011, the first version of the guidelines was released; they were revised in 2015 (OECD, 2015a).

Despite the wide availability of guidance from multilateral agencies as to best practices for corporate governance and fiscal monitoring of SOEs, many developing countries still have not adopted such international standards. The reasons for this delay are multifaceted, but one reason for certain is that changing the status quo is not a simple task. On the one hand, the extant managerial routines for SOEs may be long-standing, case specific, or rooted in the public administration tradition of the respective country. On the other hand, political and government stakeholders may be reluctant to give away the “private” benefits they accrue from conducting quasi-fiscal operations or their personal agendas (political or otherwise, such as patronage) through SOEs. Political elites may benefit from SOEs’ soft budget constraints and limited public oversight that enable them to conduct quasi-fiscal operations when regarded as beneficial (Musacchio and Pineda Ayerbe, 2019b).

Transforming the institutional setup may be socially beneficial for the country but inconvenient for the political elites. If so, the status quo proves an institutional trap equivalent to a prisoners’ dilemma: political actors in power or poised for election are aware that there are better institutional arrangements for SOEs at their disposal (such as the OECD guidelines or IMF fiscal proposals), but they have few, if any, incentives to undertake SOE reform. Neglecting SOE reform leads to continued SOE underperformance (by undertaking quasi-fiscal operations and other agendas that interfere with their core duties) and increases their fiscal cost. This institutional trap will eventually become too costly for countries to maintain over the long run, and at some point, political elites must realize that the status quo is no longer affordable. When this tipping point is reached, they are faced with only two choices: reform the SOEs or continue to ignore the fiscal risk created by SOEs and run the risk of precipitating a fiscal crisis or forced divestiture of SOEs.<sup>8</sup>

Interestingly, this story has a variety of endings. Some countries have managed to overcome the institutional trap by undertaking international commitments.<sup>9</sup> Among them are countries from Latin America, both middle-income and developing economies.<sup>10</sup> Differing legal traditions have not been

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<sup>8</sup> Privatization in the 1980s sought to reduce fiscal deficits. In Brazil, Chile, and Mexico privatization followed the 1982 economic crisis. A more recent case of this outcome is provided by Ecuador, which announced in May 2020 the liquidation of eight of its SOEs. The decision resulted from a severe fiscal crisis that followed the rapid decline in oil prices. This shock confronted a government who had in the past exercised an unbalanced power to expand its SOE portfolio without setting adequate corporate governance or fiscal monitoring policies.

<sup>9</sup> These international commitments have ranged from adhering to OECD guidelines (e.g., Colombia) or complying with contracts with multilateral institutions (Ecuador).

<sup>10</sup> Mexico was the first Latin American country to join OECD, in 1994, followed by Chile in 2010. Costa Rica and Colombia began their accession processes in 2013 and Argentina began preliminary accession work in 2017. SOE reviews for Colombia were delivered in 2015 (OECD, 2015b) and for Argentina in 2018 (OECD, 2018a). Brazil has participated at OECD since 1994 but not as an OECD member.

an impediment to adoption of international best practices on SOE corporate governance and fiscal monitoring, despite the diversity of adoptee countries' political institutions, which have ranged from presidential to parliamentary political regimes. Best practices are a collection of procedures that countries are advised to implement, and which are not enforceable standards *per se*; they are soft law. As such, they may be amended whenever shortcomings of current practices are identified or when new challenges arise and are not addressed by existing practices. Best practices are dynamic, and the subsequent versions of the OECD guidelines (2011 and 2015) are a testament to this dynamism.<sup>11</sup> Nowadays, accession to the OECD implies that a candidate country will subject itself to a review of its SOE corporate governance practices, essentially agreeing to comply. This means that, to a great extent, a significant part of the guidelines is binding when joining, although this is not true for any subsequent best practices that may follow. Countries joining the OECD found that the compulsory nature of these practices provided them with political leverage to leapfrog any remaining internal opposition and obstacles to undertake SOE reform.<sup>12</sup>

A common driver across countries of varying economic and legal traditions aiming to align their SOEs' corporate governance rules to international best practices is the belief that such rules: (i) contribute to achieving sound fiscal and economic policies and to reducing fiscal risk, (ii) help to level the playing field of competition for their own companies (both private and state-owned) in domestic and international markets, (iii) are conducive to increasing effectiveness and efficiency in delivering public goods and key inputs for manufacturing and service companies, and (iv) help to combat corruption and avoid capture of the state apparatus by specific interest groups or stakeholders.

This chapter analyzes best practices for fiscal monitoring and for SOE corporate governance practices looking specifically at the following aspects: (i) rationales for SOE ownership, (ii) the state's role as an owner, (iii) SOEs in the marketplace, (iv) equitable treatment of shareholders and other investors, (v) stakeholder relations and responsible business, (vi) disclosure and transparency, and (vii) responsibilities of the boards of SOEs. Some of the key principles of international benchmarks are highlighted and a few alternative modes of implementation are discussed by looking at the experience of select middle-income

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<sup>11</sup> Even though countries that are now willing to enter the forum are required to comply with the latest version of the principles, extant members face no enforcement procedures regarding their compliance, unless compliance has been considered as integral to their accession. Chile's accession process in 2010 stated commitments on SOE corporate governance, as did the accession processes of Argentina, Colombia, and Costa Rica.

<sup>12</sup> As examples, Chile was required to improve the corporate governance of CODELCO and Colombia to introduce a centralized ownership entity before accession. For a more general outlook on these implications, see the accession reviews made by the OECD related to SOEs (OECD, 2015b).

countries from Latin America and the Caribbean (LAC). The purpose of doing so is to exemplify the potential applicability of these best practices to CCB6 countries and their SOE reform efforts in the short and medium term.

The chapter is organized as follows. The first section discusses the different categories of SOEs in terms of corporate governance structures and their implications and presents a succinct overview of the legal and historical backgrounds of government entities in CCB6 countries. The next section lays out corporate governance principles and fiscal monitoring best practices, highlighting the principles deemed important for improving the efficiency and the economic performance of SOEs, and frames different avenues for SOE reform in CCB6 countries accordingly. The final section summarizes the conclusions and recommendations made throughout the chapter.

### **SOEs' Legal Forms, Corporate Governance, and Ownership Control**

The manner in which governments execute their ownership role in regard to SOEs is strictly related to the regulation surrounding SOEs' corporate governance. SOEs have a wide range of origins, characterized by timing of establishment and the legal constitution applied. This diversity contributes to the emergence of complex corporate governance regulations that unless tackled directly may trigger the institutional trap and fiscal risk mentioned earlier. This section explores a plausible taxonomy of origins and SOE legal structures that compose a complex body of corporate governance regulation that is likely to be found in CCB6 countries prior to SOE reform. Existing literature recognizes only two categories of SOEs: statutory SOEs and SOEs governed by private sector regulation (referred to as SS and PCS, respectively, in the tables below). (For aggregate figures by country and SOE type, see Table A4.1 in the appendix to this chapter.) The following section proposes a taxonomy that further elaborates on this categorization and provides explanations for the institutional setup normally seen in SOEs prior to reform.

#### **Statutory SOEs (SS)**

Statutory SOEs (SS) is a broad category of SOEs whose legal origins derive from a statute enacted through the legislative system.<sup>13</sup> As a category, this grouping minimizes relevant differences in SOE corporate governance regulations that are prevalent amongst SOEs. These variances are addressed here with a focus on the salient features of statutory SOEs that tend to influence their corporate governance structure, especially in developing countries. The aim is not to identify every possible SS, but to recognize how their differences in nature may affect their corresponding corporate governance structure.

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<sup>13</sup> See, for instance, p. 203 in a manual of public administration in the Indian context (Sharma and Sharma, 2002).

### *SOEs That Emerge to Provide Utilities and Public Works*

The provision of public works (infrastructure, transportation services, and utilities, among other services) has been regarded as one of the core duties of governments.<sup>14</sup> Governments perform these duties either through direct provision or through delegation to third parties. When supplied directly, public works were initially managed in-house by ministries; SOE management was closely intertwined with government administration.<sup>15</sup> Frequently, however, in-house provision of utilities encountered the administration's limited capabilities to deal with increasing scale of production, which hampered SOEs' ability to satisfactorily deliver opportune and sufficient public services to the citizenry. A typical best response conceived by governments was *corporatization* (Delmon, 2011)—that is, to transfer the operational competencies from a government department to autonomous entities controlled and funded by governments early in their respective development. These new entities were created through legislation and with organizational features and functional structures that departed from the central state bureaucracy and usually included some managerial practices found in the private sector. Some examples of typical SOE creation that reflects this separation from central government bureaucracy while remaining in government portfolios are postal services and, to a lesser extent, national ports.<sup>16</sup>

The managerial rules of early SOEs run the risk of stagnating and forgoing the evolution of laws regarding private companies. In a similar fashion, subsequent SOEs are likely to be governed by more up-to-date regulations than older SOEs, resulting in diverging governance rules across SOEs. Different approaches to management systems across SOEs and between SOEs and applied private sector laws are likely to generate an array of diverse SOE corporate governance practices, which compose a complex bundle of SOE ownership rules.

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<sup>14</sup> This rationale is embedded in the conception of government duties (Smith, 1776), and according to Vernon (1979), the category corresponds to the first rationale for government's holding of SOEs: provision of public services.

<sup>15</sup> Note, however, that Aharoni (1986) regards in-house production of public services as a category of SOEs.

<sup>16</sup> The production and distribution of drinking water and sewage services originated in the form of SOEs but today is provided by private companies or by PPPs. Port SOEs have experienced significant reorganizations over time with the increased trade following World War II and contemporary globalization (prior to the COVID-19 pandemic). As an example, in Chile, national ports were administered under the supervision of the customs authority since the early 20th century until reorganized as an SOE in the 1960s (EMPORCHI). In the late 1990s the SOE was dismembered into 10 SOEs that relied on PPPs to provide their services. Another example of these SOEs are national mints. For example, the Casa de Moneda in Chile was under the supervision of the government since colonial times, following expiration of a privilege granted by the Crown. The governance structure varied over time, remaining a government unit in the sphere of the Ministry of Finance until 2008, when it became a statutory SOE.



### *National Champions: Big-Bang SOEs*

It is common to find some SOEs that were established by statutory entities in order to develop or engage in a completely new industry or activity, as part of a public policy design. Vernon (1979) regards these cases as national champions; we label them “big-bang” SOEs because they create new industries or economic sectors. Typically, the statute creates a new actor with no domestic models (some foreign ones might exist) to emulate in terms of organizational structure and how to best deliver the outputs. Governments instead rely on the managerial rules available, whether public or private.

These big-bang SOEs may operate like monopolies for some time, but provided they are created to develop an industry and a new economic activity, the monopoly is expected to fade over time, based on the conditions of the national market.<sup>17</sup> If this transition from monopoly to competitive market takes place then, in the long run, regulations will come to govern the novel industry as a whole and not the SOE exclusively. One early example of this in Latin America is the Caja de Crédito Hipotecario (CCH), established in 1855 in Chile to provide mortgages for immovable property, a financial SOE that evolved into contemporary BancoEstado, the state-owned bank.<sup>18</sup>

The corporate governance structure of an SOE also greatly depends on the date of the SOE’s establishment and whether it operates in a competitive or a monopolistic market environment. In the Chilean example, CCH functioned within a competitive market environment, but relied on corporate governance designed in the mid-19th century.<sup>19</sup>

### *SOEs Engaged in PPPs*

A different type of SOE was needed to handle different aspects of the value chain for infrastructure and utilities’ services; governments began to consider PPPs as a recourse for these needs. Early and late examples of these types of SOEs can be found in many countries, where the SOEs operate in close relationship to the legislation that governs private companies, as an outcome of the nature of PPPs.<sup>20</sup>

<sup>17</sup> Natural monopolies are likely to be the only plausible outcome in small economies like CCB6 countries, but larger economies may experience some competition in the medium term.

<sup>18</sup> Later examples in Chile were the National Oil Company (ENAP) in 1950 and the national TV channel in 1970.

<sup>19</sup> At first, CCH did not have the ability to undertake obligations or to subscribe contracts other than the mortgages and was not given any patrimony of its own. In 1952, it was transformed into a more regular SOE, vested with all the powers of an independent entity. Since its inception, it was run by an (unpaid) board of directors led by a chair who was also the CEO (remunerated). It was under the supervision of the Ministry of Finance, with transparency of the board meetings (minutes were public record and published in the official gazette).

<sup>20</sup> Vernon (1979) does not acknowledge this type of SOE as a category.

An early example of this type of PPP is illustrated by the railroad SOE in Chile, which began with both concessions to private enterprises and with joint ventures with the state (i.e., what today would probably be called a PPP). These latter structures eventually allowed the government to accumulate and control railroad assets.<sup>21</sup> After a period of in-house management, an autonomous entity was created in 1884 to manage the railroads while maintaining close ties with the ministry.<sup>22</sup> As expected in an evolutionary case such as this, the managerial rules originated from different sources: some elements were inherited from the period of private ownership and some from the more immediate public administration regulation during the in-house phase. Cases like this are prone to result in a cumbersome and complex corporate governance regulation.

A recent PPP-related SOE in Chile is Fondo de Infraestructura S.A. (FOINSA), created in 2018 to manage the assets resulting from expirations of the infrastructure concessions utilized in the PPP concessionary model of the late 1990s.<sup>23</sup> Unlike the 20th-century experience, this SOE was devised not to operate the assets, but to manage further concessions. In addition, and despite its statutory nature, FOINSA was designed to operate under private company law in every aspect not specifically otherwise regulated by its statute.<sup>24</sup>

In both these cases, corporate governance structures are closely determined by the period in which the SOE is founded and are influenced by PPP regulations, which together provide ample room for complexity in the corporate governance regulatory framework.<sup>25</sup>

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<sup>21</sup> The example of the Santiago-Valparaíso line exemplifies the development of this SOE. In the 1840s a privilege to build a railroad between the two main cities was granted to Mr. Wheelwright, but by the 1850s the government ended up funding 50 percent of the investment, while the rest was funded by a few major businesspeople (Marín Vicuña, 1900). Later, the government funded the rest of the investment through debt. The South line was another joint venture of the government and the private sector in the late 1850s, in which the government originally invested one-third of the capital (Marín Vicuña, 1900). The following decade, the government developed extensions and, by 1873, decided to acquire the remaining shares of the mixed property railroad company.

<sup>22</sup> The new entity had a board of directors and an executive director endowed with the power to represent the entity and to take obligations on its behalf.

<sup>23</sup> The resemblance with the 19th-century railroad example is striking, except that the 21st-century experience relied on the SOE framework skipping the in-house management phase.

<sup>24</sup> FOINSA was created by Law 21.082. This form of regulation has been used for different statutory SOEs in Chile in contemporary times: “whenever possible and without prejudice to what is dictated by the statute, the SOE shall be regulated by the private company law” (Article 9, Law 21.082).

<sup>25</sup> Other examples of these SOEs are the ports that rely on PPPs and grant concessions for infrastructure construction and operations. Chile took this avenue in 1998. The new port SOEs were conceived as landlords and authorities for private partners that operate on their grounds. Costa Rica and Peru have followed similar strategies.

### *SOEs Resulting from the Nationalization of Private Firms*

Nationalized SOEs are firms acquired by governments through legislation from a previously privately held company. The origins of these SOEs are remarkably diverse, but they tend to share an orientation towards private sector managerial regulations. Even though nationalization may partially amend this feature, a significant portion of the private sector managerial rules may linger. As for corporate governance, the process of nationalization usually dictates the standard that follows, and it is not uncommon that control of the SOE is assigned to a sectoral ministry. Examples of this type of SOE are vast and so varied that a simple synoptic overview of these SOEs is not possible. The preliminary conclusion is that they are characterized by having complex corporate governance structures ultimately linked to sectoral ministries.

### *Other Statutory SOEs*

CCB6 countries provide examples of additional types of statutory SOEs in which the consequences of their corporate governance regulations are understudied. For instance, Suriname has used foundations extensively as the legal structure for SOEs. Understanding the consequences of this choice in legal architecture requires detailed examination, something that is beyond the scope of this chapter.

### **SOEs Founded by Governments, Governed by Private Sector Regulations (PCS)**

Governments, on many occasions, have resorted to private company law to create and operate SOEs. A typical reason for doing so is to enter into partnerships with private actors in joint ventures, in which case the use of private company law aids alignment. In other cases, governments create 100 percent government-owned SOEs under private company law through development agencies for practical reasons.<sup>26</sup> Another not-uncommon scenario through which private companies enter the government portfolio is a temporary reprieve or temporary bailout due to a diverse array of events, but essentially face little to no change in their legal structure as they are expected to revert back to private ownership.<sup>27</sup>

Despite the varying origins of these SOEs, they all share a corporate governance regulatory structure framed by private sector practices. However, when the legislation for the private sector is altered, the changes become

<sup>26</sup> One example is CORFO, the government development agency created in Chile in 1939, which created its companies using the joint stock company law.

<sup>27</sup> Bankruptcies, in some cases, have led governments to bail out companies through acquiring control temporarily. In Ecuador, many companies fell under the control of TV Medios during President Correa's administration. In Chile, several private firms labeled as the "strange area" fell under government control during the 1981-82 crisis (Hachette and Lüders, 1992, 16, 89-92).

binding for SOEs that operate under private company law, while statutory SOEs' regulation remains unchanged. The exceptions to this are the statutory SOEs in which discrete aspects of their operations are governed by statutory law and every other aspect relies upon private company law, such as is the current practice for the contemporary Chilean statutory SOEs.

### **SOEs with Decentralized Ownership Structures Prior to SOE Reform**

The complex corporate governance structures of some SOEs are not necessarily explained by the diverse rationales for having SOEs, but rather by the history, origin, and legal constitution of each SOE.<sup>28</sup> SOE corporate governance standards indicate how well equipped governments are to exercise their ownership duties. Countries with complex governance regulations for SOEs, and uneven application across SOEs, normally exercise ownership duties in a decentralized fashion, whereby the sectoral ministry functions as the owner of related SOEs. Decentralized governance structures imply that a government does not behave as a single, unified owner, but as a multiheaded entity, each head embodied in a different section of government (ministry) that controls corresponding SOEs. These sections of government (ministries) need not coordinate among themselves or collectively organize their different priorities, budgets, or goals. In this configuration, a government faces enormous challenges to act as an informed owner given the decentralized nature of the monitoring and control of SOEs. Such asymmetries of information allow for more mismanagement by the executives of SOEs. Furthermore, as explained in the Introduction of this volume, having multiple ministries overseeing SOEs can also enable free riding in the monitoring, increasing the leeway the SOEs have to deviate from the government objectives. In sum, the decentralized monitoring of SOEs can increase the fiscal risk associated with the underperformance of these firms.

### **The State of SOEs in CCB6 Countries**

The market orientation of the CCB6 SOEs presented in Table 4.1 shows that on the aggregate, less than half of the entities declare to have a commercial purpose. Trinidad and Tobago appears to be the only country in the group whose commercial entities compose a significant majority among their portfolio of entities (71 percent). For the rest, and particularly for Suriname, the larger proportion of entities (61 percent) corresponds to noncommercial entities.

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<sup>28</sup> Vernon (1979) summarized the rationales for governments holding SOEs as follows: (i) to provide public services, (ii) to generate income for governments (levy taxes through monopolistic pricing), (iii) to champion specific industries in which private actors are unwilling to participate, (iv) to exploit international market power and control the terms of trade, (v) to act as key agents derived from bilateral trade agreements, and (vi) to champion implementation of industrial policy.

**Table 4.1. CCB6 SOEs by Type According to Self-Declaration**

Country	% by Market Orientation		Total Number of SOEs
	Commercial	Noncommercial	
Bahamas	52	48	31
Barbados	32	68	63
Guyana	41	59	61
Jamaica	47	53	163
Suriname	39	61	110
Trinidad and Tobago	71	29	126
Total Aggregate	49	51	554

Source: Author's elaboration using the IDB CCB6 State-Owned Enterprises Database.

Looking at the founding periods shows that of the 554 entities, the majority (62 percent) were founded during the second half of the 20th century, with relatively similar proportions of entities seeking commercial (47 percent) and noncommercial (53 percent) purposes. However, since the turn of the 21st century, noncommercial entities have been created at a faster rate than before. In fact, on average, 4.5 noncommercial entities were created every year during the current century, whereas the period 1950–2000 averaged only three noncommercial entities per year. So even though noncommercial entities are by no means new in CCB6 countries, they have become more popular in recent decades.

By founding numerous SOEs in the current century, CCB6 countries diverged from the path of most Western countries in contemporary times. In comparative terms, and excluding China, a review of 40 countries revealed that the average SOE portfolio comprised 64 firms per country (OECD, 2018b). Among CCB6 countries, the Bahamas, Barbados, and Guyana all hold SOE portfolios of a similar or smaller number. The other three CCB6 nations—Jamaica, Suriname, and Trinidad and Tobago—hold SOE portfolios of 110 to 160 entities, more than double the portfolio size found in the OECD study.<sup>29</sup>

The data displayed in Table 4.2 shows that one-third of SOEs were created under contemporary legal standards (post-2000s) and two-thirds under older standards (predating 2000). Thus, only one-third of the entities

<sup>29</sup> The figures reported by Korea need to be looked at with care because they vary over time as the government has the authority to designate government entities as public institutions depending on whether they meet certain requirements on employment, level of public funding, and other factors (Act of Management of Public Institutions of Korea, Act No. 14461, Dec. 27, 2016). The OECD (2018b) study reported 56 SOEs for Korea, while public entities were 339 in 2019, with 36 public corporations, 16 market-type public corporations, and 20 quasi-market corporations (KIPF, 2019). In the 2018 and 2017 reports, these figures varied.

**Table 4.2. Establishment of Government Entities over Time**

Country	Unknown date	1700–1850	1851–1899	1900–1950	1951–2000	2001–2020	All
<b>Commercial Entities</b>							
Bahamas				1	11	3	15
Barbados	3				14	3	20
Guyana				1	14	10	25
Jamaica			1	4	49	20	74
Suriname	1		1	6	25	10	43
Trinidad and Tobago	42				27	20	89
Total	46		2	12	140	66	266
%			1	5	64	30	100
# entities per year				0.24	2.8	3.3	2.2
<b>Noncommercial Entities</b>							
Bahamas					6	8	14
Barbados	3			1	26	13	43
Guyana				3	23	7	33
Jamaica		1		4	56	25	86
Suriname	6	1	1	4	35	20	67
Trinidad and Tobago	8				9	18	35
Total	17	2	1	12	155	91	278
%		1	0	5	59	35	100
# entities per year				0.24	3.1	4.5	2.3
<b>Total Entities</b>							
Bahamas				1	17	11	29
Barbados	6			1	40	16	63
Guyana				4	37	17	58
Jamaica		1	1	8	105	45	160
Suriname	7	1	2	10	60	30	110
Trinidad and Tobago	50				36	38	124
Total Number	63	2	3	24	295	157	544
%		0	1	5	61	33	100
# entities per year				0.48	5.9	7.9	4.5

Source: Author's elaboration using the IDB CCB6 State-Owned Enterprises Database.

are likely to rely on modern corporate governance regulation and demonstrate relative similarities across them, while the vast majority created in the 1950–2000 period are likely to have diverse and outdated legal standards, and, subsequently, varied corporate governance standards among SOEs and diverging standards between older and newer SOEs.

**Table 4.3. Number of Government Entities in CCB6 Countries, by Type and Country**

Country	Commercial			Noncommercial			Total			
	SS	PCS	Not defined	SS	PCS	Not defined	SS	PCS	Not defined	All
Bahamas	4	12		6	9		10	21		31
Barbados	8	12		31	12		39	24		63
Guyana	25			36			61	0		61
Jamaica	37	40		65	21		102	61		163
Suriname	21	22		63	4		84	26		110
Trinidad and Tobago	5		85	4		32	9	0		126
Total number	100	86	85	205	46	32	305	132	117	554
Percent	18	16	15	37	8	6	55	24	21	100

Source: Author's elaboration using the IDB CCB6 State-Owned Enterprises Database.

Note: "SS" stands for statutory SOEs and "PCS" stands for SOEs that operate under private company law.

Table 4.3 presents the legal type (SS or PCS) of SOEs, as categorized in the previous sections, according to market orientation. It shows that the CCB6 countries have significantly more entities legally structured under statutory orders (305 SSs) than under private company law (132 PCSs). This does not take into account the undefined legal structure of more than 20 percent of entities. The preference for SSs over PCSs is not as acute among commercial SOEs as it is among noncommercial SOEs. In fact, while the number of SSs is 16 percent more than the number of PCSs among commercial firms, among noncommercial SOEs the number of SSs is more than four times greater (i.e., 205 vs. 46). The preference for SSs among noncommercial SOEs holds across all CCB6 countries. Only 24 percent of SOEs are PCSs (132 out of 554), which means that a minor fraction of the SOE governance rules evolve with the general legislation, while most SOEs remain with idiosyncratic rules of governance.

In summary, CCB6 countries hold larger-than-average SOE portfolios, relative to international standards, and are more prone to establish these under statutory law in contrast to the 83 percent of SOEs conceived under private company law in the OECD study (OECD, 2018b). Additionally, as a major fraction of the CCB6 SOEs were created prior to 2000, the likelihood of a wide dispersion of SOE corporate governance standards across CCB6 countries is high and decentralized ownership appears to be standard for most countries.<sup>30</sup>

<sup>30</sup> Decentralized ownership for the Bahamas is portrayed in Hosein (2021), and for Barbados in Thompson, Alleyne, and Charles-Soverall (2019).

## International Best Practices for SOE Reform Regarding Corporate Governance and Fiscal Monitoring

The prospect of SOE reform in CCB6 countries benefits from a review of the best practices for SOEs' corporate governance and fiscal monitoring. The seven OECD principles for best corporate governance standards, mentioned earlier, are complemented by a scope of applicability condition (OECD, 2015a). The fiscal monitoring best practices are recommended by various international agencies and have been operationalized in developing economies across Latin America. These two aspects are revisited in the following section, which concludes with a summary of the main elements needed for SOE reform in CCB6 countries.

### Corporate Governance Best Practices for SOEs

#### *Scope of Applicability of SOEs*

The scope of applicability for SOEs' corporate governance practices does not correspond to any one of the seven OECD principles, but rather is an important element underpinning the guidelines. In essence, it compels governments to identify the relevant set of legal entities under their control to whom the principles of corporate governance ought to be applied. The distinction between a legal entity under government control and what in this volume is called a commercial SOE is whether the organization sells products and services for which there is or could be a market price. The pursuit of public policy objectives or the ability to collect fees from users does not determine the essence of the commercial nature of an SOE. Patent and trademark offices, civil registries, and other agencies charge fees for the services they deliver, but unlike commercial SOEs these entities are not to be regarded as SOEs for corporate governance purposes because their mandates are not to supply scarce commercial goods or services<sup>31</sup> but to offer public services that are characterized as "public goods."

#### *Rationales for Ownership Principle*

The applicability principle mandates governments to formulate SOE ownership policies and to define an implementation strategy for such policies. This means governments must clarify the rationales that justify the scope of economic activities undertaken by their SOEs. The policy must be accountable, disclosed to the public, and assessed and reviewed systematically in

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<sup>31</sup> Note that regulatory agencies do not exist to "supply" regulations to the market nor do they perform monitoring and enforcing duties to satisfy a demand for them from the regulated firms. Their origin is to improve the efficiency of market allocation.



the medium term. Basically, this principle states that governments need to reassess their prior decisions about having and maintaining their SOE portfolios and be open and transparent to the public on the rationales that justify current SOE portfolios.

### *The State's Role as an Owner*

The applicability principle conveys the importance of determining the set of routines and managerial practices that define and distinguish the various roles played by the government regarding its SOEs, for the purpose of distinguishing them from the other roles governments normally perform. To understand the relevance of this principle, it may be helpful to remember that governments have to regulate their SOEs (including performing enforcement duties) and define policy that affects them in general, plus mandate policy implementation to the appropriate SOE. On top of that, governments also must act as the owners of SOEs and therefore may have distinct objectives that may be usefully juxtaposed to their role as regulator.

Implementing this principle to the full extent implies that governments need to assign the exercise of SOE ownership duties to a specialized dedicated agency, distinct from those that perform the other roles of government (regulator and policymaker). In one dimension, this means that the various government functions need to be clearly mandated to and performed by distinct and separate bodies to avoid overlap in jurisdictions and meddling of one authority in the duties of another. In practical terms, implementing this principle means that a decentralized corporate governance structure likely to result from experiences such as those of the CCB6 countries, with diverse types of governance structures controlled by sectoral ministries, must be modified and reorganized into a centralized agency, which then behaves as the sole owner of all SOEs.

A common practice to attain this standard is to establish a *concrete wall* between sectoral political authorities (such as ministers, vice ministers, etc.) and the SOEs. Plainly put, no political authority should sit on an SOE board and have the power to manage the SOE as an appendix of the ministry that she leads. Ministers (or undersecretaries) may retain the power to appoint board members, normally under a collegiate body, but need to relinquish their authority to become directors or board members themselves.

### *Ownership Entity*

Once the distinction is made between different government functions, and ownership duties clearly defined, advocates of international best practices argue that the ownership function should be assigned to a centralized ownership entity. The duties of an ownership entity include the right to act as the main shareholder for all SOEs. As such, the ownership entity can resemble a holding company found in the private sector, concerned with its SOEs'

performance and empowered to monitor and act as an active and informed shareholder.

As will become apparent, the role of the owner advocated for by international best practices covers not only the structure of SOEs' board of directors but also includes the power exercised over the board by the ownership entity. In principle, these central oversight bodies are meant to be empowered to recruit, designate, and remove SOEs' board members. Furthermore, to ensure SOEs have sufficient incentives to fulfill their mandates, and to align the incentives between the SOE's management and the owner, the ownership entity needs to purposefully implement its monitoring powers. One way of doing so is through setting special benchmarks and directives on corporate governance, goals, and incentives schemes for the boards.

In the above conceptualization, the ownership entity is responsible for monitoring SOEs. Understanding that SOEs' performance may concern other public entities, avoiding overlapping competencies among government bodies becomes important to prevent a cumbersome and ineffective monitoring strategy for SOEs. In particular, the financial dimension of ownership normally falls at the core of the interests of the Ministry of Finance, and as such it is analyzed separately below. In contrast, the effects of SOEs on the economic sector or the particular industry normally concerns sectoral ministries in their roles as regulators or policymakers, but not as owners.

Achieving a clear separation between the SOE ownership and management roles of government and that of sectoral ministries is crucial to avert fiscal risk and to attain adequate economic performance of the SOEs. Improper separation of functions between SOE management and sectoral ministries makes SOEs vulnerable to becoming an instrument of quasi-fiscal expenditure, which is problematic. While fiscal policy is subject to many checks and balances from other powers of the state, quasi-fiscal expenditures face fewer layers of control and scrutiny, for the very purpose of achieving the desired autonomy for SOEs. If sectoral ministries are not prevented from being able to use SOEs as vehicles of quasi-fiscal expenditure, SOEs will overspend and their production will be inefficient, which will eventually lead to a push for increasing public funding: hence fiscal risk.

The ownership entity needs to exercise the voting rights of the SOE owner and undertake procedures that will positively affect SOE performance. The necessary processes include nominating directors to SOE boards, ensuring that independent audits are performed in accordance with the principal's interest, monitoring SOE performance to ensure that SOE goals are met, and evaluating the firm and the board's performance. Centralized SOE ownership agencies have been introduced by many developed and middle-income countries. There is evidence that SOEs under centralized schemes

outperform SOEs governed under decentralized ownership (Musacchio and Pineda Ayerbe, 2019a).<sup>32</sup>

Regular performance evaluations, in particular, appear to be a practice that is useful for ensuring that SOEs fulfill their goals. In so doing, the ownership entity is not supposed to replace or alienate SOEs' boards. On the contrary, ownership entities have to devise mechanisms and facilitate practices that engage all parties concerned with the SOEs' performance, such that the SOEs are compelled to comply with commitments made by SOE boards to the ownership entity, and so that both the owner and the public can verify whether promises made are met in a transparent and efficient manner.

Despite the advantages of centralized ownership bodies, there are still some cases of governments that have chosen to implement a less definitive approach to exercising ownership duties. Some countries have preferred hybrid or quasi-centralized SOE corporate government schemes for some of their SOEs. In cases like this, a central ownership agency governs most but not all SOEs. The case of Chile illustrates the hybrid ownership scheme. There, most SOEs are managed by a centralized ownership agency (Sistema de Empresas Públicas, or SEP). However, the government's SOE portfolio includes a few large companies that are too salient (in terms of their fiscal and economic impact<sup>33</sup>) to overlook their de facto leverage and power. Furthermore, it cannot be assumed that they would not use this power if they were under the jurisdiction of an intermediate entity placed between the SOE and the political authority. In order to avoid the emergence of informal channels of communication between SOE leaders and the perceived "principal" (minister or head of government), which would render the formal monitoring structures of the ownership entity inoperable, Chile decided to deploy an ad hoc corporate governance structure for such large companies.

### *Simplicity of SOEs' Legal Structure*

Because SOEs can have diversity of origin in temporal terms, legal structure, forms of property, or policy aims, in addition to the range of different economic activities they may perform, the "natural" outcome for countries not engaging in SOE reform is a decentralized ownership structure. This

<sup>32</sup> Examples in South America are the cases of Brazil (Department of Development of BNDES), Chile (SEP), Paraguay (CNEP), and Peru (FONAFE). Since 2016 Argentina has developed a scheme towards greater central control of their many SOEs. Among countries with parliamentary regimes that have established centralized ownership entities are Australia, New Zealand, Sweden, and the United Kingdom.

<sup>33</sup> Chile has four large SOEs: CODELCO, ENAP, BancoEstado, and TVN, each of whom have specific corporate governance regulations. In each case, regulation distinguishes the ownership function from other government functions (sectoral policy) by assigning the management of the company to a board and the owner's function to a body composed of a council of ministers that meets occasionally in shareholders meetings with the boards.

results in a complex legal structure for SOEs that generates dissimilar regulatory frameworks across SOEs and between them and private companies. This type of disparity is replicated in SOE corporate governance standards, hindering the exercise of ownership and monitoring functions by the appropriate government entity. Similarly, diverse and complex legal structures in SOEs are likely to generate problematic weaknesses in oversight such as loopholes, duplicities of monitoring tasks in different government agencies, inadequate transparency standards, or omissions in the governance structure of SOEs.

To avoid these problems, international best practices advocate for having simple and predictable legal structures for all SOEs. This means that governments must act to address cumbersome legal structures for governing their SOEs that have resulted from a decentralized ownership policy. In practice, this principle mandates governments undertake SOE reform to attain a simple and horizontal regulatory approach for all SOEs. Having simple and predictable legal structures for SOEs means subjecting SOEs to similar procedures regarding their duties towards different government agencies. In turn, this means that government agencies need to have a predictable policy and behavior towards companies, whether SOEs or privately held. SOEs that originate as PCSs will meet this principle easily, but not all SSs will have the same underlying legal foundation. The Chilean approach to this principle was to regulate SSs as if they were PCSs in all matters other than those specifically regulated in their statutes.

A corollary of this principle is to mandate SOEs to report financial matters in a fashion similar to private firms<sup>34</sup> and to comply with sectoral formalities and criteria as any other firm is required to do in the corresponding market when monitored by a specialized government agency, including the internal revenue service.

### *SOEs in the Marketplace*

The principle of SOEs in the marketplace presupposes that they behave as fair market competitors to other firms. Having simple legal structures for SOEs is helpful for the fulfillment of this principle. Whenever simplicity of

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<sup>34</sup> With regard to financial information for SSs, Chile progressed stepwise to simplify its legal structure. By 1959 the law required SSs to submit annual financial statements to the president and to the general comptroller complying with the standards of the public sector. The comptroller could include those statements in its own annual statement. By 1975, the law mandated that all SOEs, statutory or not, submit financial information according to the regulation of private companies. In 1982 the law (Article 11 of Law 18.196) stated that SOEs needed to publish financial statements in the same fashion as private firms, operate under annual budgets approved by the Ministry of Finance, and not be bound by the financial management rules of the public sector, other than in a few specific norms, and excluding the SOEs that fell under the scope of the Ministry of Defense.

SOE legal structures requires that SOEs be regulated similarly to private competitors and abide by the same market regulations as private counterparts, SOEs become fair market players. In practice, SOEs are meant to have no privileges relative to privately owned companies. Related to this, SOEs should not be expected to be exempt from tax policy.<sup>35</sup>

In addition, international best practices allow for remedial actions to be taken on behalf of private actors when disputes emerge between them and SOEs. This is intended to eliminate any form of immunity or favoritism bestowed upon SOEs. In practice, this principle implies that SOEs are expected to comply with regulations in the same fashion as a private sector firm. In addition, whenever SOEs operate in a regulated sector, international best practices call for the enforcement of regulations to be uniformly applied to all companies operating in the market, whether private, state owned, or under a PPP legal structure.<sup>36</sup>

### *Responsible Business and Stakeholder Relations*

The way SOEs deal with and build relations with their stakeholders constitutes an area of public interest that international best practices tackle openly. Adequate standards that govern the relations between SOEs and their employees, creditors, communities, or suppliers, among other stakeholders, are important for the sustainability of SOEs. The aim of such standards is to avoid SOEs engaging in corrupt practices or being captured by specific stakeholder groups, including political elites.

Responsible SOEs ought to consider the impact of their actions on their stakeholders in the locations in which they operate. Responses by SOEs to any challenges therewith are to be overseen by their respective boards of directors and the standards applied should be set and monitored by the respective ownership entities. In this regard, the application of adequate standards for regulating conflict of interest between suppliers, employees, managers, and board members,<sup>37</sup> and the transparency of the policies that SOEs establish in terms of their corporate social responsibility (CSR) policies,

<sup>35</sup> Some countries place an extra tax burden on their SOEs, relative to private companies. In Chile, SOEs pay a specific tax levy on top of the general corporate tax (40 percent of profit, Article 2 of Decree Law 2.398 of 1978).

<sup>36</sup> Historically, Chile has been implementing this principle for SSs since 1982 when it mandated all SOEs to comply with the same standard of financial transparency required for private firms. Later on, it began to include private law regulation to the SSs' statutes in 1998 port law and perfected the drafting with the CODELCO law in 2009 to later master the legal drafting in 2017-2018 with the ENAP and TVN legislations that bind the SSs to the private company law regulation in every matter not specific to the SOE in the statute.

<sup>37</sup> SOEs that are regulated under private company law may need to follow the standards applicable to listed companies, in addition to any specific regulation that the public sector may have in this realm.

are particularly relevant. When determining CSR policies, SOEs need to consider any binding limitations they may face.<sup>38</sup>

### *Disclosure and Transparency*

It is impossible to overstate the importance of transparency and disclosure of standards that govern SOEs. International best practices advocate that as fair market players SOEs need to follow disclosure and transparency standards comparable to those of private companies. This means periodical and standardized reporting on the SOEs' businesses should be implemented. Given the relevance of SOEs to national economies, fulfilling the disclosure and transparency standard implies consenting to external audits, regularly publishing financial statements, internal audit committees within the boards of directors, and the use of accounting and financial reporting standards similar to that of private companies, at a minimum. In most cases, these standards imply publishing audited financial statements at least annually. To the extent SOEs are PCSs and therefore conceived as private companies, the standard of transparency required would already be met. If not, then transparency standards must first be set and then complied with, particularly for SSs.

The above standards, however, may not suffice because democratic societies recognize that the public and the citizenry have rights of oversight on government actions, to which they are not entitled in regard to the private sector. Therefore, to the extent that SOEs depend on the government and its supervision, they are obliged to address the public's interest in a way that private listed firms are not. This means that while it may be sufficient for SOEs in some sectors to mirror the transparency standards and disclosure policies of private companies, in other sectors, the standards for SOEs are expected to be generally stricter and skewed towards greater openness. The existence of general comptrollers with some supervisory powers over SOEs does not preclude the need for additional layers of control and supervision, beyond those that govern private companies. The balance is delicate for SOEs that compete in contestable markets, so that the layers of supervision do not become impediments for them to compete fairly.

An example of higher standards of transparency and disclosure for SOEs is the requirement to disclose the remuneration and compensation of top management and board members, as well as the gender divide in management and in aggregate employment. In this respect, ownership entities may be very useful in developing corporate governance policies for SOEs

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<sup>38</sup> An inadequate SOE CSR policy surfaced in 2008 in CODELCO (Chile). The SOE was found to have misbehaved when it announced a donation for a charity (Teletón). The announcement was objected to by a politician and requested a ruling from the general comptroller. Shortly after, the comptroller stated that SOEs had no power to allocate resources for purposes other than those set in their respective statutes, rendering sizable donations illegal (see ruling Contraloría General de la República N° 55.616, November 25, 2008).

through management routines that can enhance and enforce stricter transparency and disclosure standards.

### *The Boards and Their Responsibilities*

Boards need to develop or approve strategic business plans and short- and medium-term objectives, and to ensure that the SOEs carry out the expected economic performance implied in such plans. The ability of SOE boards to deliver the firms' expected outcomes relies heavily upon the capacities of the individual board members, their combined abilities, and the empowerment of boards to carry out their duties. In the end, it would be up to the ownership entity to find and recruit prospective board members in a manner that favors diversity, both in terms of fields of talent and in terms of gender.

For boards to deliver what is expected of them, they need to be adequately empowered, be fully accountable for their decisions, and treat other shareholders equitably. Meaningful empowerment of the boards requires that they hold the power to appoint CEOs. Being accountable for their decisions implies that they should be liable for any material damage caused to the SOEs through negligence or imprudence. Board members are expected to be objective in their decisions, and for this they must be transparent and explicit about any possible conflicts of interest. SOEs' board members and top management are expected to submit comprehensive, opportune statements of their material interests and patrimony, which are then made available to the public or monitoring bodies such as general comptrollers.<sup>39</sup>

Finally, boards are expected to take actions to monitor company policies regarding risk management, remuneration, and internal audits. Boards are expected to be subject to performance evaluations, for which ownership entities are expected to be able to provide clear guidelines and be ready to act as an informed shareholder.

### **Fiscal Monitoring**

The fiscal domain of ownership is transversal to all SOEs. The fiscal aspects of SOEs involve competencies of ministries of finance (MOFs) and therefore are separate from those of the ownership entity. Keeping them apart helps

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<sup>39</sup> Although many countries provide for the submission of public statements of interest and patrimony for key public servants and congresspeople, this obligation may not always reach to the level of SOEs' CEOs and boards of directors. Depending on the type of SOE (SS or PCS), SOEs' directors and CEOs may only be bound to submit statements if the SOE is regarded as a listed company when the law provides for such a standard (which may not be as strict as that required for key public servants). In 1999, Chilean law stated that SOEs' directors were subject to public probity norms, regardless of the regulatory structure of the SOE (statutory or company law, see Article 37 of Law 18.046). This regulation implied that directors became subject to submission of public statements of interest and patrimony. In a subsequent reform in 2016, SOEs' directors were explicitly targeted in this domain.

to avoid unnecessary friction between government agencies. MOFs tend to have quite specific concerns regarding SOEs. Although they may express genuine interest in monitoring SOEs' and boards' overall performance, the nature of these ministries restricts the scope of their monitoring duties to specific aspects of ownership distinctive and exclusive from those of the ownership entity. The primary, and most common, areas of SOE fiscal monitoring practices are described in the following subsections.

### *Authorization to Incur Debt*

Most MOFs exercise strict control over the SOEs' capacity to obtain credit from lenders. This monitoring concern appears to be advisable for several reasons. SOEs' credit is normally regarded by lenders as backed by a governmental guarantee, regardless of whether such a guarantee is explicit in the loan contracts (Jara, Wagner, and Musacchio, 2019). This assumption enables SOEs to access credit more easily, more readily, and at cheaper rates, despite the quality of the performance displayed by SOEs' management. Given that fiscal debt undertaken by the central government requires the authorization of the legislative body, credit undertaken by SOEs, which can result in fiscal debt ex post, demands a watchful exercise of monitoring and control by the government's fiscal authority.

### *Explicit Procedure and Regulation of Bilateral Flows (Dividends, Capital Supply, Current Transfers)*

Financial authorities need to include SOEs' budgets in their own definition of the public budgets to be presented to legislative authorities whenever flows of resources are expected to take place, either to support government funding or to demand resources from the fiscal coffer. Governments need to anticipate and assess the degree of certainty of the expected flow of resources in either direction, whether the amount of subsidy to be paid to SOEs for implementing specific public policies or income to be received from SOEs to finance public policies.

In order to operate effectively, MOFs and SOEs alike require sufficient levels of certainty regarding the timing and amounts of resource flows that may take place between them within a given period of time. MOF financial needs may exert unduly onerous demands on resources from SOEs that generate income for the government (usually those related to the exploitation of natural resources such as mining activities, including the extraction of hydrocarbons). These demands, which may take the form of payment of excessive dividends, imposing restrictions on investment projects, and so forth, could inflict harm on the financial and economic health of SOEs. Similarly, jealousy and strategic maneuvering on the part of the SOE in regard to their financial resources, possibly in anticipation of the aforementioned extractive attitude of the fiscal authority, may also harm the financial health of the MOF.



Resolving these recurrent tensions between SOE management and other stakeholders may require mediation. Ownership entities can prove useful in mediating these types of tensions and disagreements. But in practical terms, the primacy of the MOF tends to limit the scope of such mediation.

### *Control on the Number of Employees*

At one extreme, there are countries like Sweden, with robust ownership entities that perform lax fiscal monitoring apart from setting defined standards regarding fiscal inflows. At the other extreme, there are countries with excessive monitoring from their ownership entities that may imply comprehensive regulations, such as those regarding the management of human resources. In the middle are countries that do not regulate or monitor human resource decisions taken by SOEs but oversee only specific budgetary aspects of human resources management policies.

The flexibility of SOE management rests on its ability to define the best course of action under different circumstances, such as having the ability to hire collaborators and to define the number of employees they hire. In many countries this function is regulated by private labor law. However, the economic performance of SOEs rests heavily on their staffing decisions. Striking the right balance of control and monitoring of these types of operational costs, on the part of the MOF, and the flexibility to set human resources policy, on the side of the SOE, is a delicate and tricky task. In the case of Chile, the MOF set caps on staffing of workers, general compensation policies for collective contracts, and collective negotiations. Other than these aspects, SOEs have freedom to regulate human resources.<sup>40</sup>

### *Supervision over Major Investment Projects*

Public investment is one aspect of SOE activities that is of specific concern to the MOF. Normally, public investment procedures are regulated, and this regulation includes investment undertaken by SOEs. For example, in Chile, irrespective of the sources of funding, SOEs' investment projects are required to be listed and prioritized formally by the MOF.<sup>41</sup> They also must fulfill the social financial profitability assessment that regulates public investment in general.

## **Highlighting the Basic Elements for SOE Reform in CCB6 Countries**

### *Fiscal Monitoring*

Fiscal monitoring on the same terms as elaborated previously is needed. The responsible unit(s) at MOFs need not have a high number of personnel

<sup>40</sup> For instance, one such policy is to set upper limits to indemnizations payable when terminating labor contracts and to make them binding for all SOEs.

<sup>41</sup> The procedure is done once a year and a list of investment projects and their amounts are identified in an MOF decree, which is a necessary condition for the investment to be undertaken.

but rather a few highly qualified staff members. The authority of the unit is subject to the authority vested in the MOF, and the personnel in the unit would implement control over SOEs' investment, borrowing, budgeting behavior, and employment benchmarks accordingly.

### *Transitioning towards a Centralized Ownership Entity*

As mentioned, the OECD guidelines advocate for a clear separation of the role of SOE owner from other government competencies in regards to SOEs, and at least among Latin American countries, the evidence supports this advocacy (Musacchio and Pineda Ayerbe, 2019a). In numerous countries, ownership entities in charge of SOE governance fall administratively either under the influence of the MOF (as in Australia, Paraguay, Peru, or the United Kingdom) or under the Ministry of Economic Affairs and Innovation or Trade and Industry (such as in Chile, Norway, or Switzerland). In the CCB6, the SOE units at the MOF fulfill neither the fiscal monitoring duties nor the ownership duties of the government because they do not have the administrative capabilities to monitor the vast number of SOEs these countries have, thus preventing them from acting as a single owner in the fiscal or ownership domain.

Ownership entities can fulfill their duties under the architecture of a government agency within the government bureaucracy. Although some countries have chosen to regard such entities as SOEs themselves (such as the Coordinating Company for State-Owned Enterprises of Ecuador, known by its Spanish acronym "EMCO"), there is no evidence that there is any advantage in such a strategy. Government ownership entities are in essence monitoring bodies, and as such the government bureaucracy may be adequate, inasmuch as it enables acquiring human resources with the appropriate competencies and providing attractive enough compensation to limit high turnover and loss of accumulated experience in very technical skills, such as the ones performed by ownership entities.<sup>42</sup>

The real challenge of SOE reform is transitioning from a decentralized ownership framework to a centralized one. In the case of CBB6 countries, the size of SOE portfolios poses a special challenge; monitoring this many entities is difficult in general and will prove an obstacle for a meaningful transition to a centralized framework. The risk of this transition is creating an overstaffed agency aiming to monitor a large portfolio. Governments should bear in mind that these entities can function effectively with as few as one or two dozen professionals, depending on the portfolio size.

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<sup>42</sup> The experience of Chile in this respect is notable. A significant percentage of the technical personnel that performs the monitoring duties of the ownership entity, SEP, has remained in office over several government administrations since 2000, when SEP took its current legal structure. In practice, they are governed under private labor law, but are regulated by government law in every other aspect of their functioning.

The main challenge is to acquire enough momentum to achieve SOE reform. Chile attempted to undertake such a transition towards a centralized model during the 1997–2003 period. It was a stepwise transition, with several elements that contributed to improved corporate governance structures in the early 2000s. First, an ownership entity was created to delegate the ownership functions residing in a government agency that owned many PCSs (e.g., CORFO) to an autonomous but related body (SEP). Although aspects of centralized ownership had existed for all CORFO's SOEs created under corporate law since their outset, CORFO's bureaucracy also meddled with the policy mandates of these firms, hindering full execution of the ownership function. Thus, in 1997 and in 2001, the ownership duties of CORFO's SOEs were transferred from a department of CORFO into an entity outside the bureaucracy, yet still under its purview. Through this reform, the new ownership entity obtained the authority to nominate the board members of CORFO's SOEs by delegation and therefore to perform the monitoring duties that were derivatives of the competencies of the owner under private company law. At the same time, SSs outside the scope of the development agency had statutes that provided for specific parameters for the nomination of their board of directors, configuring a decentralized ownership structure for such SOEs.<sup>43</sup> In 2002, a political scandal—which revealed an unlawful scheme built to facilitate compensating civil servants for their work in the concessions area at the Ministry of Public Works—facilitated SOE reform for the SSs.<sup>44</sup> The scandal triggered formulation of a new regulation for civil servant compensation, and through this effort, Congress gave the authority to the government to change the manner of appointing boards of SSs whose operations depended more on central government financial support and generated fiscal risk (the railroad and the postal service SOEs). The new regulation gave the ownership entity the authority to nominate board members for these SSs, strengthening the authority and public credibility of the ownership entity. The same type of SOE reform was applied in the case of the 10 port SSs.

In practice, it is plausible that the civil service regulation of 2003 was used as an opportunity to make long-wanted changes to SSs that relied heavily on inflows of fiscal resources. Until then, no political leader had expressed open

<sup>43</sup> These SSs are ASMAR, BancoEstado, CODELCO, Correos de Chile, EFE, ENAER, ENAMI, ENAP, FAMAE, and TVN.

<sup>44</sup> The referenced scandal is known as the MOP-GATE case, which resulted in the Minister of Public Works serving time in prison. Although MOP-GATE involved criminal offenses, the case helped to unearth other practices used to unjustly remunerate civil servants of high professional profile, which were eliminated through the reform. One practice was using SOE board chair seats as forms of compensation for high-ranking civil servants. The new law put a cap on the extra remunerations to be paid on top of public salaries for highly ranked civil servants, and one of these remunerations included the stipends received as board members of SOEs.

and strong enough support for SOE reform to curtail cronyism and to exercise strict monitoring, although the diagnosis of poor monitoring on behalf of the SSs' owner was already well established.<sup>45</sup> The 2003 reform took place only after a positive example of a good corporate governance model for SOE ownership was provided by the functioning centralized ownership entity (SEP), and the decentralized ownership model still in use revealed important monitoring problems and heavy fiscal risk for other SSs. This context led the administration of President Lagos to change the statutes of two old SSs (postal service and railroads) and 10 newly created public port SOEs and to transfer the authority to nominate board members to the SEP ownership entity.<sup>46</sup> The remaining SSs continued outside the scope of the SEP ownership entity but developed adequate corporate governance rules.<sup>47</sup>

Below is a description of the main functions that such entities normally perform.

### *Board Members' Nomination*

One of the most important functions of an ownership entity is to be able to nominate board members. It is quite common that SSs have set a mechanism in their statutes determining who are to be appointed as board members and how this process should be conducted. In many cases, the political authorities are expected to form part of the SOEs' boards. Such appointments are inconsistent with international best practices primarily because they preclude the separation of functions that the government must undertake with respect to their SOEs from those in the interests of the SOEs themselves. To eliminate the problems that derive from arrangements of this sort, countries need to transfer the powers for board nominations vested in political authorities to ownership entities.<sup>48</sup> Normally, this type of change is a matter of law; however, for SOEs regulated under company law, the government agency holding control of the shares retains the authority to nominate shareholders. In such cases, they can directly delegate the authority to the ownership entity.

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<sup>45</sup> An antecedent to the MOP-GATE case was another scandal that revealed generous retirement compensation paid to former managers of one SS in 2000 (ENAMI). Also in those years a high official of the railroad SOE was accused of corruption, but after a long criminal process he was cleared of all charges.

<sup>46</sup> In Chile, this reform was the outcome of Article 6 transitory in Law 19.863 of 2003, and the Decrees with Force of Law N. 22, 24, and 25 of 2003.

<sup>47</sup> The corporate governance structure of the large SOEs was improved in 2009 for CODELCO and in 2018 for TVN and ENAP. BancoEstado had an adequate corporate governance regulation since 1978. The remaining challenge is ENAMI, whose corporate governance standard needs to be updated.

<sup>48</sup> In practice, there are some countries in which the political authorities retain the authority to nominate board members (such as in Peru or Sweden), but in practice it is the ownership entity who performs the task of selecting the candidates and produces the short lists given to the nominating authority who formalizes the decisions.

### *Performance Supervision and Evaluation of SOEs*

A critical monitoring task that an ownership entity needs to perform is to devise SOEs' performance evaluation schemes. The balance that must be struck here is to devise appropriate schemes without overstepping the responsibility of the boards in managing SOEs. Instead, ownership entities need to supervise with the objective of seeing that goals set by the boards of SOEs for a specific period are met. Performance evaluation schemes examine deviations from the goals at the end of each period (in some cases with pecuniary incentives); in practice, boards usually apply the incentive scheme to the SOEs' personnel.

Related to this, monitoring duties of ownership entities also include monitoring the performance and functioning of the boards, such as frequency of meetings, reporting of board activities, publication of the board subcommittee reports, etc.

### *Soft Law (Guidelines)*

Ownership entities are frequently found to assume a soft regulatory function by setting governance routines for their SOEs. This soft regulatory approach is advisable, because it allows for flexibility of implementation across different SOEs, while also allowing modification of the standards over time whenever necessary, without requiring the intervention of the legislative branch of government.

Regulations that cannot be enforced may not seem useful. However, soft regulation does not equate to unenforceability. On the contrary, SOE compliance to soft law standards can be encouraged through SOE performance evaluations and evaluations of board performance. This practice facilitates alignment between the incentives of the boards and those of the ownership entity.

### *Budget Procedures and SOE Performance Evaluation Schemes*

The budgeting schemes of SOEs are normally undertaken within the framework of private company law, although in practice their formulation often overlaps with the administrative requirements imposed by the fiscal authorities. In particular, the two domains may not need to coincide, but the timing defined by fiscal authorities prevails for SOEs' own planning activities. The frequent occurrence of this type of misalignment is not particularly troublesome.

More relevant is how centralized ownership can use these budgeting procedures to their advantage, by linking budgeting information requests made by the MOF in such a way that builds upon SOEs' performance evaluation schemes. Similarly, the financial transparency requirements derived from private company law also provide leverage for the ownership entities when making their information requests to the SOE. This information provides valuable inputs when carrying out periodic SOE performance evaluations.

Some developed societies are opening the budgeting procedures to the citizenry, with increasing degrees of transparency and higher levels

of public engagement. The extent to which this becomes proactive on the part of SOEs is an open issue. Ownership entities can play an important role in facing this challenge, without the need to rely on legislative reforms. They can devise increasing standards of transparency and adequate avenues of participation in their SOEs through soft law making, striking a balance between public accountability and firm competitiveness. The means are the inclusion of novel standards in performance evaluation schemes.<sup>49</sup>

### *Report to the Government (Executive, Congress, and the Public)*

Ownership entities have powers vested in them as representatives of the government ownership stake in SOEs. In this capacity, ownership entities face the challenge of reporting SOEs' activities and performance to the public and to the different relevant authorities with regularity and transparency.

## Conclusion

Good SOE corporate governance practices comprise an important element of SOEs' de facto capabilities to carry out their mandates and deliver upon public expectations. These standards tend to determine whether governments can adequately distinguish between the different roles they play with regard to SOEs: at a minimum, (i) ownership, (ii) regulation and rule enforcement, (iii) policymaking, and (iv) financing.

Complex and differential treatment or regulation across SOEs make it difficult for governments to attain SOEs' desired outcomes and to fulfill SOEs' mandates. Diverse corporate governance regulation and inadequate fiscal monitoring protocols across SOEs hinders the ability of governments to adequately oversee costs of SOEs and to obtain expected inflows of income or know with certainty the outflows (in the form of subsidies) that SOEs may demand from the government. More generally, disperse corporate governance regulation challenges the competitiveness of SOEs and consequently may affect private companies nationally and internationally. Governments may end up focusing their efforts and resources on financing ill-managed SOEs instead of on their government programs. Governments may desire to engage in SOE reform but lack sufficient impetus to undertake it; in this scenario, they may be forced to take extreme measures when in crisis (political or economic). Ultimately, they undertake SOE reform to adopt international best practices or divest.

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<sup>49</sup> The current advisory commission for transparency and efficiency of the public expenditure in Chile discusses this issue to promote adequate and up-to-date standards of citizenry participation and transparency in different forms of public expenditure (direct and indirect, current and time distant).

Performing a separate role as SOE owner requires that governments become and act as informed shareholders that actively pursue the firms' aims. Acting in such a manner depends critically on the ability of governments to act through specialized ownership entities. This is not atypical, as governments tend to find it advisable within their long-term interests to overcome uneven SOE regulation that hampers their ability to properly monitor the economic performance of SOEs. At the same time, experience shows that this evolution does not always happen naturally but occurs when facing imminent crisis.

Acknowledging that the history of SOEs may produce different institutional features that tend to be case specific to each SOE, either due to the type of SOE (SS vs. PCS) or due to the historical period in which they were created, institutional evolution towards centralized ownership policy will hardly happen naturally. Decentralized ownership is the default standard, quite common among developing countries like those of the CCB6, but it is not a good standard. However, centralized ownership has become popular in South America whereby Brazil, Chile, Ecuador, Paraguay, and Peru have been perfecting their ownership policy through increased centralization. Facing financial crises, financial scandals or adherence to international treaties have been used to initiate and deepen these types of SOE reforms.

As mentioned, corporate governance best practices promote avoidance of differential corporate governance treatment of SOEs within one country and therefore also promote the idea of centralized ownership entities. These entities are expected to perform several shareholder duties, such as selecting and nominating board members, performing evaluations and developing performance targets, developing corporate governance policy, and assisting sector ministries in steering SOEs to attain their desired outcomes. However, the overwhelming dominance and de facto power of some large SOEs indicate that setting ad hoc corporate governance regulation for such large SOEs cannot be discarded, though the strategy is not exempt from risks.

The international best practices for corporate governance reviewed in this article are shared in an effort to help CCB6 governments to better perform their ownership role, knowing that the practices advocated here have been adopted successfully in countries despite different types of economies (developed and less advanced), political systems (parliamentarian or presidential), SOE legal structures (statutory vs. those created under corporate law), SOE age (new or old), or the sector or purpose of the SOE. The CCB6 should recognize in these principles powerful allies for improving their government policies. Because changing the status quo may be difficult, international leverage may be required, either from international funding bodies or from international forums.

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## CHAPTER 5

# Institutional and Regulatory Framework of SOEs in the CCB6: A Need for Harmonization to Reduce Fiscal Risk and Increase Productivity

### Introduction

In previous chapters of this volume the authors have shown that state-owned enterprises (SOEs) in the Caribbean have historically been an important tool for development, but that in recent years their underperformance has generated a variety of fiscal costs and risks. To a large extent, the problem of SOEs in the CCB6 countries—the Bahamas (BHS), Barbados (BRB), Guyana (GUY), Jamaica (JAM), Suriname (SUR), and Trinidad and Tobago (TTO)—can be linked to the institutional framework used to monitor their performance, a lack of capabilities to conduct such monitoring, and the precarious role in which their quasi-fiscal or social objectives place them.

This chapter examines the institutional and regulatory framework of SOEs in CCB6 countries. According to the World Bank (2014), a clearly defined legal and regulatory framework for SOEs is essential for communicating key expectations to SOE shareholders, boards, management, and all other stakeholders, including the general public. The OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015) also suggest a clear separation of the ownership role of the government, the centralization of the ownership role into one ministry or agency, the standardization of legal forms of SOEs (preferably having commercial SOEs adopting the corporate form), and overall improvements in transparency

and clarity in the objectives of SOEs. Recent work of the Inter-American Development Bank (IDB) (Musacchio and Pineda Ayerbe, 2019) also emphasizes the importance of improving monitoring and transparency of SOEs to reduce the fiscal risks they impose on their owners—requiring frequent capital injections and occasionally large bailouts. Improving the role SOE units and agencies play to act as owners also improves the performance of these firms and hardens the budget constraint they face, thus reducing fiscal risks.

Some of the recommended institutional and regulatory frameworks for SOEs are already in place in the CCB6. Yet, many of the SOE units lack teeth to exercise their role as owners, and in most countries governments still have a two-tier monitoring structure (i.e., with a line ministry and the Ministry of Finance doing the monitoring of an SOE), in which line ministries are often more powerful than the Ministry of Finance (MOF) in exercising control over the enterprises they oversee. These line ministries also have disproportionate power to create new SOEs and are often not subject to the oversight of the SOE monitoring units or committees that are usually part of the MOF and that analyze the feasibility of new public enterprises. Previous chapters have shown that SOEs in the CCB6 perform significantly worse than in other regions, even adjusting for scale. This suggests that the frameworks are either not effective or not being implemented properly, both because of the lack of political will and because of how costly they are to implement in small economies. This chapter discusses both problems.

Moreover, this chapter also uncovers three additional features of the institutional and regulatory framework of SOEs: (i) no standardized legal form for SOEs across countries and the logic behind specific legal forms within countries is not clear; (ii) significant corruption in the region; and (iii) transparency initiatives are still a work in progress, especially for SOEs. That is, there is a need for the legal forms of SOEs to clearly reflect the key expectations and objectives of these firms. There is an opportunity to move more noncommercial SOEs from public to private law, such as not-for-profit or association law. As is the case with corporatization—that is, the adoption of corporate features in organizations that do not operate under corporate law—the shift to private law should improve governance, monitoring and evaluation, and productivity.

The CCB6 countries are deficient in the designation of the establishment of SOEs as well. There is no independent committee that carries out the creation of an SOE. The establishment is essentially at the behest of the line ministry and does not require thorough deliberation. Importantly, there is a need for harmonized codes of corporate governance as well as better monitoring and evaluation (M&E) frameworks across these and other countries. The CCB6 could use assistance in providing harmonized templates for corporate governance and M&E frameworks.

In small developing countries, the competitiveness and productivity of SOEs may even be more important because of scarce resources, both in

relative and absolute terms, while the need for measurable developmental outcomes is preeminent. SOEs that provide key public services and fulfill important social objectives must deliver the needed outcomes efficiently and effectively, purely commercial SOEs must deliver dividends to finance the inputs, and those SOEs with both a commercial and social purpose may have to provide the necessary infrastructure efficiently and effectively.

Finally, there are significant transparency and corruption concerns across the CCB6, in particular in commodity-exporting countries. Corruption in Jamaica, Suriname, Trinidad and Tobago, and especially Guyana is high, even when compared to similar island nations. The added value of good governance of SOEs in small countries is high. The likelihood of conflicts of interest, nepotism, or cronyism is high because of the small size of the countries and subsequent small pool of potential board members and close relationships between them. Opportunities for advancement in terms of income or prestige are limited, perhaps giving rise to less-than-honorable practices in order to get ahead.

This chapter addresses these issues and provides a variety of recommendations to improve the future of SOEs in CCB6 countries that may be applicable to other nations in the region as well.

## SOEs and Their Legal Forms

The previous chapter elaborated on some of the complications that emanate from the fact that SOEs take a variety of legal forms across and within CCB6 countries. In these nations, noncommercial SOEs, including most regulatory agencies as well as education and health-care entities, are established by individual statutes, following a framework inherited from their colonizing country (the United Kingdom or the Netherlands). In Suriname, the only country in the group with a non-Anglo-Saxon colonizer, noncommercial SOEs may also be established under private sector law, with nonprofit statutes, and as foundations (*stichtingen*).

In Barbados and Guyana, commercial SOEs are established only by statutory law (e.g., Government of Barbados Enterprise or Guyana Public Corporation). In Jamaica and Trinidad and Tobago, commercial SOEs are established under private commercial law only as limited liability companies or corporations. In the Bahamas and Suriname, commercial SOEs can be established under either statutory law (statutory corporations in the Bahamas and *sui generis* companies in Suriname) or under private commercial law. In the Bahamas, these statutory corporations can have additional shareholders, they can be publicly traded, and the government of the Bahamas can be a majority or minority shareholder. Such is the case with the Bank of the Bahamas, the Arawak Port Development, and the Bahamas Telecommunications Company. In Suriname, statutory commercial companies do not issue shares and the government has sole ownership; only commercial SOEs established under private commercial law can have shareholders—this form

is often used for instances in which the government partners with the private sector in public-private partnerships (PPPs).

Allowing only two legal forms for the establishment of SOEs, as is the case in four out of the six CCB6 countries, may simplify the regulatory framework. However, clarity of objective seems to be lost in the simplification. The expectation of a commercial SOE, especially those established under private law, is clear: the goal is to make a profit or at least to be financially sustainable. Yet, in practice, 24 percent of limited liability companies are either partially or fully funded by their shareholder (the government). About 10 percent also receive a subsidy, presumably to fulfill public policy. The extent to which the SOE is responsible for implementing public policy is not clear solely from the legal form. For example, the Jamaica National Agency for Accreditation and the Youth Training and Employment Partnership Programme Ltd. (YTEPP) of Trinidad and Tobago were established as limited liability companies, though it is likely that they have a social-economic rather than a commercial objective.

In addition, the objectives of the noncommercial statutory SOEs are quite diverse. In Jamaica, this group includes the River Rafting Board and the Civil Aviation Authority as well as the Petroleum Corporation of Jamaica (i.e., the former national oil company in charge of operating oil and energy exploration in Jamaica, not to be confused with Petrojam, which is a partially privatized oil and gas company traded in the stock exchange).

When there are many legal forms, the link between organizational form and commercial or noncommercial orientation of the firm is not always clear, as is the case in Suriname. There, the National Hospital (Stichting s' Lands Hospitaal), established in 1760, is a foundation, while the Psychiatric Centrum (Psychiatrisch Centrum Suriname), established in 1895, and the Academic Hospital (Academisch Ziekenhuis Paramaribo), established in 1966, were nationalized (*landsbedrijven*) in 1973, which results in a form similar to statutory SOEs.

In exploring further distinctions between legal types and the rationalizations of SOEs in the CCB6, the following section will begin to illustrate why it is important for the CCB6 countries to embark on governance reform together, resulting in more standardization in terminology and templates. Currently, each country uses different legal forms and terminology for similar SOEs and has different rationalizations for similar forms. This makes it difficult to readily compare and benchmark public financial management (PFM) and SOE performance, which subsequently hinders knowledge sharing and attractiveness to investors. In a sense, there is a need for an integration in regard to SOE legal entities similar to that which EU countries have embarked on in regard to trade and investments.

### Rationalization of SOEs' Legal Forms

By the broadest definition, SOEs are entities over which the government exercises financial control or is in a position to direct the policy of that entity. As

this definition can refer to numerous depictions and structures for SOEs, it is useful in our efforts to assess fiscal risks to further categorize SOE characteristics. There are three primary means by which governments rationalize SOEs: presence of an economic objective, establishment by statute versus quasi-governmental, and constituted under either private or public sector law.

### *Commercial and Noncommercial Objectives*

Interestingly, statutory forms of SOEs (individual or unified act of parliament or private law) do not consistently correspond to an economic objective (or a noneconomic objective). While patterns may be observed (as noted in the preceding section), the legal form of an SOE is not a clear indication of whether the firm has an economic objective (more commonly referred to as a commercial purpose). A firm is considered to have a commercial purpose if any or all of the following items are true:

- One of its objectives is to produce financial gain.
- It has economically significant prices, also referred to as “market prices.” Jamaica’s Categorization and Rationalization of Public Bodies (Government of Jamaica, 2016) states that these prices are such that “sales cover the majority (*over 50 percent*) of the producer’s costs.”
- It serves a significant economic function, essentially meaning that there is substantial market demand for the products or services provided by the SOE (OECD, 2015). A telecommunications company is a good example, but not so much a board of education or maritime authority.

Most, but not all, SOEs are constituted by legal statutes. In Barbados, Guyana, Jamaica, and Trinidad and Tobago, public bodies are explicitly defined as those corporate bodies that are not suited to be part of a ministry and are therefore separate bodies controlled by the government and answerable to the legislature. Quasi-governmental entities are a type of SOE that is not constituted through a legal order. They are not separate bodies but are granted sufficient independence to be able to present a complete set of accounts, while the governmental authority acts a shareholder (IMF, 2014, 13). In the CCB6, only the Bahamas appears to have quasi-governmental entities.

### *Constituted under Public Law or under Private Law*

SOEs in the CCB6 may be constituted by statute in three forms (for more detail by country see Table 5.1):

- Individually by an act of parliament, making them a statutory body.
- Through a unified law that is only applicable to SOEs (for example, the Government of Barbados Enterprise, the Public Corporations Act of Guyana, and the Law on National Companies in Suriname).



By private law, which is also unified but is not exclusive to SOEs. For example, commercial codes, companies act, nonprofit act, etc.

SOEs established by an individual or unified act of parliament (or law) are generally divided into two main categories: statutory corporations and statutory boards. Statutory SOEs with a largely economic objective are commonly established as statutory corporations and typically aim for financial self-sufficiency. The government is usually the only shareholder, though in some cases other SOEs are co-shareholders. “Body corporate” refers to the fact that the entity is a legal person, separate from its stakeholders. Typical statutory corporations include utility companies such as waste management, telecommunication, power, and water. In the CCB6, these entities can be and often are established either under their specific statute or in a collective statute, as is the case in Suriname.

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#### **BOX 5.1. ARE REGULATORY AND STATUTORY BOARDS FOR PROFIT?**

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A regulatory board, established as a statutory board, that levies fees is not legally engaged in a commercial activity, despite the fees generating a financial return for the government. Regulatory bodies may collect fees for lotteries, gaming, casinos, racing, or other gambling activities, and these are typically structured so as to produce a return for the government. In some countries, this is also the case for fees related to telecommunication licenses. If established as a statutory company, a telecommunications firm (e.g., Telesur in Suriname) is also not considered to be involved in commercial activities, even if it generates a profit.

The ramifications of this distinction are important. It may very well be that if a statutory board or corporation generates surplus revenues, the government has no legal recourse to collect that surplus as there are no shares and therefore no dividends to be paid. It may also have implications for employee benefits and taxes, and most certainly has serious consequences for sectors in which SOEs compete with private enterprises.

If the statutory body competes with private firms in its product offerings, then the government funding and subsidies can distort the market resulting in unfair advantages or dampening market signals. In Suriname, the Central Accounting Department (CLAD) is a statutory body (Landsbedrijf) that offers auditing and other accounting services to other SOEs. In principle, these SOEs pay for the service. To attract qualified, high-performing accountants, CLAD must offer competitive salaries. On the one hand, these salaries are allegedly higher than the salaries for public servants in Suriname. On the other hand, CLAD is expected to offer auditing services to SOEs in the social sectors, which may have limited cash flow or insufficient capital to pay for these services. These audits have become mandatory in Suriname. CLAD charges lower prices to be more accessible to SOEs, but those fees may not reflect the actual costs to CLAD and there may still be some firms that cannot or will not pay for its services.

Statutory SOEs established with a noncommercial objective are almost always statutory boards, but it should be noted that while statutory boards are commonly cost centers, they can also have commercial objectives. Statutory boards span a few different subtypes. One group includes schools, hospitals, and other providers of social services. These are typically cost centers. Another group comprises regulatory boards, the supreme audit institution, and other supervisory entities. Some are financially sustainable due to the fact that they collect fees, such as airport, road, and port authorities or tourism boards.

SOEs established by private law *and* that have a largely economic objective are typically limited liability companies. Terms used in the CCB6 include:

- Corporation or incorporated company
- Limited liability company, abbreviated as LLC. In British law, which is followed by five of the CCB6 countries, an LLC is a *public* limited liability company (as opposed to an LLC in the United States, which is essentially a private limited liability company—a hybrid between a sole ownership and a corporation)
- Naamloze Vennootschap (Sociedad Anónima, Société Anonyme), literally “Anonymous Association,” in Suriname—comparable to an LLC in nations that follow British law.

The common thread amongst these private-law SOEs is that all can be listed on exchanges, can accept outside shareholders, and are required to disclose their financial statements publicly. Data available from 555 SOEs in the CCB6 indicate that more than 90 percent are fully government owned (less than 10 percent have nongovernmental shareholders). SOEs in this limited pool with nongovernmental ownership include Barbados National Oil Company and National Helicopter Service in Trinidad and Tobago. The Governments of Trinidad and Tobago and Jamaica are co-shareholders in Caribbean Airlines and several Caribbean countries are shareholders of the regional carrier LIAT. All are required to disclose financial statements, but a review of the 70 most economically important commercial SOEs in the CCB6 shows that only 75 percent comply with this requirement.

In the case of Suriname, SOEs with a largely noneconomic objective may also be established using private law as not-for-profit institutions (NPIs) and take the legal form of associations, foundations, and cooperatives, among others. In Suriname (and other countries of Dutch heritage), all entities established under private law, their directors, and their general conditions must be registered with the respective country’s Chamber of Commerce. Depending on the type of entity, the firm’s annual financial statements must also be deposited with the Chamber.

Confusion frequently arises in the following four circumstances. First, when an SOE has a hybrid function (i.e., both commercial and social—for

**Table 5.1. Rationale for SOE Legal Structures**

Objective	Individual or unified statutory law	Private law	Term in this chapter
Economic objective	Statutory body, public body, Publiekrechtelijk lichaam	Private law body, Privaatrechtelijk lichaam	Statutory body
	Statutory corporation Sui generis	Public limited liability company (LLC), corporation, incorporated, Naamloze Vennootschap	Public corporation
Noneconomic objective	Statutory board	Association, foundation, cooperative	Public regulator Public society
	Barbados and Guyana each have unified laws for statutory corporations. Suriname has a unified law for statutory boards that are regulators.	Unified laws	Statutory corporations and statutory boards

Source: Authors' elaboration.

instance, the Public Transportation Company of Suriname is a limited liability company under private law, but also has a social objective). Second, when countries try to rationalize and oversimplify their system. This issue is very apparent in a country like Jamaica, which has chosen to make LLCs and statutory boards the only legal forms for SOEs. Subsequently, the Golden Age Home, the Women's Center Foundation of Jamaica, and the National Education Trust are all LLCs without a commercial objective. In its day-to-day meaning, however, an LLC is understood to have a commercial objective.

Third, confusion between commercial and noncommercial objectives and the legal form of corporations also arises when countries seem to use

## BOX 5.2. CORPORATIONS THAT ARE REALLY STATUTORY BOARDS

*The American Heritage Dictionary* defines a corporation as a body of persons granted a charter to legally recognize it as a separate entity with its own rights, privileges, and liabilities, distinct from its members. Such a body can also be created for purposes of government.

In a business environment a corporation is most often associated with a legal entity with a profit motive.

It comes as a surprise, then, that the National Housing Corporation of Barbados is a statutory board, as is the Bahamas' Antiquities, Monuments, and Museum Corporation; the Public Broadcasting Corporation of Jamaica; and the Trinidad and Tobago Housing Development Corporation.

the term “corporation” to refer to a legal body, not necessarily a profit-seeking enterprise. Finally, there is also confusion because the term “statutory board” is used for regulatory agencies as well as other entities that are not properly corporations. The regulatory agency, however, has decidedly distinct objectives from the other “statutory boards.” Suriname makes a distinction between private law and unified law for public regulators, such as the Central Bank, the Central National Accounting Department, the Supreme Audit Institution, and the Department for Management of Public Debt, etc.

### SOE Types across the CCB6

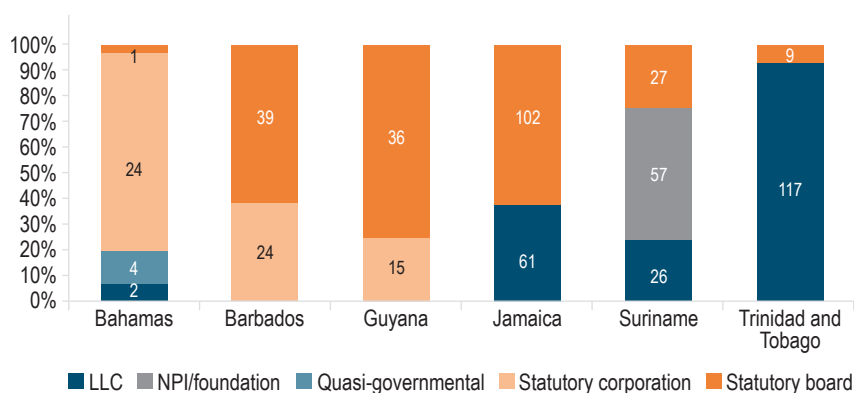
While in theory the aforementioned criteria provide clear rationalizations for SOE legislation, in reality there are numerous ways in which SOEs are established, none of which appear to be consistently applied across countries or even within them. Without a common application of these forms, governments and SOEs are unable to compare their performance against similar SOEs. In terms of establishing SOEs, in the Bahamas, this can only be done through special legislation. In Barbados it is special legislation or company law. In Guyana there seem to be no SOEs established by general company law. In the other CCB6 countries, all forms are used.

To better understand an SOE’s objectives, then, it is useful to assess other leading factors, specifically whether the legislative framework aligns with the type of SOE in practice and what type of funding mechanism the SOE employs.

### SOE Types Applied across the CCB6

Considering the actual landscape of SOEs in the CCB6, wide variances in types of SOEs between and within countries are quite notable (see Figure 5.1).

**Figure 5.1. Legal Form of SOEs in CCB6 Countries**



Source: Authors' elaboration using the IDB CCB6 State-Owned Enterprises Database.

**Table 5.2. Existing Categories of SOE by Country**

Country	Public body/statutory body		Private law	
	Commercial	Noncommercial	LLC/corporation	Not-for-profit
Bahamas	Statutory corporation (some have other shareholders)	Statutory body Body corporate	Corporation, including publicly traded	No
Barbados	Government of Barbados Enterprise (GBE)	SB Noncommercial	No	No
Guyana	Public corporation	Statutory agency	No	No
Jamaica	No	Statutory body	Limited liability company	No
Suriname	Sui generis, no shares	National company (Landsbedrijven)	Limited liability company (N.V.) with shares, with or without other shareholders	Foundation
Trinidad and Tobago	No	Statutory authority	Limited liability companies, with or without other shareholders	No

Source: Authors' elaboration.

Jamaica and Trinidad and Tobago only have private companies (LLCs) and statutory boards. Barbados and Guyana only have government companies (Government of Barbados Enterprise and public corporations, respectively) and statutory boards. The Bahamas and Suriname have multiple forms. The Bahamas is the only country with quasi-governmental SOEs. Suriname is the only country with SOEs under nonprofit private law. The country has foundations and “national companies” including, among others, regulatory boards, the supreme audit institution, and the national accounting bureau. However, there is no consistency: a hospital can be established either by specific legislation or as a foundation.

Looking at the number of SOEs per country under each legal form, it is noticeable that the Bahamas allows for SOEs to be established under private company law but infrequently does so. Jamaica and Trinidad and Tobago only allow for LLCs and statutory boards, yet Trinidad proportionally has many more LLCs than Jamaica does. Barbados and Guyana, which have only statutory SOEs, have relatively few SOEs and most are statutory boards. Suriname has a relatively high number of SOEs within each category. This may very well be derived from the high value the Dutch Kingdom places on organization (see Table 5.2 for more detail by country).

### SOE Financing

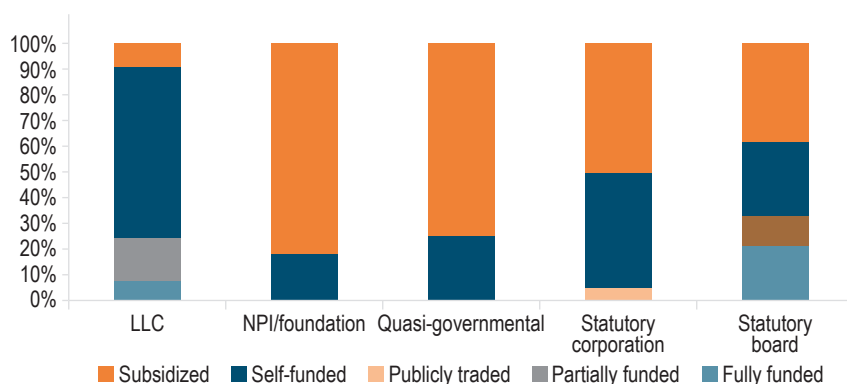
Another way to determine the objective of, and therefore the expectations for, an SOE is to examine its modes of financing. One would expect that SOEs with a commercial objective (the LLCs and statutory corporations)

would receive fewer funds from the government. This pattern holds true in the CCB6.

As shown in Figures 5.2 and 5.3, on the whole SOEs in the CCB6 are funded independently of their legal form. As expected, LLCs are more likely to be self-sufficient, while statutory boards and NPIs are more likely to be fully funded by the government. More than half of all statutory corporations and 34 percent of LLCs receive a subsidy, reflecting their obligation to perform a public service.

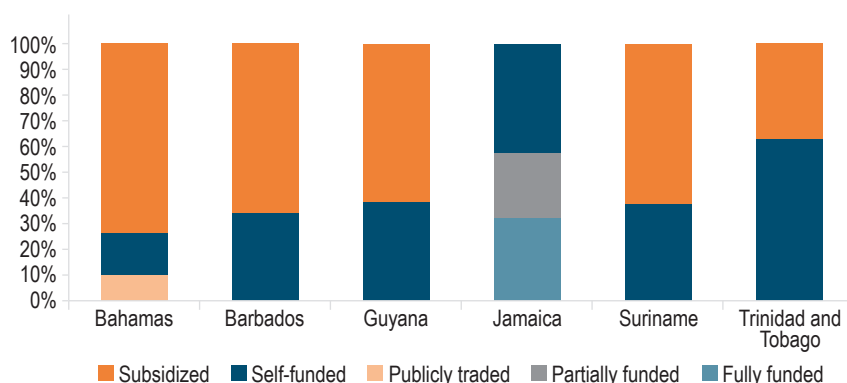
Going forward, more intentional and periodic comparison of the modes of financing across different types of SOEs in the CCB6 would assist in evaluating whether the financing policy for a particular category of SOE is appropriate and identifying underperformance, or alternatively exceptional performance, from individual SOEs relative to their peers in the same sector.

**Figure 5.2. Funding by Legal Form in CCB6 Countries**



Source: Authors' elaboration using the IDB CCB6 State-Owned Enterprises Database.

**Figure 5.3. SOE Funding by Country in the CCB6**



Source: Authors' elaboration using the IDB CCB6 State-Owned Enterprises Database.

## Institutional and Regulatory Framework

The necessary institutional and regulatory frameworks for SOEs in the CCB6 are largely either in place or being discussed. The challenge, however, centers around effective implementation of these frameworks given the lack of unified laws, the state of corporate governance practices, the human resource challenges, and the lack of transparency frameworks to both promote best practices and reduce corruption.

There are three important reasons for an institutional and regulatory framework for SOEs. First, because an SOE is often the sole provider of an important product, the SOE has sufficient leverage to misuse its position vis-à-vis third parties. Secondly, because of their size and lack of transparency, SOEs are easily abused for personal interest, nepotism, corruption, and politics, which increase the fiscal risk posed by these SOEs. Finally, a good regulatory framework promotes PPPs with and foreign direct investments in SOEs and the economy generally, efficiently leveraging government resources for economic growth.

Cornerstones of such a regulatory framework are legislative acts related to the accountability of government, corporate governance, government procurement, regulation, anti-corruption, fair trade, transparency, and consumer protection. As can be seen in Table 5.3, most of the CCB6 have relatively recent (amended) laws in these areas. Barbados needs to update its law on government procurement, the Bahamas on anti-corruption, and Suriname on fair trade and consumer protection. Harmonized laws, as exist in the EU for these areas, may be beneficial to simplify the adoption of best practices and to also facilitate monitoring and evaluation of SOEs.

**Table 5.3. Regulatory Framework in CCB6 Countries**

Area	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Government accountability	Financial Administration and Audit (amended 2013)	Financial Administration and Audit Rules (2011); Financial Administration and Audit Supplies Rules (1977); Public Finance Management Act (2019)	The Fiscal Management and Accountability Act (2003); Audit Act (2004)	Public Bodies Management and Accountability Act (2014); Financial Administration and Audit (Fiscal Responsibility Framework) Regulations, (2012) Financial Administrative and Audit Act (2015)	Government Accounts Act (2019)	Freedom of Information Act (1999); Exchequer and Audit Act (1959, updated through 2016)

(continued on next page)

**Table 5.3. Regulatory Framework in CCB6 Countries** *(continued)*

Area	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Corporate governance	Corporate Governance Bill (2018)	N/A	N/A	Corporate Governance Framework for Public Bodies (2012)	Law of Financial Reporting (2017)	Corporate Governance Code (2013)
Government procurement	Financial Administration and Audit Act (2010) (amended to allow for Public Procurement Department)	N/A	Procurement Act (2003); the Public Procurement Commission Tribunal Act (2004); Small Business Act (2004)	Public Sector Procurement Policy (2010)	Public Procurement Act (2015) preceded by the Financial Administration and Audit Act (1959); Contractor General Act (1983)	Public Procurement and Disposal of Public Property Act (2015), amended in 2016
Anti-corruption	Prevention of Bribery (1976)	Prevention of Corruption Act (2012–2031)	Witness Protection Act (2018)	Corruption Prevention Act (2001); Integrity Commission Act (2016)	Anti-Corruption Law (2017)	Prevention of Corruption Act (amended 2011)
Fair trade and consumer protection	Consumer Protection Act (2006); Fair Competition Act (2018)	Fair Competition Act (2002), Consumer Protection Act (2002)	Competition and Fair Trading Act (2006)	Fair Competition Act (1993); Consumer Protection Act (2005)	N/A	Consumer Protection and Safety Act (1985); Fair Trading Act (2006)

Source: Authors' elaboration.

### Unified Laws or Codes

The CCB6 countries typically have unified SOE laws (see Table 5.4). This is especially true with regard to SOEs engaged in “commercial” activities. As discussed earlier, in all the CCB6 countries except for Barbados and Guyana there

**Table 5.4. Unified Laws in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Unified law applicable to SOEs	Companies Act (2012)	None	Public Corporations Act (1988)	Companies Act of Jamaica (2004)	Commercial Code (1936); Law on National Companies (1971); and Law on Foundations (1968)	Companies Act (1995)

Source: IDB SOE Monitoring and Corporate Governance Questionnaire (2018).



are government-controlled limited liability companies. These limited liability companies are all established under their country's respective unified companies act or commercial codes. The four countries with government-controlled SOEs under company law—namely the Bahamas, Jamaica, Suriname, and Trinidad and Tobago—do not have unifying laws for statutory corporations, even when they have statutory corporations. For example, Suriname has Telesur, the telecommunications company, as a statutory corporation (*sui generis*). In the Bahamas, Bahamas Power & Light, Bahamas Telecommunications Company, and Bahamas Water and Sewerage Corporation are all statutory corporations.

The absence of a unified law for statutory SOE companies may reflect an underlying thought that “commercial companies” should ideally reside under private law. Jamaica and Trinidad and Tobago, which both have relatively recent reforms in the SOE legal framework, do not have statutory corporations. Conversely, Guyana and Barbados do not have government-controlled limited liability companies, but they have unifying laws for their statutory corporations: in Barbados the Government of Barbados Enterprise and in Guyana the Public Corporations Act.

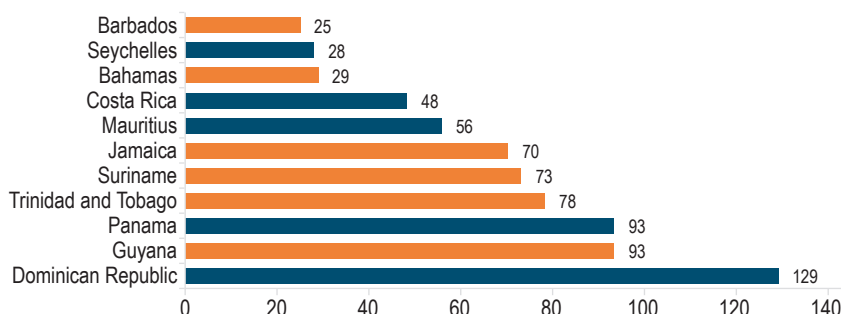
Only Suriname has a unifying law for its statutory boards, namely the Law on National Companies (*Landsbedrijven*), which went into effect in 1973. Suriname is also unique in that it has government-controlled foundations. These are established under the same unifying law as all private foundations, specifically the Law on Foundations (*Wet op Stichtingen*).

### Corruption and Transparency

An important concern when it comes to the monitoring and evaluation of SOEs is how difficult it is to eradicate corruption. This is to a large extent a consequence of the fact that transparency practices are still underdeveloped, fiscal governance still allows for ad hoc requests of funds from the government, and cost overruns are only dealt with when it is too late (i.e., that there is no close monitoring of projects on a monthly or quarterly basis). This is a problem because the overall institutional framework in the CCB6 seems to be very permissive of corrupt practices. Figure 5.4 provides data from Transparency International's Corruption Perceptions Index, which shows that commodity exporters perform poorly relative to non-commodity exporters. The worst performer in the CCB6 is Guyana, which ranks 93 out of 198 countries. Jamaica, Suriname, and Trinidad and Tobago rank in the 70s, while the Bahamas and Barbados rank in the 20s.

To further assess CCB6 nations' performance, their corruption rankings are compared to similar countries in Central America (Costa Rica and Panama) and CARIFORUM member the Dominican Republic, which are closest in terms of geographic characteristics, population, and development levels. African Mauritius (pop. 1.3 million; GDP/cap: US\$11,000) and Seychelles (pop. 98,000; GDP/cap: US\$30,000) are also included in the comparison in Figure 5.4. Other than

**Figure 5.4. Corruption Perceptions Index Rankings for CCB6 and Selected Countries (2019)**



Source: Transparency International (2019).

the Bahamas and Barbados, most CCB6 countries have high perceived levels of corruption relative to similar African island nations and Central American countries of similar income levels. The Bahamas and Barbados, the smallest of the CCB6 with the highest GDP/capita, rank in the top 15 percent on the index together with Seychelles. The only island nation that performs worse than the CCB6 commodity exporters is the Dominican Republic.

### Transparency

Transparency in public finances is key to improving how governments monitor the fiscal risk that accompanies having such a large number of SOEs of such diverse legal forms, firms, and objectives. Though there is still much work to do to improve financial reporting by SOEs, the CCB6 nations have started to make significant improvements in fiscal transparency. Obtaining complete financials for most SOEs is complicated, especially in commodity-exporting nations (less so in Trinidad and Tobago). The Bahamas and Barbados lack a centralized repository of financial reports of SOEs and the financial reports on SOE websites reflect changes in accounting practices over time that make it hard to evaluate performance. Moreover, most CCB6 nations monitor financial reports infrequently and sporadically (e.g., once a year for most), which makes it more difficult to prevent financial complications that require emergency injections of fiscal funds.

Only in the last decade have CCB6 nations begun to adopt international transparency practices in fiscal reporting. For instance, the Fiscal Transparency Code and Evaluation of the International Monetary Fund (IMF) and the guidelines provided by the Extractive Industries Transparency Initiative (EITI) are starting to be adopted more widely in the Caribbean. Trinidad and Tobago, a relatively populous and high-income member of the CCB6 and an oil-producing state, became a member of the EITI in 2011. Suriname and

**Table 5.5. Recent Public Financial Management Reforms in CCB6 Countries**

Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Yes, draft Public Financial Management bill (2018)	Yes, amendment of Financial Management and Audit Act (2019)	No	Yes, development of M&E Framework for Public Entities	Yes, Government Accounts Act (2019), which includes SOEs	No, last reform was in 2011

Source: Authors' elaboration.

Guyana, both comparatively smaller and lower income than Trinidad and Tobago, produce oil, gold, and bauxite and became members only in 2017. Since its EITI accession in 2011, Trinidad and Tobago has produced various reports that claim that by 2020 this nation had achieved “meaningful progress.” These reports contrast with the fact that Trinidad and Tobago has actually been falling in the Transparency International corruption ranking. As of 2020, Suriname and Guyana’s evaluations were still assessed against the 2016 benchmark, making it harder to determine year-on-year progress. Transparency International shows some improvement for Suriname (up three spots in the ranking) and Guyana (up eight spots) in 2019 alone (Transparency International, 2019).

Most of the CCB6 countries are going through some type of PFM reform (see Table 5.5). Some reforms are specific to SOEs, as in Jamaica, where an M&E framework for public entities is being developed. Other reforms are for the financial management of the public sector and its entities as a whole, as is the case in the Bahamas, Barbados, and Suriname. In 2017, Suriname passed a law that went into effect in 2020 that requires public and private companies to produce and disclose financial reports depending on their size.

These steps are critical to keep abreast of new developments in best practices and to effectively enforce reforms so as to minimize the fiscal risk that SOEs pose to governments. However, the reforms do not seem to explicitly consider the fact that small economies have limited human and financial resources to adopt all of the best practices. Even with the best intentions, implementing reforms independently of one another, at regular intervals into the future, remains a challenge for these small states. This is especially true for those countries with lower incomes and smaller populations. Jamaica has a relatively low income but a huge pool of talent, which, for example, Guyana and Suriname do not have.

### Designation and Establishment of SOEs

Each CCB6 country has different (and multiple) procedures to designate the establishment of an SOE (see Table 5.6). The role of the Minister of

**Table 5.6. Procedures to Establish an SOE in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Can each line ministry establish an SOE under its authority?	No	No	Yes	Yes	No	Yes
Who is the final designator?	Parliament	Cabinet or parliament	Line minister	Parliament and Minister of Finance	Cabinet or parliament	Minister of Finance
What is the role of the MOF?	None	Analyzes feasibility of SOE	None	Approves the establishment	None	Is the ownership entity
Is there an independent committee that deliberates the establishment of new SOEs?	No	No	No	No	No	No

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

Finance in the designation also varies. None of the countries has an independent committee to carry out the establishment of an SOE. Because of this, countries miss out on the opportunity to rationalize their portfolio of SOEs by evaluating whether a new need can be covered by an existing SOE. The task of evaluation is instead left to the cabinet or parliament, which are unlikely to have the resources to perform a thorough analysis. This leaves room for establishing SOEs without a convincing business case, arbitrarily determining the number of board members, and setting performance objectives that are not benchmarked against similar SOEs elsewhere.

In the Bahamas, Barbados, and Suriname, line ministries cannot establish SOEs under their authority; in Barbados the MOF analyzes the feasibility of the SOE. These are practices that the rest of the CCB6 countries could adopt.

## Ownership Function

For all practical purposes, in all CCB6 countries, the ownership of SOEs remains with each line ministry (see Table 5.7 for details on the monitoring unit in each country). In the Bahamas, Barbados, Jamaica, and Trinidad and Tobago, there is dual ownership between the line ministry and the MOF in which line ministries exercise most of the ownership functions while the MOF retains the role of financial comptroller.

**Table 5.7. Monitoring and Ownership of SOEs in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Placement of ownership	Each line ministry	Dual ownership: MOF and line ministry	Each line ministry  MOF remains corporation sole	Each line ministry  Shares are held by Accountant General's Department	Cabinet of the VP, by mandate of the president  The Cabinet of the VP mandates the ownership to the line ministries	Dual ownership: MOF and line ministry  Ministry of Finance remains corporation sole
Does MOF have a dedicated team to manage SOEs?	No	No	N/A	Yes	More or less	Yes

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

Box 5.3 presents the cases of the national oil companies of Jamaica and Barbados. These cases illustrate that even within the structure of one firm there is variation in ownership types (minority vs. majority ownership; joint ventures, etc.). The first case in the box illustrates how Jamaica used the Petroleum Corporation of Jamaica (PCJ) as a holding company that then acted as owner of the refining company Petrojam, the Petroleum Company of Jamaica (PETCOM), and other subsidiaries. Moreover, this holding structure has been recently rationalized and PCJ has been absorbed back into the Ministry of Science, Energy, and Technology (MSET).

In contrast, the second part of Box 5.3 shows a more stable and typical approach in Barbados, where the Ministry of Energy, Small Business, and Entrepreneurship acts as the sole owner and directly oversees the operation of two companies: Barbados National Oil Company Limited (BNOCL), which carries out upstream operations, and the National Petroleum Corporation (NPC), which undertakes the downstream distribution.

In terms of centralized monitoring units, in Jamaica and Trinidad and Tobago there is a dedicated team from the MOF that monitors all SOEs in the country. This unit is intended to not only exercise some control over the SOEs but also to improve the reporting practices of SOEs (in the last five years this SOE unit has made significant progress in monitoring and reporting, resulting in improved financial results).

In Suriname, the MOF has a dedicated team to monitor SOEs, with little to no power to exercise control over all the firms it oversees. In practice, it serves only to manage the financing of SOEs that receive subsidies. The

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**BOX 5.3. NATIONAL OIL COMPANIES AND OWNERSHIP IN JAMAICA AND BARBADOS**

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**Jamaica: The Petroleum Corporation of Jamaica**

The Petroleum Corporation of Jamaica (PCJ) is a statutory corporation under the Ministry of Science, Energy, and Technology (MSET) formally created and empowered by the Petroleum Act of 1979, with the exclusive right to explore and develop the petroleum resources of Jamaica. The mandate was later expanded in 1995 with the responsibility for facilitating the development of the country's energy resources in support of the overall strategy for national development (implementing the National Energy Policy 2009–2030).

PCJ holds equity in a number of subsidiaries: Petrojam (refinery), Petrojam Ethanol, Petroleum Company of Jamaica (PETCOM)—which markets a variety of petroleum products, industrial fuels, and lubricants—and Wigton Wind Farm Limited (WWF), Jamaica's largest wind energy-generating facility. PCJ also participates in Aircraft Refueling Services Limited (joint venture between Air BP and Petrojam).

The first one, Petrojam, is a limited liability company and owns the only petroleum refinery in the country. It was acquired in 1982, after ESSO Kingston refinery closed after 18 years, and was sold to the government and established as Petrojam. In 2006 a 49 percent share was sold to PDVSA (the national oil company of Venezuela) and the other 51 percent was held by PCJ. In 2019, Petrojam was reacquired<sup>a</sup> by the government of Jamaica and today is a 100 percent government-owned enterprise. The refinery has a capacity of 35,000 barrels per day (but is currently only using 56 percent capacity) and refines imported crude oil to produce mainly diesel, heavy fuel oil, kerosene, jet fuel, liquefied petroleum gas (LPG), asphalt, and gasoline; it also imports finished products for the domestic market. It had approximately 246 employees at the end of 2019.

Despite the company being profitable, net profits have been minimal and have declined over the last five years, except for 2019 (when they were US\$22 million, a 20 percent increase). It also has a weak financial position (negative net financial position and negative cash and cash equivalent for years), as well as weak operational performance (i.e., low capacity utilization, lower sales, etc.). This is mainly due to decreasing production levels that have led to more imports of finished products, increasing operational expenses, creating investment project cost overruns, and reducing sales (due to lower demand for heavy fuel oil from power company JPS Co. and bauxite refiners). Also, the refinery's operations were affected by difficulty in obtaining credit to purchase feedstock because of the impact of U.S. sanctions imposed on PDVSA in August 2017, which added to other constraints affected its ability to expand and upgrade its aging infrastructure and affected its storage capacity.

In 2019 the prime minister's cabinet announced the decision to close PCJ and subsume its functions into MSET as part of an ongoing rationalization plan of public bodies. In 2020, discussions were underway to convert the refinery

*(continued on next page)*

### BOX 5.3. NATIONAL OIL COMPANIES AND OWNERSHIP IN JAMAICA AND BARBADOS *(continued)*

into an import terminal to supply Jamaica's demand for oil products in the coming years.

#### **Barbados: The National Petroleum Corporation and Barbados National Oil Company**

The National Petroleum Corporation (NPC) is a statutory body established in 1979 under the National Petroleum Corporation Act 1979, which established the corporation's general functions as the production of crude oil, natural gas, and liquefied petroleum. However, it was only in 1982 that it started operating after the functions of the Natural Gas Corporation (formed in 1873) were transferred to the NPC. Since then, its primary function has been the sale of natural gas for domestic, commercial, and industrial use through its pipeline network.

The corporation's general functions are carried out by an associated company, the Barbados National Oil Company Limited (BNOCL), which started operations in 1982 when the Barbados government purchased the former Mobil Exploration. The company's principal activities include upstream (i.e., onshore exploration and production) and downstream operations (i.e., shipping, importation storage, diesel and fuel oil supply to the bunkering sector, etc.). Since January 2006, the corporation has held 24.5 percent of the equity of BNOCL while the Government of Barbados holds the remainder. BNOCL comprises three subsidiaries: Barbados National Oilfield Services Limited (BNOSL, operator in production-sharing contract), Barbados National Terminal Company Limited (BNTCL, manages the importation and supply of gasoline, diesel, and fuel oil), and Barbados National Oil Holding Company Limited (BNOHCL, manages properties). Additionally, the company acquired a 30 percent equity interest in Asphalt Processors Inc. In 2019, BNTCL produced 1,041 barrels per day (375,000 barrels per year), one of its highest numbers in the last decade along with the levels reached in 2015 (932,000 barrels per year). These numbers are significantly smaller than those of other Caribbean producers such as Suriname and Trinidad and Tobago. In 2019, the Government of Barbados reported a US\$71.17 million profit for BNTCL and US\$19.16 million for NPC (together, they contributed 48.3 percent of SOEs' aggregate profits). However, financial statements are not publicly available since 2014 and reports from the government are not regularly disclosed.

*Source:* Petrojam financial statements, PCJ and NPC websites, press releases, and U.S. Energy information.

<sup>a</sup> This happened against the backdrop of the imposition of an Executive Order by the U.S. Government in 2018 that prohibits American companies from transacting business with wholly or partially owned Venezuelan entities. Under the Compulsory Acquisition Act 2019, the 49 percent shareholding in Petrojam Limited previously held by PDVSA was vested in the Accountant General of Jamaica as of February 22, 2019.

SOEs that are completely self-financed, often the larger SOEs, do not coordinate with the unit in the MOF, which means that their fiscal risk is not properly monitored by this specialized unit.

Moreover, throughout the CCB6 there are few regulatory agencies in key sectors like mining or oil and gas, which makes the SOEs de facto regulators and the largest players in these industries. Box 5.4 presents the case of Staatsolie Maatschappij Suriname N.V., the national oil company in Suriname and de facto regulator of the industry.

Students of SOE reform argue that the two-tier ownership model has a variety of problems, the most prominent among them being the so-called “multiple principals” problem. That is, since multiple agencies monitor each SOE, it becomes unclear who is responsible for monitoring, data collection, and enforcement. This ill-defined accountability fosters a free-rider mentality between ministries and agencies, ultimately leading to poor monitoring practices (see Musacchio and Pineda Ayerbe, 2019, xxix).

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#### **BOX 5.4. STAATSOLIE MAATSCHAPPIJ SURINAME N.V.: THE COMPANY AND THE PETROLEUM REGULATOR**

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The extractive industries play a central role in the economy of Suriname. Bauxite has been the dominant industry for most of the past century, although extraction and exports have come to a halt recently as accessible reserves were exhausted, and gold emerged as the primary extractive industry. The oil sector is smaller than mining, but there has been important production since the 1980s due to low-cost onshore oil resources and it is expected to thrive after new prospects for offshore oil were recently identified.

The wholly state-owned oil and gold company Staatsolie has played a central role in the extractive industries for decades. It was established in 1980 as a limited liability company with the Republic of Suriname as sole shareholder. It holds the exclusive concession rights for exploration and production of all onshore and offshore hydrocarbon reserves in Suriname by virtue of the Mining Decree (Official Gazette 1986, no. 28), giving it an effective monopoly in most oil activities. Accordingly, it is the only oil-producing and -refining company and the largest supplier of fuel oil and refined products, although its monopoly does not extend to retail distribution. Currently, its commercial activities are concentrated in exploration, drilling, production, refining, marketing, sales, transport of crude and refined products, and generation of electricity.

In addition to its commercial activities, Staatsolie acts as a state agent on behalf of the government as the regulator of the Surinamese petroleum sector. In this capacity, the company must assess Suriname’s offshore hydrocarbon potential and attracts and negotiates petroleum contracts with international oil companies (production-sharing agreements, or PSA) according to the Petroleum Law

*(continued on next page)*



**BOX 5.4. STAATSOLIE MAATSCHAPPIJ SURINAME N.V.: THE COMPANY AND THE PETROLEUM REGULATOR** *(continued)*

(1991). Staatsolie also monitors the execution of these contracts. Open blocks are made available through competitive bidding rounds. International oil companies operating offshore in Suriname currently include Apache Suriname, Cairn Energy, Chevron, Equinor, ExxonMobil, Hess, Kosmos Energy, Petronas, Pluspetrol, Ratio Oil Exploration, and Tullow Oil. Staatsolie also undertakes other noncommercial activities by contributing to a wide range of community projects in education, culture, sports, health, safety, environment, and projects for the underprivileged through the Staatsolie Foundation for Community Development, which supports sustainable projects.

Staatsolie has a 25 percent limited partnership interest in Suriname Gold Project C.V. (the “Merian Partnership”). Newmont Suriname LLC is the managing partner of the C.V. with a 75 percent interest in the Merian Partnership. Commercial operations started in late 2016 and the first full year of production was 2017. Staatsolie has also entered into a 30 percent partnership agreement with IAMGOLD’s Rosebel Gold Mines N.V. (“RGM”) regarding the Pikin Saramacca gold mining operation (the “Saramacca Project”), for which commercial operations commenced in April 2020.<sup>a</sup>

Over the last 30 years, commercial oil production has only taken place in the onshore Tambaredjo, Calcutta, and Tambaredjo Northwest fields located in the Suriname-Guyana Basin. These fields are currently producing approximately 16,383 barrels per day or 6 million barrels a year (despite an original oil-in-place estimate of 1 billion barrels), a figure that is far below that of the LAC region (1.4 million barrels per day). It also has a refinery opened in 1997 whose current refining capacity is 15,000 barrels per day. Staatsolie’s gross revenue in 2019 was US\$500 million, from sales of fuel oil and crude (50 percent), premium diesel (34 percent), premium gasoline (11 percent), bitumen (1 percent) and others (4 percent) to the Suriname and the Caribbean markets. It had 1,114 employees as of January 2019. Additionally, with the objective to secure access to the strategic markets in the region and undertake power generation activities, it has three subsidiaries: Staatsolie Power Company Suriname S.V., GOW2 Energy Suriname S.V., and Ventrin Petroleum Company Limited (Trinidad and Tobago).

Staatsolie has been profitable for the past 39 years except for the years 1991, 1998, and 2016, when oil prices were historically low. The integrated and low-cost nature of Staatsolie’s oil business combined with investments in gold and power generation have diversified its revenue base and helped to mitigate cash-flow volatility across the commodity price cycle. In 2019 Staatsolie reported an EBITDA of US\$368 million (in 2019 Merian contributed US\$101 million to that figure thanks to favorable gold prices), an EBITDA margin of 73 percent, a net profit of US\$120 million, and an equity of US\$1.3 billion. Staatsolie’s contribution to the government of Suriname consists of taxes, dividends (50 percent of net profit), and royalties, which amounted to US\$172 million in 2019, compared to US\$150 million in 2018.

*(continued on next page)*

#### **BOX 5.4. STAATSOLIE MAATSCHAPPIJ SURINAME N.V.: THE COMPANY AND THE PETROLEUM REGULATOR** *(continued)*

The company has been capitalized through loans from the government, which in 2016 issued bonds to lend Staatsolie US\$300 million to repay part of a syndicated loan used for construction and expansion of its refinery. The company met this payment in 2018 as well as all payments obligations to its bondholders since the first bond issued in 2010. In 2019, the company reported a debt/EBITDA leverage ratio of 1.9 and a debt/capital ratio of 35 percent and a total US\$588 million debt.

The year 2019 was transformational for the industry after the first offshore discovery made by Apache Corp. and Total S.A. in the Maka Central-1 discovery in Block 58 offshore Suriname-Guyana Basin. The estimated reserves are 200–300 MMbbls. If the Maka Central-1 find is eventually developed, Staatsolie has the option to take a 20 percent stake in the field and other following offshore discoveries. To meet the investment needs of developing these new projects, the company has designed an investment plan 2020–2027 for a total US\$1.053 billion, funded with 50 percent external debt. In this regard, Staatsolie entered the international capital markets, starting with a recent international bond issuance for US\$195 million listed on the Dutch Caribbean Stock Exchange (DCSX), and it expects to list some bonds on the London or New York Stock Exchanges.

Despite showing adequate financial performance and being considered one of the most successful SOEs in Suriname, Staatsolie's low production levels in comparison to other oil SOEs in the LAC region and its offshore resource potential show a low productive performance. One of its main weaknesses has been its lack of capacity to assess Suriname's offshore hydrocarbon potential as a company and as a state agent, as well as the lack of investment in exploration and improving productivity and efficiency of wells, and promoting recovery from the mature fields (Staatsolie's oil fields are mature and its reserves are declining). Acknowledging these challenges, the company is currently launching a comprehensive geology program to acquire, interpret, and promote new geological data about mineral resource availability. It is also focusing on increasing productivity and efficiency of wells and actively promoting exploration onshore and offshore.

*Sources:* Staatsolie financial statements, website, and press releases; World Bank (2017).

<sup>a</sup> Another Suriname SOE involved in mining is Grasshopper Aluminum Company (Grassalco N.V.), founded in 1971.

### **Joint and Minority Shares, and Public-Private Partnerships**

Table 5.8 shows the variation in ownership schemes across CCB6 countries, with no standard approach to ownership. In Barbados and Guyana partnerships with the private sector to own some of the companies are more a work in progress than in other CCB6 countries.

**Table 5.8. Government Ownership Types in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Joint shares?	Yes	No	No	Yes	Yes	Yes
Government as majority shareholder?	Yes	No	No	Yes, one (Petrojam Limited)	No	Yes
Government as minority shareholder?	Yes	No	No	No	Yes	Yes
PPP policy?	In development	N/A	In development	Yes	No	Yes

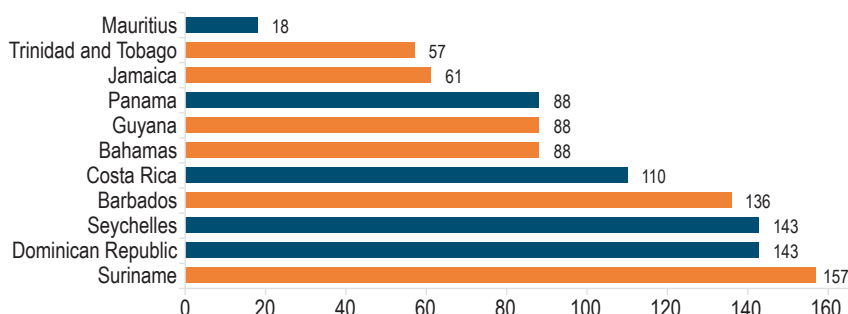
Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

At present, SOEs in the CCB6 rarely have minority shareholders. Even rarer are minority shareholders that are not another SOE or the government of another Caribbean country. As previously noted, Venezuelan-owned PDVSA was a minority shareholder (49 percent) in Petrojam. Arawak Port Development in the Bahamas is jointly owned by the government of the Bahamas (40 percent), Arawak Port Development Holding (40 percent), and the Bahamian public (20 percent). The Barbados National Oil Company is jointly owned by the Government of Barbados (75.5 percent) and the National Petroleum Company (24.5 percent), a statutory board. In Suriname, the government is the majority shareholder in one bank, Hakrinbank (51 percent). In Trinidad and Tobago, SOE LLCs' stakes in one another form a complicated maze of interconnectedness, making the government an indirect owner of several SOEs, perhaps leading to a lack of oversight.

One of the problems caused by the lack of harmonized SOE laws with clearly delimited corporate forms is that there are no explicit protections for minority shareholders in SOEs. This problem is averted when the SOE is established under general company law (e.g., if it is a limited liability company), as minority shareholders in these instances will have the same protection as do minority shareholders in private enterprises. Statutory entities established under public law, however, generally do not have shares and so these protections have not been considered.

As seen in Figure 5.5, the CCB6, together with its peers in Central America, as well as the Seychelles, share deficiencies in their protection of minority shareholders, according to the World Bank's Protecting Minority Investors Index (World Bank, 2019b). Minority shareholder protection is important not only for SOEs that are publicly traded in stock exchanges, but also to encourage PPPs and to attract foreign direct investment (FDI). Trinidad and Tobago and Jamaica receive the highest ratings out of the CCB6, presumably

**Figure 5.5. Protecting Minority Investors Index Rankings for CCB6 and Selected Countries (2019)**



Source: World Bank (2019b).

because they have more active stock exchanges. Stock exchanges usually introduce norms and rules that protect minority shareholders. Thus, having SOEs operating as statutory corporations or LLCs with private shareholders puts minority shareholders in a legal gray area. Suriname has vast experience with joint ventures in the mining sector yet lacks more broadly codified (and explicit) protections for minority shareholders.

Finally, the lack of protections for private investors also matters for PPPs, which are long-term contracts between the government and a private party to develop and/or manage specific assets, usually large infrastructure projects. PPPs can be financed with a combination of private and public funds and/or using project financing. They are expected to increase the efficiency of SOEs, and therefore lower their fiscal risk, because the private party is likely to bring demonstrable expertise to an endeavor that provides both a growth and a learning opportunity for a small country, such as establishment or upgrading of an international airport, a power company, or a telecom company (Reyes-Tagle, 2018). Some of the countries already have PPP policies, while for others such policies are still in development. Suriname, notably, has neither a PPP policy nor one in development.

An active pursuit of PPPs is supported by the Caribbean Development Bank (CDB). In 2015, CDB established a US\$1.2 million Regional Public-Private Partnerships Support Facility in collaboration with the World Bank, the IDB, the Multilateral Investment Fund, and the Public Private Infrastructure Advisory Facility. The facility's mandate is to promote PPP policies and projects in CDB's borrowing member countries. CDB offers training resources and support to countries on developing PPPs including a PPP Helpdesk, a toolkit, and summaries of lessons learned.

Despite these efforts, more PPPs in the CCB6 do not seem to be forthcoming. The PPP for Jamaica's Sangster Airport was completed in 2003.

Consolidated Water Inc. out of the Cayman Islands is under contract with the government of the Bahamas to provide water for Nassau, among others, but plans outlined in 2014 by the CDB for both Jamaica and Dominica do not seem to have materialized. Queyranne, Daal, and Funke (2019) speak to the benefits of PPPs but provide no examples of recent PPPs. In a report on PPPs, the World Bank records a 10-megawatt geothermal plan in St. Vincent and the Grenadines, a railway project in Cuba, and another project in the Dominican Republic, but no projects in the CCB6 (World Bank, 2019a). There may be many reasons for the lack of progress, including limited experience and human resources within the countries to develop and implement plans, which further disincentivizes FDI and PPPs themselves.

## Looking Ahead: The Emerging Role of Sustainability and the Evolving Role of Governance and M&E

### Sustainability, Climate Action, and COVID-19 Recovery

The CCB6, already at the epicenter of climate change and its implications, has been hard hit by the COVID-19 pandemic. This region needs support for further economic development. Though collective action is infrequently observed, the countries have joined forces, perhaps most visibly, in the Caribbean Climate-Smart Coalition.

Private funding is essential to achieving the Sustainable Development Goals, climate action, and a sustainable COVID-19 recovery. In addition, there is some evidence that SOEs can play a role in global environmental engagement (Hsu, Liang, and Matos, 2020). Achieving resilience and sustainability requires adaptation of regulation and adoption of new ways of doing business, even for SOEs. Efficiency is increased by a common harmonized framework provided by a third party and the accompanying institutions.

### Evolving Role of Governance

As countries move forward with corporate governance reforms of their SOEs, and as the definition of what constitutes good corporate governance and M&E evolves, the key actors must develop new systems and procedures to fulfill these new requirements (see Table 5.9 for a summary of the competencies required going forward in CCB6 nations). They should also dedicate resources to keeping abreast of developments; given that these requirements to stay up to date may place additional pressure on already limited resources, it would be wise to consider joining forces on this.

Good corporate governance today requires board members to fulfill not just fiduciary duties, but also to provide strategic insight. Consequently, the strategic insight required of SOE board members increases relative to the need for competency in accounting, finance, or legal matters, something

**Table 5.9. Competencies Required in the Future for Key Actors in CCB6 SOEs**

Competency	SOE management	SOE board	Line ministry	M&E unit
Accounting/Financial Reporting	high	low	low	low
Financial Analysis	high	medium	medium	medium
Management Accounting	high	low	medium	high
Management Reporting	high	low	medium	high
Public/Social Policy	high	medium	high	low
Business Planning (long term)	high	medium	low	low
Annual Planning	high	low	low	low
Corporate Strategy	medium	high	high	high
OECD Guidelines	low	medium	high	high
Country Laws	low	medium	high	high

Source: Authors' elaboration.

Note: The levels correspond to how important each competency is for each group.

that may require more sophisticated training or board members with managerial experience.

As governance is increasingly understood as more than just financial oversight, the role of the central SOE unit in managing the country's portfolio of SOEs, both commercial and noncommercial, is also required to change. First, these M&E units are to become more than support organizations to line ministries and their SOEs, enabling them to transition to new standardized best practices for governance and M&E. Second, the SOE unit should be competent in strategic management of the portfolio of SOEs for the financial and social benefit of the country. It should be able to collect the required information of SOEs and consistently provide the related comprehensive management reports to the respective cabinet and parliament. Third, the SOE unit should be able to advise the cabinet and parliament on strategic decisions with regards to the portfolio. In the terminology of the Boston Consulting Group's growth share matrix, it should know which SOEs are the cash cows, stars, pets, and question marks within the portfolio.<sup>1</sup> A recommended approach is to consider SOEs' placement through a product life cycle lens, distinguishing which SOEs are in an introductory, growth, maturity, or declining stage and the relative level of investment that accompanies each stage. Finally, the SOE unit should keep a close eye on the competitiveness of SOEs and therefore of the country (see more details on benchmark models for SOE units in Chapter 8).

<sup>1</sup> See <https://www.bcg.com/about/overview/our-history/growth-share-matrix> for more on BCG's growth share matrix.

In countries of larger scale, these tasks are well performed by a holding company or in a highly centralized department. In small countries, the SOE units may need to hire experts intermittently to assist with technical aspects related to strategy, governance (particularly management reporting), and legislative framework.

### **Achieving Improved M&E**

As developments such as fiscal stability programs require line ministries to actively govern and monitor SOEs under their supervision, there is a risk that each line ministry will develop its own system, leaving the MOF or SOE/M&E unit to convert a myriad of systems to a comparable format. This scenario would result in great inefficiencies as the line ministries and/or the M&E unit both attempt to continue introducing improved processes for their specific SOEs, leading to duplicated efforts.

Additional inefficiencies result from each country developing its own M&E system that does not optimize use of limited resources nor consider benchmark KPIs for similar industries across similar countries. Hence, their newly developed M&E will not be able to assess whether the SOEs are indeed managed in a globally competitive way that would yield optimal financial or social returns for the government or which would attract local or foreign PPP partners.

Countries should avail themselves of the IDB's technical assistance to develop SOE units and M&E frameworks appropriate for their economies. The IDB can provide the CCB6 with access to standardized templates and a database. By creating consistency and adhering to standards used more broadly, the systems would allow for more insightful management reports for cabinets and parliaments and allow for comparisons within and across countries. The templates should seek accessibility and feasibility by mixing best practices for the CCB6 and other small countries. Some of these templates for governance, SOE unit design and duties, and performance evaluation methods are developed in more detail in Chapter 8.

### **Recommendations to Improve the Legal Form of SOEs**

Going forward it is essential to develop legal and regulatory frameworks that focus on increasing the clarity of the objectives and expectations for each SOE. Bearing in mind the limited financial and human resources to develop and upkeep different pieces of legislation, the proposed framework recognizes four types of SOEs, of which three types can be easily implemented under legislation that already exists in each country.

- i. Existing SOEs with a largely commercial objective could be reconfigured under the same commercial code as private enterprises, as is the case in

Jamaica, Suriname, and Trinidad and Tobago, and would become LLCs (or corporations), ensuring a level playing field and adding to competitiveness. Those that can be corporatized can be listed on the securities exchange and accept outside shareholders. This would automatically improve corporate governance (World Bank, 2014) without having to develop and maintain a law specifically for commercial SOEs. One would have to determine the threshold at which an SOE becomes a commercial enterprise and how an SOE should be compensated for fulfilling any required social objective.

- ii. SOEs with social objectives or that provide important public goods, which the IMF refers to as NPIs (not-for-profit institutions), could be established under the same private law as nongovernment entities with the same goal as foundations. These are SOEs with largely social and public objectives such as education, health care, social housing, etc. To the extent that there are nongovernmental NPIs fulfilling similar roles to other governmental NPIs, having these SOEs function under the same law provides a level playing field and facilitates collaboration. One would have to determine the threshold at which an SOE becomes an NPI and how the compensation for their social objectives will be met by the MOF (the best practices for compensating SOEs for quasi-fiscal operations are explained in Chapters 2 and 8 of this volume). The statutes of state-owned foundations could be harmonized to ensure that their number of board members and conditions for their rotation and discharge, fiscal year, form of financing, etc. are the same across the sector.
- iii. SOEs that essentially “serve a particular subset of other market producers” (IMF, 2014)—in other words, that “serve a common interest or benefit a group of enterprises” (IMF, 2014)—can be moved to the appropriate private law that governs private trade associations, research institutes, etc. The relevant private stakeholders benefited by this SOE could form the board and/or be members of the board, with or without ex officio board members representing the government. Such a structure would also benefit the governance because the direct beneficiaries will play an active role in determining strategy and conducting monitoring and evaluation. In the Dutch Caribbean, the chambers of commerce typically have a quota for board members representing each small business and large enterprises. The employers’ organizations also have representatives from different sectors.
- iv. SOEs with a regulatory task or that function as an “authority” (e.g., energy regulators, supreme audit institutions, standards boards, education councils, maritime and civil aviation authorities, etc.) could have a separate unified legal form. Suriname seems to be the only country in the CCB6 that has a unified law, the Law on National Companies (Wet op Landsbedrijven), for this purpose.



It is important to maintain a clear legal separation between SOEs with a commercial and noncommercial objective, and determine what should be done with any surplus revenue produced by entities in either category, while maintaining the entity's incentive to increase effectiveness and efficiency (OECD, 2015). Failure to determine this runs the risk of a noncommercial firm setting higher fees than necessary and using the return for its own internal reasons (nicer offices, higher wages, etc.), rather than returning it to the government as a sort of dividend. Conversely, a commercial entity may produce a profit from its commercial arm yet insist that the government continue to subsidize 100 percent of its social policy objective.

## Conclusion

The CCB6 countries seem to have most of the required institutional and regulatory frameworks in place for good governance and monitoring and evaluation of their SOEs. Yet, given the performance of their SOEs, the adherence to these frameworks seems to lag compared with other regions of the world. Overall, it seems that these countries could benefit from a variety of much-needed reforms to the institutional and regulatory framework of SOEs. This chapter has not only diagnosed the state of the different key institutions that determine how SOEs are established, owned, governed, monitored, and evaluated, but also has provided a series of recommendations to improve the institutions that govern the creation and monitoring of SOEs as well as internal governance provisions to improve the transparency of SOEs and reduce corruption overall.

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## CHAPTER 6

# Corporate Governance: Boards of Directors of CCB6 SOEs

### Introduction

Small countries, including the CCB6 countries— the Bahamas (BHS), Barbados (BRB), Jamaica (JAM), Guyana (GUY), Suriname (SUR), and Trinidad and Tobago (TTO)—are at a structural disadvantage when it comes to effective governance of their state-owned enterprises (SOEs), despite being poised to gain the most from global best practices. Consider the fact that almost every country in the Caribbean, regardless of size, requires an electricity company, a water company, a telecom company, an international airport, and seaports, which are commonly managed as SOEs. The populations of the CCB6 range from close to 300,000 in Barbados to nearly 3 million in Jamaica. GDP per capita ranges from US\$5,500 in Guyana to US\$33,000 in the Bahamas. Consequently, the number of SOEs per capita or per unit of GDP in these small countries is relatively high, as discussed in the Introduction and Chapter 2 of this volume. This also implies that the structural disadvantage when it comes to the fiscal risk of Caribbean SOEs is compounded by the relatively small scale afforded to these firms by their home markets and the resulting inefficiency and lack of human resources given the size of the pool of talent from which they can draw managers. This increased burden and the accompanying risks suggest that corporate governance in the CCB6 must meet high standards while at the same time dealing with the disadvantages of size and lack of qualified human resources (essential for board composition or systems development). Furthermore, the small size of the populations, and especially of the talent pool, also

increases the propensity for close relationships among actors, leading to relatively frequent occurrence of conflicts of interest, nepotism, and, potentially, corruption.

It is against this background that the CCB6 must improve the corporate governance and legal framework of SOEs, primarily for their own fiscal benefit and developmental needs, but also in order to attract foreign direct investment (FDI) and to comply with donor requirements. Yet, current best practices in corporate governance (e.g., the OECD or World Bank-IFC guidelines) increase fixed costs for SOEs and subsequently pose an additional fiscal burden. The return on these initiatives is not always evident for small economies. Even if the returns outweigh the cost, these countries have limited human and financial resources to develop, implement, evaluate, and adapt these practices on their own. Future governance guidelines, which will likely include strategies for environmental and social aspects, will add an additional cost and thus potentially increase the overall fiscal burden of SOEs. For these reasons, governments of the CCB6 and other small nations are well advised to approach the issue of governance of their SOEs in a strategic manner. The goal should be to increase efficiency of governance by incrementally scaling improvements in the quality of governance practices.

This chapter will focus on current practices and pitfalls in SOE practices regarding boards of directors. The analysis suggests that larger or higher-income countries within the CCB6 are farther along in the implementation of best practices. For instance, while SOE boards in all CCB6 countries are regulated by constitutional statutes or bylaws, only Trinidad and Tobago has a corporate governance code. The CCB6 nations have formal procedures for appointing board members, but open seats are not published. A public pool of potential candidates only exists in Trinidad and Tobago. Guyana, Jamaica, and Trinidad and Tobago have explicit requirements for the selection of board members, while the Bahamas, Barbados, and Suriname do not. In Barbados, Jamaica, and Trinidad and Tobago, ministers cannot serve on boards. In the other countries, however, there are no restrictions on ministers serving on SOE boards. Generally, employees can only be appointed to boards as *ex officio* members. Over two-thirds of the SOEs in this study post the names of board members and management on their websites. In most cases, an SOE's board is responsible for appointing the CEO, albeit allegedly after the blessing of the line minister. Jamaica and Trinidad and Tobago have formal evaluation procedures for their boards, while the other countries do not have such practices. Though the degree varies, a systemic underlying current of political interference is present in all countries.

In any case, what is primarily lacking in the Caribbean is perhaps the conviction that in the long-term there are net benefits to better governance. This chapter examines the current practices of the CCB6 in regard to SOE boards and their efforts to meet or exceed the Organisation for Economic

Co-operation and Development (OECD) guidelines of 2015 and 2018 (OECD, 2015, 2018) and the International Finance Corporation (IFC) Corporate Governance Progression Matrix for State-Owned Enterprises (IFC, 2019). We provide practical solutions to implement improved practices, mostly based in three areas: (i) increasing the scale of corporate governance interventions by jointly developing systems or duplicating existing systems; (ii) enabling and encouraging the use of foreign nationals on boards, which can reduce conflicts of interest and increase the quality of boards; and (iii) developing benchmarks to compare performance of SOE boards against similar countries in the region and elsewhere.

## An Overview of Commercial SOEs in CCB6 Countries

This analysis will focus on corporate governance practices in commercial SOEs in the CCB6. The International Monetary Fund (IMF) first distinguishes between financial and nonfinancial SOEs, and then further distinguishes between commercial and noncommercial SOEs. In the CCB6, there is a rather marked difference in the corporate governance practices of financial and nonfinancial SOEs.

Financial SOEs across the Caribbean have adhered to a code of corporate governance for some decades now as a requirement for the relevant licenses of the institutions, their boards of directors, executive teams, and general operations. These codes are periodically revised as shown in the Table 6.1. The lessons learned from financial institutions could prove valuable when developing guidelines for other SOEs, specifically around issues of conflict of interest, material interests, and independence. One might assume that (most) people on the boards of central banks would have expertise in the financial sector. In the small nations of the CCB6, just about everyone of note has close ties with the financial sector, whether as a businessperson, a former employee of financial institutions, a supplier, a charity, or some other

**Table 6.1. Corporate Governance in Caribbean Financial Institutions**

Code of Corporate Governance for Institutions under Supervision of the Central Bank	
Country	Last revision
Bahamas	2012
Barbados	2013
Guyana	2008
Jamaica	2008
Suriname	N/A
Trinidad and Tobago	2007

Source: Central Bank of the Bahamas (2012), Central Bank of Barbados (2013), Bank of Guyana (2008), Bank of Jamaica (2008), Central Bank of Suriname (2015), Central Bank of Trinidad and Tobago (2021).

form of relationship. Given this high intersectionality, how central banks address issues of potential conflicts of interest among their board members may be of interest for nonfinancial SOEs.

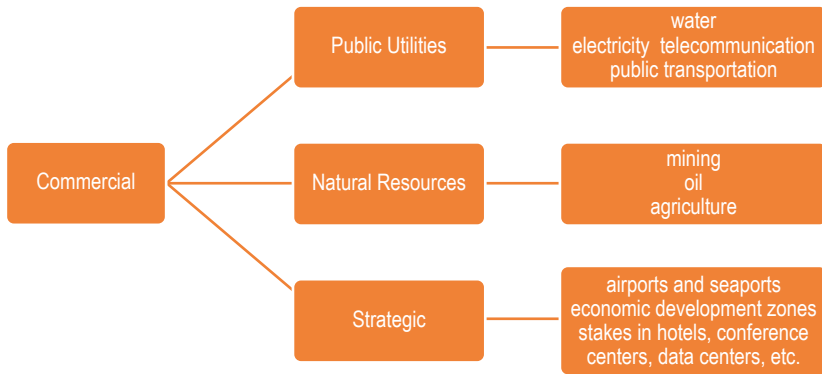
Noncommercial SOEs are also discussed at the start because some of the lessons learned may be relevant for noncommercial SOEs' considerations and some countries may choose to include their noncommercial SOEs in their efforts towards corporate governance reform.

The OECD Guidelines on Corporate Governance were designed for commercial SOEs. However, the objectives of commercial SOEs vary widely. Some SOEs fulfill a primarily social developmental role, such as providing power, water, telecommunications, public transportation, or waste management. In many countries, these were initially public services but they were privatized to increase competitiveness and service offerings (e.g., the Barbados Water Authority, which was privatized in 1980). The revenue streams of these SOEs are rather stable and not subject to external shocks. However, since they fulfill basic public needs, they can fall subject to political pressure. In addition, employees are sometimes treated in the same manner as public servants, with the corresponding benefits and culture.

A second group of commercial SOEs is primarily tasked with the provision of infrastructure to facilitate economic development. Classic presentations are majority or minority stakes in international airports and seaports, airlines, data centers, and economic development zones (free zones and industrial zones). These are deemed of strategic importance for the country's economic development. Examples from the CCB6 include the Suriname government's stake in Hotel Torarica, the various CCB6 governments' stakes in LIAT Airlines, and the Trinidad and Tobago government's stake in National Helicopter Services Ltd.

For yet a third group of commercial SOEs, the primary role is to generate income for the country by exploiting important natural resources, often commodities (oil is easily recognized, but this also includes mining and sometimes agriculture). These activities can bring in important dividends for the government, but are subject to severe external shocks, as can be seen in the case of Suriname when the price of gold fell in 2015. Figure 6.1 provides a schematic of the types of commercial SOEs.

This categorization is important because it centers the focus on the overall goal of SOEs. Thus, it begins to shed light on the informal institutional framework that accompanies or should accompany each type of SOE. The goal of a public water company, for example, even if it is incorporated under standard corporate law, is not to generate income for the public treasury. However, producing high returns (or a high government take in terms of taxes and dividends) is the goal of an SOE in the mining industry. The water company should perhaps have at least one *ex officio* board member from the line ministry to inform on relevant social policies and ensure these are taken into account. But should the mining company have a government

**Figure 6.1. Types of Commercial SOEs**

Source: Authors' elaboration.

official on its board? The required soft skills for board members of a public transportation company are likely to be different from those required of board members of a gold mining company.

### Nonfinancial, Noncommercial SOEs

While this analysis does not address nonfinancial, noncommercial SOEs, it is useful for completeness and for perspective to note possible subcategories within this group. Nonfinancial and noncommercial SOEs can be subdivided into the following:

Regulatory bodies such as the central auditing office, the aviation and maritime authority, energy regulator, school boards, etc.

Nonprofit entities, regardless of how they are legally established. For example, a public transportation company might be established as a corporation under standard corporate law, as is the case with the National Transport Company in Suriname, but it is essentially a nonprofit entity, fulfilling primarily public social policy, and is likely to receive a subsidy. Nonprofit entities can also be essentially business service organizations (BSOs), which include distribution companies, bureaus of standards, chambers of commerce (in Suriname), etc. Depending on their clientele, these nonprofit entities may be self-sufficient, but would not necessarily make a profit.

Currently, SOEs in the CCB6 are categorized by their legal status, rather than by their primary objective or role. According to the World Bank, classification based on primary objective is particularly helpful in keeping organizational purpose at the forefront when developing governance strategy. As the following sections will demonstrate, the risk that individual SOEs pose to their respective governments differs primarily based on their organizational purposes rather than on their legal status.



## The OECD Guidelines and the IFC Corporate Governance Progression Matrix for State-Owned Enterprises

Our discussion on the role of SOE boards is based on two frameworks: the OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015) and the World Bank-IFC's Corporate Governance Progression Matrix for SOEs (IFC, 2019). The OECD guidelines establish clear targets for corporate governance practices. The Corporate Governance Progression Matrix lays out concrete steps for implementation and elaborates on environmental and social strategies in addition to corporate governance strategies.

### The OECD Guidelines on Corporate Governance

The OECD has outlined seven guidelines with respect to the corporate governance of SOEs. Guideline VII addresses the responsibilities of SOE boards, broadly stating that:

The boards of SOEs should have the necessary authority, competencies, and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions (OECD, 2015, 26).

Guideline VII further elaborates upon this with the following sub-guidelines (OECD, 2015):

- A. The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the enterprise's performance. The role of SOE boards should be clearly defined in legislation, preferably according to company law. The board should be fully accountable to the owners, act in the best interest of the enterprise and treat all shareholders equitably.
- B. SOE boards should effectively carry out their functions of setting strategy and supervising management, based on broad mandates and objectives set by the government. They should have the power to appoint and remove the CEO. They should set executive remuneration levels that are in the long term interest of the enterprise.
- C. SOE board composition should allow the exercise of objective and independent judgment. All board members, including any public officials, should be nominated based on qualifications and have equivalent legal responsibilities.
- D. Independent board members, where applicable, should be free of any material interests or relationships with the enterprise, its management, other major shareholders and the ownership entity that could jeopardise their exercise of objective judgement.
- E. Mechanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and to limit political interference in board processes.

- F. The Chair should assume responsibility for boardroom efficiency and, when necessary in co-ordination with other board members, act as the liaison for communications with the state ownership entity. Good practice calls for the Chair to be separate from the CEO.
- G. If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence.
- H. SOE boards should consider setting up specialised committees, composed of independent and qualified members, to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration. The establishment of specialised committees should improve boardroom efficiency and should not detract from the responsibility of the full board.
- I. SOE boards should, under the Chair's oversight, carry out an annual, well-structured evaluation to appraise their performance and efficiency.
- J. SOEs should develop 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 the equivalent corporate organ.

It is in the context of this guidance that we will examine the performance of SOE boards in the CCB6. The following section, "Adopting the OECD Guidelines for the Composition of Boards," addresses each of the above sub-guidelines in turn.

### **IFC Corporate Governance Progression Matrix for State-Owned Enterprises**

The Corporate Governance Progression Matrix developed by the World Bank's IFC in 2019 outlines steps for the introduction of environmental, social, and governance (ESG) strategies in the SOE context. These include Basic Practices, Intermediate Practices, Good International Practices, and Leadership. The strength of the matrix is that it provides more concrete steps for governance than the OECD guidelines including, for instance, the suggested minimum number of board meetings per year as well as a suggested percentage of independent board members and audit committee members. The IFC also details the attributes of an independent board member. The matrix also provides concrete benchmarks with regard to ESG strategies.

It is widely recognized that the CCB6 countries are highly vulnerable to natural disasters. Hsu, Liang, and Matos (2020) suggest, based on research in large emerging economies, that SOEs may play a bigger role in global environmental engagement than their private sector counterparts. Hence, consideration of the environmental and social elements, alongside corporate governance reform efforts, is highly relevant for SOEs in CCB6 countries.

This full-spectrum approach will enhance resiliency in the face of natural disasters and attractiveness for FDI and donor investments as it demonstrates progress towards the Sustainable Development Goals (SDGs) and climate action.

## Adopting the OECD Guidelines for the Composition of Boards

### A Clear Mandate and Ultimate Responsibility

Adherence to Sub-Guideline A of OECD Guideline VII is met by adherence to the following three principles: (i) the boards of SOEs are assigned clear mandates and ultimate responsibility for their respective enterprise's performance; (ii) the role of each SOE board is defined in legislation, preferably according to private sector regulations; and (iii) each board is fully accountable to the relevant SOE's owner, acts in the best interest of the enterprise, and treats all shareholders equitably (OECD, 2015).

Across the CCB6 there is little consistency in the choice of legal entity for new SOEs (e.g., a hospital can be established as a foundation or as a public body, as is the case in Suriname). In addition, commercial SOEs are not all established under private sector law. Several are established by individual statutory law to reflect their social or strategic importance to the country. These include power companies, water companies, and telecommunication companies. This variance in origin and structure means that while the overall mandate and responsibility of each SOE is known, there is a wide range of differences with regards to autonomy over capital investments, financial disclosure, and other governance characteristics (for further discussion see Chapter 4).

While all the CCB6 countries have a corporate governance code for their financial institutions, it appears that only Jamaica and Trinidad and Tobago have the equivalent of a corporate governance code for their nonfinancial SOEs, as shown in Table 6.2. The Bahamas and Barbados had draft bills as this volume was being prepared in 2020, but no bill for nonfinancial SOEs had been approved yet. In terms of clear mandates, across the CCB6, all the SOE boards have been assigned a formal mandate via their respective Acts of Incorporation, which are also referred to as statutes or charters. Invariably, these state the board's authority, its competencies, and expectations for objectivity. The acts are also often further detailed in the bylaws. This and other parts of the regulatory and institutional framework for the boards of SOEs in the CCB6 are often copied or adapted from the framework of the colonizing country (the United Kingdom or the Kingdom of the Netherlands) prior to the country's independence in the second half of the 20th century. The acts denote the board's full accountability, but the tools to enforce this accountability are often not specified and it is not clear if each board member must sign to formally accept accountability.

**Table 6.2. Existence of a Corporate Governance Code in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Do you have any corporate governance code?	No	No, but the acts provide guidelines	No	Not yet; there is a corporate governance framework in the making	No, but there are bylaws	Yes, as well as the State Enterprises Performance Monitoring Manual
Is an SOE's board of directors regulated by a constitution and bylaws?	No	Yes, acts and bylaws	Yes, acts and bylaws and Revenue Authority Act (1996)	Yes, acts and bylaws	Yes, acts and bylaws	Yes, acts and bylaws and the State Enterprises Performance Monitoring Manual

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

### *What Can Governments Do?*

In terms of establishing a clear mandate and responsibility for the board, the suggestion is twofold. First, governments should establish new commercial SOEs under private sector law and convert existing SOEs to operate under corporate law where possible, or to at least adapt the acts and bylaws of the SOE to approximate company law. Second, governments can improve the accountability of board members by providing specific tools for this purpose.

To improve accountability and performance of boards in the short run, board nominees should be properly informed of the expectations of the role before they accept the position, and an onboarding and training program should be introduced for new board members. The onboarding package could include the company act, bylaws, financial reports of the previous 3–5 years, business plans for the next 3–5 years, related public policies, minutes of board meetings of the previous two years, the code of ethics, a statement that they have no material interest in competing entities, and a nondisclosure agreement. Board members should also attest to understanding the need for transparency in SOEs, which includes, but is not limited to, attendance at board meetings, compensation, disclosure of possible conflict of interest, etc.

To further improve the performance of boards, incentives/rewards based on the performance of the SOE could be instituted for board members. As suggested by the World Bank, listing the SOE on the respective securities exchanges would also facilitate greater accountability and transparency.

On a higher level, efficiency could be increased across all the CCB6 countries if a template for issues related to SOE governance were introduced that makes use of lessons learned and best practices in the region. The governance rules, which have basically been designed for large states, may need some adjustment for smaller states where the financial and human resources are limited, SOEs are relatively small, and the potential for connections and conflicts of interest is higher. In addition, using a common

template as a base would enable the countries to implement appropriate governance and updates more quickly and at a lower cost, since they would not have to start from scratch. In the future, common templates would allow for better comparisons between SOEs within the region. The countries are all members of the Caribbean Community (CARICOM) and strive towards a single market, so this commonality is highly feasible. It will also benefit the smaller Eastern Caribbean states when it is their turn to improve the governance of their SOEs.

### **Setting Strategy and Supervising Management**

The goal of Sub-Guideline B is to further delineate the tasks of a board to effectively carry out the board's "functions of setting strategy and supervising management, based on broad mandates and objectives set by the government" (OECD, 2015). Considering the IFC Progression Matrix, setting strategy could also be considered providing leadership with regard to ESG strategies. Essential considerations in the supervisory functions of boards are whether a board has the power to appoint and remove the CEO and to set executive remuneration levels.

#### ***Setting Out Strategy***

With regard to setting out strategy, progress is varied across the CCB6. Some have bills that articulate the roles and ideal functioning of SOE boards quite comprehensively, while others are still in the process of ratifying such bills. Trinidad and Tobago, as well as Jamaica, have had corporate governance frameworks since 2011-2012; it may be time to revisit and update these. In the Bahamas and Barbados, on the other hand, similar bills were expected to be proposed in 2020 as this chapter was finalized.

The draft bills for the Bahamas and Barbados mention the Statement of Corporate Intent (SCI) as the first step in the governance process. Among others, the SCI states the public policies to which the SOE seeks to contribute. The business plan may also state the dividend that the SOE seeks to pay. It would seem, however, that it is the government that should be the first to propose the social or financial results and/or dividends it expects to receive from the SOEs in order to meet fiscal or revenue targets.

#### ***Supervising Management***

With regard to supervising management, in all countries, the respective board generally nominates the CEO, but in some countries this appointment must be approved by the line minister or cabinet in office, sometimes based on previously specified qualifications. Even when the board is responsible for appointing the CEO, setting CEO remuneration, and dismissal determinations, these actions are usually conducted with the blessing of a minister or cabinet in office.

**Table 6.3. Appointment of SOE Chairperson and CEO in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Are the SOEs' CEO or chair appointed by the board of directors?	No	The CEO is, the chair is not	Yes	The CEO is, the chair is not	No	No
If not, who is the final designator of the SOEs' institution head?	Line minister	Cabinet	N/A	N/A	President, Minister of Finance, or line minister	Parliament and cabinet

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

In Barbados, Guyana, and Jamaica, the CEO is typically appointed by the board, as shown in Table 6.3. In Barbados this is explicitly after competitive selection. The CEO then comes under contract. The chairperson of the board, if a different person, is typically appointed by the cabinet, upon the recommendation of the line minister.

In Barbados, the final decision regarding the company's CEO or chairperson is made by the cabinet. Usually, the chairperson and board members place their seats at the discretion of the minister whenever the minister changes or the government administration changes. The CEO is normally replaced via a separation package if the government changes, as has been the case with the Caribbean Broadcasting Corporation, National Housing Corporation, and the Transport Board.

Going forward, for the countries that employ an SCI for each SOE, the government should issue terms of reference stating its expectations as to the public policies that each SOE is to contribute to, to what extent the SOE should do so, and how success will be measured. In addition, the government should propose the financial results and/or dividends it expects to receive from the SOE to meet its revenue targets. These steps should be done before the SOE issues its SCI.

The overall process could also include standardization for executive remuneration, as is done in the Netherlands and soon in the Dutch countries of Aruba and Curaçao (see Box 6.1). A further step would be to standardize the total remuneration of executive teams as a percentage of total personnel expenses. SOE financial statements and business plans would also show adherence to these norms.

### Board Composition for Objective and Independent Judgment

Sub-Guideline C states that SOE board composition "should allow the exercise of objective and independent judgment. All board members, including any public officials, should be nominated based on qualifications and have equivalent legal responsibilities" (OECD, 2015).

**BOX 6.1. THE PRIME MINISTER'S NORM**

In 2013 the Netherlands instated the Law on Standardization of the Highest Income (Wet op Normering Topinkomens) in state-related entities. The law, better known as the Balkenende-norm, after a former prime minister of the Netherlands, states that the total remuneration package of a CEO of a state-related entity should not exceed 130 percent of the prime minister's total remuneration. The norm is scaled depending on the size of the entity and the share of revenue derived from activities for which the entity has a monopoly. Consultants' fees are also standardized in relation to the norm. The maximum remuneration package is adjusted annually. As a result of the COVID-19 pandemic and the ensuing fiscal hardship, Aruba and Curaçao began working to introduce a similar norm in 2020.

***Board Selection***

As shown in Table 6.4, in none of the countries are the openings for board members published externally or subject to competition. It is not often that the required qualifications are explicitly specified or that a pool of qualified candidates exists. Specifying the expertise and experience required from board members through a skills matrix enhances the objectivity and transparency in nominating and appointing board members and can subsequently enhance the quality of the board.

***Women on Boards***

All CCB6 countries have women in SOE management and on SOE boards (see Figures 6.2 and 6.3), yet female representation is well below 50 percent and women leading either an SOE management team or an SOE board are almost nonexistent in the CCB6. In considering the availability of qualified women for leadership roles it is useful to understand that “female enrollment in, and graduation from, Caribbean colleges and universities usually outnumber that of males” (Chipman-Johnson and VanderPool, 2003), as has been the case for many years. The outpacing of women to men holds true across all fields except for engineering and technology, and the ratio is suspected to grow to over two females for every male in tertiary education. This suggests the imbalance of male to female leadership has not persisted without some structural interference or discrimination.

Given the need in the CCB6 to increase the size of the pool of possible directors and SOE executives and the obvious value of diversity in leadership and management, women's increased participation on boards (and in executive teams) is not only highly desirable but long overdue given the trends in higher education. SOEs should consider active recruitment of women and

**Table 6.4. Selection of SOE Boards of Directors in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Are the SOE board member openings published externally and subject to competition?	No	No	No	No	No	No
Do SOEs include explicit requirements for the selection of board members (nationality, work experience, educational level, etc.)?	No	No	Yes	Yes	No	Yes
If yes, what are the stipulated requirements (nationality, work experience, educational level, etc.)?	N/A	None, although some SOEs may elect to have nationals only		Some boards will specify required education and experience	Not stipulated	Nationality and industry experience are key considerations
Do you maintain a pool of candidates for future board of directors' appointment?	No	No	No	Not yet; it is being considered	No	Yes

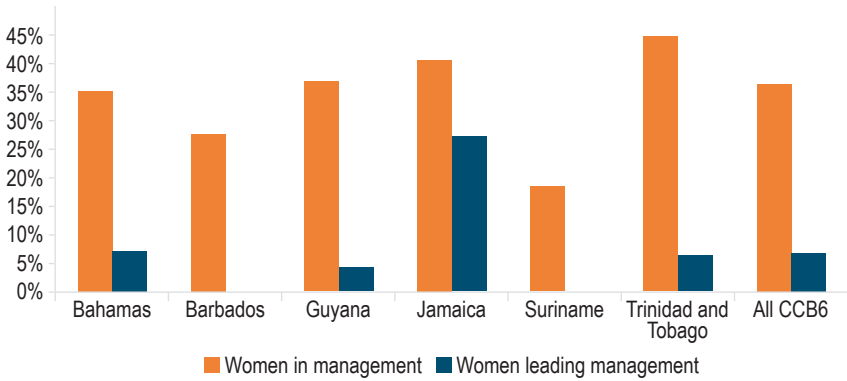
Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

other underrepresented groups. Some European countries have addressed this by setting quotas for the inclusion of women on boards.

Additionally, the structural lack of qualified human resources for all higher functions, including boards, could be surmounted not only through increasing recruiting of women, but also by providing training and preparation for women who have not had access to on-the-job training and learning. Providing continuing courses on governance that are open to all, for instance via massive open online courses (MOOCs), enlarges the pool of qualified board members. When building a pool of candidates or inviting participants to a course, care should be exercised to specifically target under-represented groups.

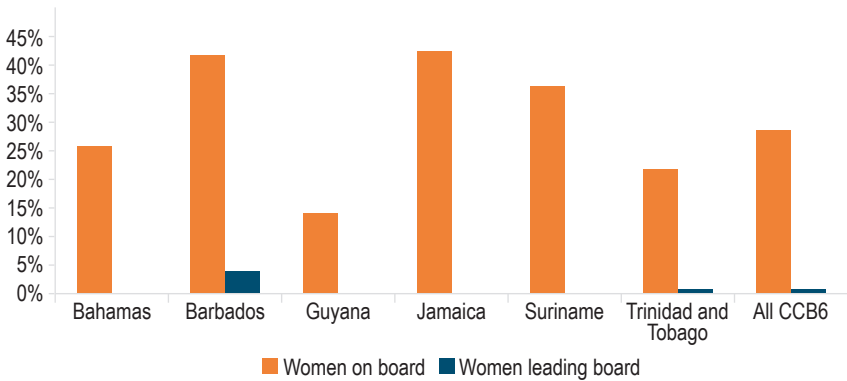


**Figure 6.2. Women in SOE Management and on Boards in CCB6 Countries**



Source: Authors' elaboration using the IDB CCB6 State-Owned Enterprises Database.

**Figure 6.3. Women on SOE Boards in CCB6 Countries**



Source: Authors' elaboration using the IDB CCB6 State-Owned Enterprises Database.

### Board Eligibility

The CCB6 countries have different rules around the eligibility of elected officials to sit on SOE boards (see Table 6.5). In the Bahamas, Guyana, and Suriname, elected officials are permitted to sit on SOE boards. In Barbados, Jamaica, and Trinidad and Tobago, ministers cannot sit on boards, but members of parliament can. In some countries, certain officials—such as the director of finance or economic affairs, their permanent secretary, or another senior public official—are invited to sit on boards only *ex officio*.

Foreign nationals are typically not found on SOE boards in the CCB6, but they could allow CCB6 SOEs to overcome the problems of small pools of talent and the connected nature of these small societies that lead to conflicts of interest and nepotism. To illustrate the problem of small talent pools,

**Table 6.5. Appointment of SOE Board Members in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Can ministers or government officials be appointed as board members?	Yes	Not ministers, but members of parliament, senators, permanent secretaries, and director of finance and economic affairs can	Yes	Not ministers, but members of parliament, senators, permanent secretaries, and other senior public servants can, if not in their line ministry	Yes	Not ministers, but members of parliament, senators, permanent secretaries, and director of finance and economic affairs can
Can foreigners be appointed as board members?	No	Yes, but there has never been a case where a foreigner served on a national board	Yes	No	Yes, when specified in the Act	Yes, when specified in the Act; sometimes there is a regional representative
Can employees be appointed as board members?	No	No. The permanent secretaries serve as ex officio members on all boards under purview of the line ministry. In other cases where employees do serve, they do so as ex officio members of the board.	Yes; some boards have union members	No	No information available; research needed	Yes, as ex officio members

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

consider the following example. Typically, there is but one power company in a country. Everyone who has enough demonstrable expertise on “energy” to add value to the board with subject matter expertise has had a relationship with the power company. Also consider that SOEs in these countries are relatively large, which means just about everyone has a family member or close friend who is an employee, supplier, or charitable beneficiary of the largest SOEs. Thus, it is hard for experts to be truly independent.

Allowing foreign nationals to sit on boards can be a way to enable the presence of someone with expertise and without a conflict or material interest. This is a common practice on the boards of some of the best-governed SOEs in the world; for example, Aramco (the Saudi Arabian Oil Company) has many foreigners on their board, and the Panama Canal Authority also follows this practice. In the CCB6, there is free mobility of specialized labor between countries. The tourism-based nations of the CCB6—the Bahamas, Barbados, and Jamaica—also have large numbers of returning foreign visitors, some of whom have specific expertise and even property in the countries. These experts could add value on boards, and the increase in convenience of digital meetings has made this possibility less cumbersome. The CCB6 also have large diasporas, sometimes equal to or larger than the local population. Thus, CCB6 expatriates could also be called on to serve on boards if they have the proper qualifications.

### *Board Preparation and Alignment*

For all board members, proper preparation and onboarding is essential. Requiring aspiring board members for commercial SOEs to have served on boards of noncommercial SOEs/foundations (with little or no remuneration) will ensure that they have a good understanding of the government landscape before coming onboard. This also demonstrates a willingness to serve the nation in a mostly volunteer capacity. Potential board members could also be required to shadow seasoned board members to learn the needed skills.

At the start of new board members' tenures, workshops on the KPIs and drivers of the sector/industry as well as on the company's goals for the next 3–5 years should be provided. A manual on best practices for board members should be developed to prepare professionals, whether insiders or outsiders to the industry, to serve on SOE boards. In the Caribbean, such a manual would be particularly useful in training SOE board members on auditing and ethical behavior. These manuals could be drafted by the corporate governance institutes of each nation or by centralized monitoring agencies in charge of overseeing SOEs.

### **Independent Board Members Free of Material Interests**

Per Sub-Guideline D, “independent board members, where applicable, should be free of any material interests or relationships with the enterprise, its management, other major shareholders and the ownership entity that could jeopardise their exercise of objective judgement” (OECD, 2015).

### *Independence*

All CCB6 SOEs have independent boards, at least on paper, as shown in Table 6.6. Board members are often independent in that they are not direct stakeholders of the SOE. Typically, they are also not employees, major

**Table 6.6. Independence of SOE Boards in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Internal board	No	No	No	No	No	No
External board	Yes	Yes	Yes	Yes	Yes	Yes
Independent board	Yes	Yes	Yes	Yes	Yes	Yes

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

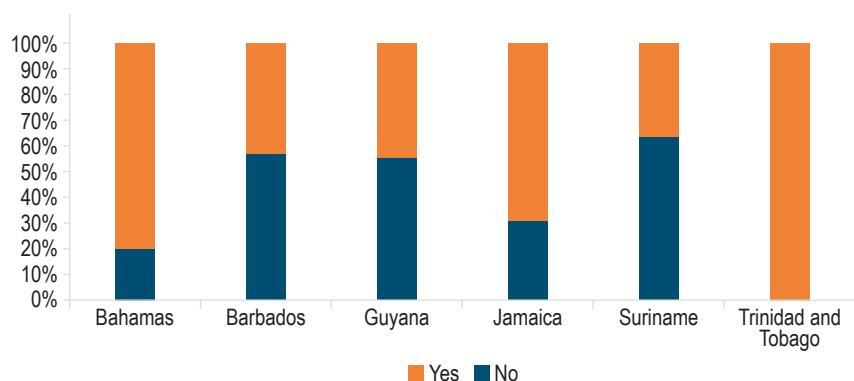
clients, or suppliers of the SOE. However, board members are nominated and appointed by the line minister and/or cabinet in office and tender their resignation when the administration changes. Having board members that are appointed by the current cabinet in office ensures that the public policies that are a priority for the administration in office are followed. In this sense, they are not independent of political influence and demands on the SOE.

The Guyana Revenue Authority requires certain boards to include members of the Central Bank, Director of Budgets, or the Ministry of Finance (MOF); for example, the board of the Guyana Water Company includes the permanent secretary of the line ministry. Typically, ministers cannot be board members. Civil servants, members of parliament, and members of the military, however, usually can serve on boards. It is recommended that SOE boards include at least two truly independent members, selected for their deep expertise and high objectivity. These board members would also provide continuity to the board and reduce the asymmetries of information between SOEs and the ministries that oversee them.

### **Material Interest**

Pending bills in several of the CCB6 countries mention that board members should be free of material interests related to the enterprise. However, if and how this is established at the beginning of their term or monitored during their term is not stated. As mentioned before, in small countries with limited qualified human resources and high interrelatedness of candidates, and where there is often disinterest by qualified individuals to do public service, it may be difficult to fully achieve the requirement that board members or their immediate families have no material interest in the enterprise. In addition, the perception that a board seat serves to safeguard one's own interest persists (i.e., one believes that a board seat is a "lobbying role" of sorts). This may result from confusion around the legal requirement for select boards to be composed of equal representatives of government, labor, and the private sector.

It is difficult to achieve and monitor true independence of board members, but there are steps that countries can take. Prospective board members

**Figure 6.4. Board Members Published on SOE Websites**

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

should be required to disclose all interest in an SOE prior to accepting the position, so that the potential risk can be assessed. They should be informed that some interest will not impede them from serving on a particular board, but that the interest should be disclosed and that board members are expected to abstain from contributing to discussions when they have an interest.

Additionally, the SOE should be transparent about who is on the board and the executive team. More than 60 percent of commercial SOEs in the CCB6 publish the names of either the supervisory board of directors or the executive team on their websites (see Figure 6.4), but other affiliations and business interests should also be published. Some SOEs, especially in the Bahamas and Jamaica, also include the background, expertise, and experience of the board and executive team. To help determine what should be posted, the IFC provides an Indicative Independent Director Definition.<sup>1</sup> Countries can follow such definitions of board independence and publish them in the “Governance” section of SOE websites so that the general public can also help evaluate the independence of directors.

### Mechanisms to Avoid Conflicts of Interest

Sub-Guideline E states that “mechanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and to limit political interference in board processes” (OECD, 2015). Conflicts of interest, which as discussed previously may to some

<sup>1</sup> See [https://www.ifc.org/wps/wcm/connect/b3f84d89-541a-45cc-a7db-41a20c021763/IFC\\_Indicative\\_Independent\\_Director\\_Definition\\_062719.pdf?MOD=AJPERES&CVID=mKqqtnW](https://www.ifc.org/wps/wcm/connect/b3f84d89-541a-45cc-a7db-41a20c021763/IFC_Indicative_Independent_Director_Definition_062719.pdf?MOD=AJPERES&CVID=mKqqtnW).

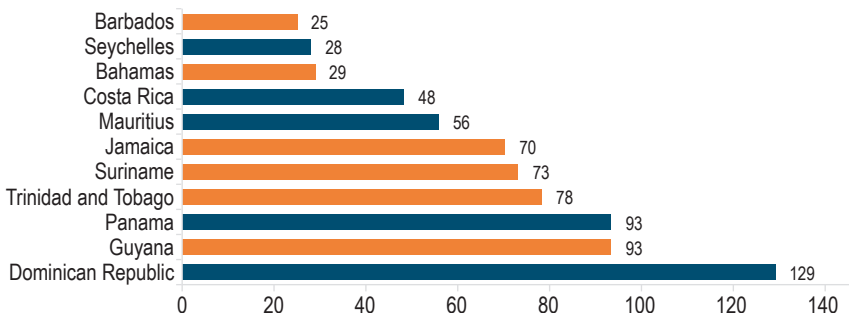
extent be unavoidable, are problematic in that they may result in board members using the SOE for personal gain or to advance a political agenda, either of which poses a serious fiscal risk. Conflicts of interest may manifest as nepotism, political abuse, favoritism in procurement issues, and outright corruption.

### Corruption

Aside from disclosures around material interests, indexes of perceived corruption are another means of assessing conflict of interest. In its 2017 Global Corruption Barometer report, “People and Corruption: Latin America and the Caribbean,” Transparency International (2017) found that over 60 percent of the people interviewed in the countries felt that corruption in their country had risen in the previous 12 months. The percentages for the CCB6 ranged from a high of 62 percent in Trinidad and Tobago to a low of 37 percent in Barbados. In all countries, including those in the CCB6, over half the people surveyed felt that corruption in government is a big problem. For perceived issues with government corruption, the percentages ranged from a high of 82 percent in Trinidad and Tobago to a low of 53 percent, again in Barbados. In the 2019 Corruption Perceptions Index of 198 countries by Transparency International (2019), all the CCB6 countries ranked in the top half of least-corrupt countries. The Bahamas and Barbados ranked in the top 30, as shown in the graph below. Even so, there is room for improvement in all the countries (see Figure 6.5).

In 2018, Transparency International wrote that: “Most English-speaking Caribbean countries score exactly the same as last year, showing complete stagnation. Despite the current administrations in Jamaica, the Bahamas, and Barbados, which rose to power based on bold anti-corruption platforms, any visible improvements are still very limited” (Transparency International, 2019). In Jamaica, the Petrojam scandal involving the national oil company

**Figure 6.5. Corruption Perceptions Index Rankings for CCB6 and Selected Countries (2019)**



Source: Transparency International (2019).

shows that nepotism, mismanagement of public funds, and other forms of corruption are still well rooted in the Caribbean. Procurement and contract awarding have been particularly problematic. In the Petrojam case, the auditor general found violations in procurement (e.g., severe cost overruns), mismanagement of capital investments, questionable recruitment and compensation practices for top executives, and inadequate oversight of the operations in general (Auditor General's Department of Jamaica, 2018).

### *Procurement*

Procurement may well be the area in which conflicts of interest are most likely to occur. Some of the typical abuses of procurement practices in SOEs were found by Jamaica's auditor general's report of the activities on Petrojam. In particular, some of the inputs for a refinery were below the quality demanded, volumes received were below what was paid for, and the mishandling of capital projects led to severe cost overruns. Many of the oversight mistakes were in fact attributed to the board of directors and its committees, which often failed to meet regularly and to oversee key expenses closely (Auditor General's Department of Jamaica, 2018, 30–41).

The most recent WTO Trade Policy Review of Suriname notes that “the regulatory framework for government procurement continues to contain inconsistencies (such as lack of transparency)” (WTO, 2013). With regard to Guyana, the WTO notes in its review that “the Procurement Act is applied to public procurement at the national, ministerial, government agency, and regional level, but not to procurement by public corporations and other state bodies” (WTO, 2015). In its review of Trinidad and Tobago, the WTO notes that the country's public procurement regulations are undergoing significant changes and that “the (new) Act will govern procurement by all state agencies using public money under a single regulatory framework” (WTO, 2019).

Caribbean SOEs are taking measures to address perceived corruption. Several SOEs are publishing tendering procedures, as well as the open and awarded tenders, on their websites. A number of SOEs, including Jamaica's Rural Water Supply Company Ltd. and Aeronautical Telecommunications Ltd., have gone to great lengths to increase their transparency by publishing on their websites not only the names of the board members but also other information such as their qualifications, experience, and other functions they hold as well as their compensation arrangements. In 2017, Suriname joined the Extractive Industries Transparency Initiative (EITI), an initiative supported by a multistakeholder group (government, private sector, and NGOs) that is already being implemented in 52 countries with extractive industries. The National Gas Company of Trinidad and Tobago has a designated officer for the Freedom of Information Act (FOIA) and publishes the name on its website.

## BOX 6.2. THE CASE OF SANOFI

The case of Sanofi, a multinational pharmaceutical company, can provide some guidance for how to change expectations and incentives. Sanofi details its understanding and expectations for integrity on its website for all to read (Sanofi, 2018). In particular, the Code of Ethics lists what employees must do in areas such as dealing with conflict of interest, participating in public life, respecting free competition, fighting bribery and corruption, interacting with patients, interacting with the scientific community, being transparent about their products, and how to raise a concern. SOEs should have similar ethics websites with guidelines for employees, executives, and board members.

### *What Can Governments Do to Reduce Corruption?*

More can be done to reduce corruption or the perception thereof. If the country's regulatory framework for procurement does not suffice, the SOE should develop and follow a policy for procurement. Following the Procurement Policy and Procedures of the International Organization for Standardization (ISO, 2018) or something similar may be helpful in this regard.

There can also be legal prescriptions to reduce conflict of interest, such as:

- Having board members sign a conflict-of-interest policy prior to accepting a board position
- Specifying how long a board member can serve in legal codes and having acts and bylaws that ensure effective rotation
- Having codes, acts, and/or bylaws that specify the minimum time lapse between being an executive and serving as an independent board member
- Having codes or acts that specify the minimum time lapse between two tenures on the board
- Having codes or acts that specify the maximum number of SOE boards a person may serve on concurrently.

Transparency International also provides a list of 10 Anti-Corruption Principles for State-Owned Enterprises (Wilkinson, 2017). Perhaps the most concrete initiative that we have come across is that of the pharmaceutical company Sanofi, which specifies on its website concrete expectations for employees and stakeholders (see Box 6.2). It takes two parties for a corrupt action to take place. Too often anti-corruption initiatives and information are geared only to the SOEs and have no penalties for suppliers and others involved in corruption.

### **Functions of the Chair and Separation from CEO**

According to the OECD's Sub-Guideline F, "the Chair should assume responsibility for boardroom efficiency and, when necessary in co-ordination with



**Table 6.7. Frequency of SOE Board Meetings and Sharing of Meeting Minutes in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Frequency of board meetings	Quarterly	Monthly	Monthly	Quarterly	Varies depending on SOE	Varies, but mostly monthly
Are minutes and reports shared with government?	Yes	Yes, with the line ministry	Yes, some are sent to the line minister	Yes, with the permanent secretary	No information available; research needed	Yes

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

other board members, act as the liaison for communications with the state ownership entity. Good practice calls for the Chair to be separate from the CEO" (OECD, 2015).

The board procedures outlined in the IFC Progression Matrix (IFC, 2019) include board charters that define the role and procedures of the board and committees, frequency and length of board and committee meetings, and training of board members. A review of the CCB6 country assessments shows that generally attendance at board meetings is taken and minutes recorded and filed with the state ownership entity (Table 6.7).

Separation between the chair of the board and the CEO is considered a two-tier governance structure. A review of the 65 commercial SOEs in this study reveals that an overwhelming majority already have this structure in place, with the functions of the chair of the board and the CEO separated. This is most common among larger SOEs. Therefore, countries should decide which types or sizes of SOE must have a two-tier structure and which type/size can suffice with a one-tier structure. The divide is not along the lines of commercial versus noncommercial. A large hospital, which is a noncommercial entity, may need a two-tier system because of its large procurement budget and recruitment needs, as well as the effect of its policies on other entities in the health-care sector and on the public in general.

### Effective Employee Representation on Boards

Sub-Guideline G states, "if employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence" (OECD, 2015).

Table 6.8 indicates that, except for Guyana, employees do not serve on SOE boards in the CCB6.<sup>2</sup> This situation contrasts with that in the OECD

<sup>2</sup> In several countries, the permanent secretary of the line ministry, or a representative, may serve as ex officio members on corporate boards falling under the ministry.

**Table 6.8. Employees on SOE Boards in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Can employees be appointed as board members?	No	As ex officio members	Yes	N/A	No	As ex officio members

Source: Authors' elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

countries, where, by 2015, only two countries—the United States and Singapore—did not grant workers representation on boards. This lack of employee representation is unfortunate, given that the OECD (2017) finds employee representation to be effective to improve board monitoring capabilities and to represent the interests of the labor force. The EU Directives on board-level employee representation may serve as a guideline as to the size of company, sector, method of selection, and maximum number of employees to sit on the board (Schulten and Zagelmeyer, 1998; Händel, 2016).

SOEs in the CCB6 can decide if and when they would like to introduce employee representation on their boards. In the meantime, mechanisms should be in place for the board to receive regular input from employees, just as it would from other stakeholders. If the decision is made to include employees, care should be taken to inform the potential representatives that their role is to guard the interests of the company as a whole, not exclusively that of the employee. In addition, care should be taken to select representatives that are as equally qualified and prepared as other board members.

### Specialized Independent and Qualified Committees

According to Sub-Guideline H, “SOE boards should consider setting up specialised committees, composed of independent and qualified members, to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration. The establishment of specialised committees should improve boardroom efficiency and should not detract from the responsibility of the full board” (OECD, 2015).

From our review of CCB6 practices, it appears that most large SOEs have at least an audit committee. It is not clear to what degree this committee's membership is independent from the executive board. The SOEs in the CCB6 do not commonly have risk and remuneration or other committees. This could be due to lack of competency or due to insufficient human or financial resources to institute such committees. Besides the committees mentioned above, the IFC Progression Matrix (IFC, 2019) also calls for specialized committees to deal with conflicts of interest and technical topics such as procurement, cybersecurity, and environmental, social, and sustainability issues. Again, whether CCB6 SOEs can adopt these recommendations depends to a

large extent on the availability of talent and resources to fund the necessary board seats to have enough board members for those committees.

As stated elsewhere, governance requirements place a disproportionately heavy burden on the SOEs and country resources in small nations. The addition of environmental, social, and sustainability issues, which are likely to be increasingly expected and scrutinized in the near future, also increase the burden. To increase efficiency and consistency, governments may consider establishing “centralized” pools of qualified professionals who may participate in, assist, or serve as the secretariat for specialized committees of several SOEs. In addition, standardized templates and tools that are applicable for all countries should be developed to further improve efficiency.

### Self-Evaluation by the Board

In Sub-Guideline I the OECD addresses best practices for boards of directors to carry out annual self-evaluations, under the chair’s oversight, to appraise their performance and efficiency (OECD, 2015). As Table 6.9 reveals, SOE boards in Jamaica and Trinidad and Tobago—the countries that have instruments equivalent to a code of corporate governance—are evaluated by the MOF or the line ministry; it is not a self-evaluation. In the other CCB6 countries, there is some degree of monitoring of the board conducted through required regular meetings, whose minutes are generally shared with the government. Typically, when the cabinet changes or a large capital investment or other impactful action (including layoffs) is necessary, or before, the board or executive team appears before the cabinet or parliament, separately from the shareholder meeting, to explain the state of the company and necessary actions. When minority shareholders have voting rights, these may also prove to be a form of monitoring. In fact, the World Bank suggests that having other shareholders, including by means of listing the SOE on securities exchanges, will enhance performance (World Bank, 2014).

The IFC Progression Matrix (IFC, 2019) further speaks to evaluations of even individual directors, conducted or facilitated by a third party, and the

**Table 6.9. Evaluation of SOE Boards in CCB6 Countries**

	Bahamas	Barbados	Guyana	Jamaica	Suriname	Trinidad and Tobago
Do you conduct performance evaluation of the board of directors?	No	No	No	Yes	No	Yes
Who conducts the performance evaluation of the board of directors?	N/A	N/A	N/A	MOF and line ministry	N/A	MOF and line ministry

Source: Authors’ elaboration based on IDB SOE Monitoring and Corporate Governance Questionnaire (2018).

outcomes from these evaluations being considered in decisions on whether to renew board mandates.

### *Benchmarks Lacking*

Unfortunately, existing evaluations only consider the performance of an individual SOE in isolation. The performance is not benchmarked against the performance of other SOEs in the country, similar SOEs in other similar countries, or similar private enterprises in the country or elsewhere. Therefore, it may well be that an SOE in the mining sector receives a positive evaluation because of a positive or improved EBITDA, even when, all else equal, its ROI is significantly lower than that of private mining companies or similar mining companies elsewhere.

To improve the effectiveness of existing and future evaluations, it would be helpful if a database of the financials and KPIs of important SOEs and competing private enterprises in all the countries is created and made accessible to the public. Regional universities can play an important supporting role in this endeavor.

### **Efficient Internal Audit Procedures**

Best practices call for an efficient internal audit function that reports directly to the board and to the audit committee, as addressed by Sub-Guideline J (OECD, 2015). The larger commercial SOEs in the CCB6 typically have internal audit procedures as well as external auditors. It should be noted that they also have the resources to do so. Noncommercial SOEs, some of which may be large and pose significant risk to public finances, might not have the resources to do so or would rather apply their resources to fulfilling their social objective.

At least one, if not all, of the Big Four auditing firms is present in each CCB6 country. Their fees are somewhat geared towards auditing financial institutions, large private enterprises (in industry and hospitality), and large commercial SOEs. For a smaller SOE, the cost of external audits may be relatively high compared to the overall balance sheet. Thus, it could be difficult politically to justify paying auditors a large amount of money when the limited funding available is also needed for the purchase of uniforms, safety equipment, capacity building, and so forth.

It is feasible for SOEs in small countries to comply with the OECD guidelines through more efficient means, without posing excessive additional burden to public finances and despite limited qualified human resources. A Regulatory Impact Assessment (RIA) should be performed prior to committing to each OECD guideline. In most instances, the commercial, often self-sufficient SOE can manage the internal burden of professional governance. The social SOEs, which receive the most subsidies from government and are less likely to have a sustainable operational model, might not be able

to shoulder this burden internally. Even if both the commercial and social SOEs are able to carry their burden internally, the burden of professional governance on the individual line ministries and the MOF should be assessed.

## Conclusions and Recommendations

Caribbean countries are under pressure to improve their public financial management, including the management of their SOEs, to create the fiscal space necessary to invest in their developmental goals, including the SDGs and the Paris Accord—for which the expectation is that funds do not come solely from developed nations but that lower-income countries contribute substantially.

Corporate governance reform is a key strategy for reducing the fiscal risk posed by SOEs, increasing financial returns to governments from commercial SOEs, and enhancing social and developmental returns. Additionally, better and more transparent governance of SOEs contributes to reduced perception of corruption in the country and increased FDI, specifically by reducing the perceived risk for a foreign entity interested in participating in public-private partnerships with the government.

However, complying with OECD guidelines may pose a disproportionate burden on these small countries and their SOEs due to limited financial and human resources. Proper governance requires an SOE department within the central government so it is advisable that countries assess the impact of new regulations prior to committing to them. It is also advisable that countries increase their efficiency with regard to governance by establishing digital platforms to share templates, lessons learned, and other relevant materials, focusing on those most relevant for small countries. Centralizing some functions, such as risk and remuneration committees, may also be considered. In addition to enhancing the quality of boards and reducing corruption, countries should endeavor to include more women, young professionals, and other underrepresented groups on boards of directors. Finally, countries should leverage SOEs as an opportunity to maintain human capital and attract nationals in the diaspora, regional professionals, and repeat and qualified visiting tourists to increase the pool of candidates for board membership. These are all ways to “gain some brains,” albeit part time.

Large commercial SOEs are likely able to carry the burden of increased regulation, but noncommercial subsidized SOEs may not be able to do so. They might have a less business-like approach, might not be able to attract the best human resources (because of lower wages), and may prioritize social goals over financial goals. Nonetheless, because heavy subsidization enables them to fulfill basic needs such as providing water, electricity, transportation, housing, health care, and education for the large majority of the population, many of whom cannot afford these services otherwise, these

social SOEs are not likely to develop alternative funding streams and therefore pose a significant risk to public finances if not governed well.

Here are some easy steps to improve governance of SOE boards in the CCB6 beyond the steps recommended in the IFC Progression Matrix (IFC, 2019):

- Be transparent. Existing procedures for appointing board members, the board's role and performance, and the qualifications, material interests, affiliations, and remunerations of board members should be published on websites.
- Provide and require proper training and onboarding both before and after board members are appointed.
- Educate both direct stakeholders and the general public about what exactly constitute conflicts, material interest, independence, etc. and the difference between confidentiality, nondisclosure, transparency, and similar concepts. If the general public knows the guidelines, they can aid in monitoring.
- Develop a pool of potential board members. Train them, appoint them to noncommercial boards, and allow them to shadow board members of commercial SOEs prior to joining these boards.
- Consider appointing nonresidents to SOE boards. These could be nationals in the diaspora or foreign nationals, including those from neighboring countries. They may have unique expertise and are likely to have fewer conflicts of interest. The CCB6 countries have many choices for expanding their pool of potential board members: their diasporas are generally very large and looking to contribute even if they do not want to move back home. In addition, some of the countries have many repeat visitors (tourists), some of which have real estate in the country and therefore a vested interest. Accelerated digitalization and internet connectivity has greatly improved the possibilities for these various groups of people to participate.
- Include noncommercial SOEs in the efforts to improve governance to increase the scale of the efforts and spread the risk. Collaborate across countries to improve governance and design the efforts so that they are highly duplicable. Collaboration increases the scale and lessons learned. In the Compete Caribbean Partnership Facility, IDB helps CARIFORUM countries develop and implement duplicable reforms with regard to the business-enabling environment. A similar approach can be taken with regard to the corporate governance of SOEs. Most of the CCB6 countries are Anglophone; Suriname can tap into the resources of Curaçao, also in the Dutch Caribbean.

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# Section III

## The Way Forward



# Financial Management of External Risk Exposure: The Case for Hedging in the Context of State-Owned Firms

## Introduction

Around the world, both firms and countries face significant volatility in their cash flows. In this context, this book would be incomplete if it did not include a discussion on how to mitigate the effects of such volatility. Most recommendations for state-owned enterprises (SOEs)—in this book and elsewhere—focus on efforts to improve the financial and operational sustainability of SOEs. In contrast, this chapter explores how to mitigate the variance around these aspects.

Hedging is the generic term for strategies for reducing exposure to some cash-flow risks. For example, a company that sells oil could buy an offsetting position in another investment that is inversely related to oil price. This other investment could be a financial derivative, or it could be an account payable, promising to pay the value of a given number of oil barrels. In principle, this could also work for other activities, like tourism.

Concretely, Caribbean governments face massive volatility in cash flows from exports of goods and services, either through fiscal revenues, from public companies, or in terms of flows to the whole economy, which later impact their tax base. This volatility has several implications for fiscal management. For example, it may limit the effective separation of SOEs' finances from the sovereign's (e.g., bailouts) or the country's ability to conduct countercyclical fiscal policies.

This chapter starts by measuring the sensitivity to external shocks, including commodity prices and tourism. This is extremely relevant nowadays, given that commodity prices have dropped and tourism came to a complete halt due to the global health emergency caused by COVID-19. Subsequently, we explore how to mitigate these fluctuations through various types of hedging: forwards, options, and alternative arrangements.

To start, it should be acknowledged that these risks stemming from exposure to the international economy are not the only ones faced by the governments of the CCB6 nations—the Bahamas (BHS), Barbados (BRB), Jamaica (JAM), Guyana (GUY), Suriname (SUR), and Trinidad and Tobago (TTO). In fact, these risks tend to be smaller than those caused by large natural disasters such as a sizable hurricane. This chapter will focus on the former as the fiscal impacts (Ouattara and Strobl, 2013) of, and the insurance mechanisms (Borensztein, Cavallo, and Valenzuela, 2009) for safeguarding against, these natural shocks have been explored already.<sup>1</sup>

Our work has a natural connection to the literature on the cyclicity of fiscal policy and its relationship to commodities or the international economy (e.g., Kaminsky, 2010; Gavin and Perotti, 1997). As well established in the existing literature, many models indicate that governments should not impose additional tax burdens during downturns of the cycle (Barro, 1979), a strategy known as tax smoothing. While this normative finding may reflect the behavior of advanced economies, it seems at odds with the more common procyclical taxation approach of developing countries (Vegh and Vuletin, 2015; Talvi and Vegh, 2005).<sup>2</sup>

A large body of literature on corporate hedging has focused on the specifics of firm hedging when exposed to some international risk, such as commodity price fluctuations (e.g., Tufano, 1998; Donders, Jara, and Wagner, 2018). Unlike these papers that look at firm- or micro-level hedging, this chapter examines macro-level hedging, along the lines of Borensztein, Jeanne, and Sandri (2013), for Caribbean economies, thinking about risk

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<sup>1</sup> Using synthetic control methods, Cavallo et al. (2013) find that large natural disasters do not impact long-run economic growth, at least after controlling for large political events in the aftermath of the disaster. Hausmann, Rodríguez, and Wagner (2008) explore various types of crises, including those originated by a natural disaster, and del Valle, de Janvry, and Sadoulet (2019) discuss the mechanisms to distribute disaster relief funds.

<sup>2</sup> Sometimes windfalls of external resources, such as a rise in commodity prices, may generate a permanent rather than a temporary increase in spending, kicking off a spiral of indebtedness. This apparent misjudgment of the temporary nature of a cycle may not necessarily originate from individual psychology, but from political economy problems and limited fiscal institutions to manage this transitory shock (see Tornell and Lane, 1999; Frankel, Vegh, and Vuletin, 2013; Velasco, 2000). In this paper we take a cyclical view, assuming fluctuations do not generate a permanent shift. This approach underscores the focus of the chapter on hedging risk in the context of sustainable means for income, spending, and deficits. Other structural policies are needed when balances become unsustainable.

management for the consolidated government.<sup>3</sup> The focus is on significant international risks instead of large natural disasters.

The first section of this chapter estimates exposure regressions to get a first approximation of how the fiscal accounts react to changes in commodity prices or tourism. We do not aim for precise magnitudes but instead note that the structure of the economy may matter for the type of risk exposure. For instance, as expected, the results lend some support to the idea that commodity-driven economies in the Caribbean are more sensitive to commodity shocks than to tourism shocks.

The second section—the largest portion of this chapter—discusses the different avenues for hedging risk exposures. In it, we use the narrative approach of a “tale of two countries.” The third section is more exploratory and discusses specific challenges in applying these hedging principles to the Caribbean economies. Finally, the chapter concludes with a few remarks.

## Why Hedge? Estimating Risk Exposures

Smoothing the commodity and tourism cycles could bring more stability to the Caribbean fiscal accounts. Given this book’s focus on SOEs, one may be tempted to start by calculating the exposure of each individual firm’s cash flows to either tourism or commodities. Indeed, the previous chapters argued that these enterprises face relevant volatility. Nonetheless, as will become clearer later in this chapter, there is a possibility of cross-hedging within the government. Therefore, we start by calculating the overall exposures of the fiscal accounts, rather than those of individual SOEs.

### Data on Fiscal Outcomes and Exports, Including Tourism

Like the early chapters of the book, this chapter uses data from IMF’s World Economic Outlook (WEO), Government Finance Statistics (GFS), and Commodity Terms of Trade (PCTOT) datasets, as well as the World Bank’s World Development Indicators (WDI) and data from the Caribbean Tourism Organization (n.d.) to map tourists’ countries of origin, which will be useful for instrumenting tourism flows.

Most of the analysis centers on the CCB6 nations. Organisation of Eastern Caribbean States (OECS) economies<sup>4</sup> are used as a benchmark. As shown in other chapters, Guyana, Suriname, and Trinidad and Tobago have a much stronger dependency on natural resources, while the Bahamas, Barbados, and Jamaica depend much more on tourism (see Figure 7.1). This almost bi-modal distinction will be important in subsequent sections that measure exposures to different factors.

<sup>3</sup> Including all agencies and SOEs.

<sup>4</sup> Antigua and Barbuda, Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines.

**Figure 7.1. Composition of Trade for CCB6 Countries: Tourism vs. Natural Resources**



Source: World Bank (n.d.).

Notes: Shares are reported for 2016. While the vertical axis directly represents the share of tourism on exports, the horizontal axis represents the rents from natural resources as a share of exports. This is not the same as natural resource exports. The exact definition is available from World Bank (n.d.).

### Empirical Model

Exposure regressions aim to measure the extent to which fiscal outcomes react to shocks on various types of export determinants.<sup>5</sup> Namely, we estimate:

$$\Delta git = \mu i + \lambda t + \beta \Delta yit + \epsilon it, \quad (1)$$

; where  $\Delta git$  is the change in a fiscal outcome (gross or net) and  $\Delta yit$  represents the change in the external variable (e.g., exports, tourism, or commodity prices, among others). Fiscal outcomes are measured in logs or share of GDP, sometimes using trend GDP as denominator. The regressions could be estimated in various aggregations: groups of countries, as a panel, or for each country separately.

### Basic Results

We start by running a cross-country panel regression using exports or the right-hand side (RHS). Recall from Figure 7.1 that the composition of trade is remarkably different between groups. While some have large endowments of natural resources, others depend mostly on tourism.

<sup>5</sup> Given endogeneity concerns, the exogenous component of risk exposure is estimated later in this chapter by using an Instrumental Variables (IV) approach.

**Table 7.1. Fiscal Exposure to Export Shocks of CCB6 Countries**

	$\Delta$ Revenues			$\Delta$ Gross Debt			$\Delta$ Primary Balance	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$\Delta \ln \text{exports}$	0.50*** [0.114]	0.046 [0.028]	0.10* [0.040]	-0.006 [0.091]	-0.12 [0.075]	-0.056 [0.074]	0.056 [0.029]	0.057 [0.033]
Observations	140	140	140	131	131	131	140	140
Countries	6	6	6	6	6	6	6	6

Source: Fiscal outcomes are obtained from IMF (2019) and transformed into USD using exchange rate data from the World Bank (n.d.).

Notes: Dependent variable in columns (1) and (4) is expressed as log change. Dependent variable in columns (2), (5), and (7) is expressed as share of GDP while in columns (3), (6), and (8) it is expressed as a share of GDP trend (estimated with a Hodrick-Prescott filter). Constant term is not reported, and all specifications include country and time fixed effects. Hence, regression estimated is of the form  $\Delta g_{it} = \mu_i + \lambda t + \beta \Delta y_{it} + \varepsilon_{it}$ . Standard errors are reported in brackets and clustered at a country level. Symbols of statistical significance are \*\*\* for 1 percent level, \*\* for 5 percent, and \* for 10 percent level.

Table 7.1 displays these estimates. Column (1), for example, shows a positive and statistically significant elasticity of 0.5 between exports and fiscal revenues. This means that for an average CCB6 economy, a 10 percent drop in exports is associated with a 5 percent drop in fiscal revenues. Column (2) runs a similar exercise in points of GDP and finds no significant coefficient. This might be due to volatility in the denominator (GDP) instead of exports. For that reason, we also run a regression of revenues over trend GDP. In that case we find a statistically significant coefficient of 0.1 (p-value < 0.1).

Note, however, that while shocks on exports have a significant effect on government revenues, net outcomes do not vary significantly. In particular, we do not find a significant coefficient between exports and changes in debt, likewise with primary balances. Still, though, point estimates have the expected signs.

Another possible exposure of Caribbean economies may come from tourism. Lower tourism receipts may lead to deteriorating fiscal outcomes by reducing the international flow of resources that come from tourists, as well as their multiplier effects. In theory this could both lower fiscal revenues and require some additional expenditures.

We can measure the tourism cycle by using changes in international tourism arrivals as our right-hand-side variable on Equation (1). Table 7.2 shows that even though the coefficient on revenues is too noisy, a growth in arrivals improves fiscal outcomes like debt and primary balances. For instance, a 10 percent increase in arrivals is associated with an improvement of roughly 0.5 percent in the primary balance as a share of GDP and an improvement of one percentage point in debt stocks as a share of GDP.

After these initial results, it is important to be careful with the interpretation of what we have so far. The lack of significance of exports and tourism in some specifications might not be a result of government balances naturally



**Table 7.2. Risk Exposure of CCB6 Countries to Changes in Tourism Flows**

	$\Delta$ Revenues			$\Delta$ Gross Debt			$\Delta$ Primary Balance	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$\Delta \ln$ Arrivals	0.21 [0.161]	0.005 [0.035]	0.021 [0.045]	-0.14** [0.048]	-0.12** [0.036]	-0.098** [0.035]	0.054* [0.025]	0.057* [0.023]
Observations	135	135	135	131	131	131	135	135
Countries	6	6	6	6	6	6	6	6

Source: Fiscal outcomes are obtained from IMF (2019) and transformed into USD using exchange rate data from the World Bank (n.d.).

Notes: Dependent variable in columns (1) and (4) is expressed as log change. Dependent variable in columns (2), (5), and (7) is expressed as share of GDP while in columns (3), (6), and (8) it is expressed as a share of GDP trend (estimated with a Hodrick-Prescott filter). Constant term is not reported, and all specifications include country and time fixed effects. Regression estimated has the form  $\Delta g_{it} = \mu_i + \lambda_t + \beta \Delta y_{it} + \varepsilon_{it}$ . Standard errors are reported in brackets and clustered at a country level. Symbols of statistical significance are \*\*\* for 1 percent level, \*\* for 5 percent, and \* for 10 percent level.

hedged against exports, but rather a result of heterogeneity in the exposure parameter  $\beta$  across countries and to different types of international risks (e.g., commodity risk vs. tourism). Alternatively, when expenditures are also procyclical and governments lack access to finance, net fiscal balances do not have exposure, but at a massive social cost, since expenditures have to drop during bad times. Another limitation of these basic results is that tourism and exports are in fact endogenous, in the sense that they may depend on fiscal outcomes.

### Differential Effects by Export Structure

As previously noted, countries in the CCB6 have different underlying economies, some intensive in tourism and some in natural resource exports. In this context, rather than calculating an average impact of the shock across all countries, it seems more useful to see whether the relevant shock interacts with the actual export orientation of the country. In practice, this means testing whether shocks in commodity prices or tourism impact differently countries intensive in tourism (the Bahamas, Barbados, and Jamaica) versus those intensive in the production of natural resources (Guyana, Suriname, and Trinidad and Tobago). We estimate the following regression, in which  $CCB6^{Commodity}$  and  $CCB6^{Tourism}$  are dummy variables for each type of country, while fiscal outcomes are measured as a share of GDP:

$$g_{it} = \mu_i + \lambda_t + \beta_0 \times \Delta \ln CEPI_{i,t}^{Comm} + \beta_1 \Delta \ln CEPI_{i,t}^{Comm} \times CCB6^{Commodity}_{i,t} + Y_0 \times \Delta \ln Tourism_{i,t} + Y_1 \Delta \ln Tourism_{i,t} \times CCB6^{Tourism}_{i,t} + \varepsilon_{it} \quad (2)$$

That is, when looking at commodity prices (CEPI),<sup>6</sup> the coefficient for tourism-intensive countries is the placebo effect  $\beta_0$ . The “treatment group” is

<sup>6</sup> CEPI refers to the commodity export price index.

**Table 7.3. Differential Exposure to Commodities and Tourism Shocks in CCB6 Countries**

Dependent Variable	$\Delta$ Revenues	$\Delta$ Expenditure	$\Delta$ Gross Debt	$\Delta$ Primary Balance
$\Delta \ln \text{CEPI}$	-0.059 [0.085]	0.024 [0.215]	0.74 [0.407]	-0.082 [0.107]
$\Delta \ln \text{CEPI} \times \text{CCB6}^{\text{Commodities}}$	0.25** [0.080]	-0.034 [0.216]	-0.64* [0.279]	0.30* [0.150]
$\Delta \ln \text{Tourism}$	-0.018* [0.008]	-0.003 [0.008]	-0.061** [0.022]	-0.010 [0.012]
$\Delta \ln \text{Tourism} \times \text{CCB6}^{\text{Tourism}}$	0.034 [0.049]	-0.023 [0.050]	-0.14 [0.169]	0.041* [0.016]
Observations	136	136	132	136

Source: Fiscal outcomes are obtained from IMF (2019) and transformed into USD using exchange rate data from the World Bank (n.d.).

Notes: All dependent variables are reported as a share of GDP. Regression estimated has the form  $g_{it} = \mu_i + \lambda_t + \beta_0 \times \Delta \ln \text{CEPI}_{it}^{\text{Comm}} + \beta_1 \Delta \ln \text{CEPI}_{it}^{\text{Comm}} \times \text{CCB6}^{\text{Commodity}} + \gamma_0 \times \Delta \ln \text{Tourism}_{it} + \gamma_1 \Delta \ln \text{Tourism}_{it} \times \text{CCB6}^{\text{Tourism}} + \varepsilon_{it}$ , where  $\text{CCB6}^{\text{Commodity}}$  and  $\text{CCB6}^{\text{Tourism}}$  are dummy variables. Constant term is not reported, and all specifications include country and time fixed effects. Standard errors are reported in brackets and clustered at a country level. Symbols of statistical significance are \*\*\* for 1 percent level, \*\* for 5 percent, and \* for 10 percent level.

composed of those countries that are commodity exporters. This last effect is captured by the coefficient on the interaction,  $\beta_1$ . Analogous coefficients measure the effect on tourism. For instance, the coefficient  $\beta_1$  captures increases in tourism in tourism-intensive economies.

Table 7.3 shows the results from this regression. Note from rows (1) and (2) that while the standalone commodity price index does not significantly affect fiscal outcomes for the whole group, this price does have a differential (and significant) effect on revenues, gross debt, and primary balances of the commodity-exporting subgroup of countries.

Roughly speaking, every 1 percent rise in commodities is associated with an increase in revenues of around 2.5 points of GDP in fiscal revenues (p-value < 0.05), but only for those countries that depend on commodities. This improves the primary balance by a statistically similar amount, associated with a lowering of gross debt.

The analogous coefficient for the case of tourism offers some evidence of an effect when looking at the primary balance, with a 10 percent increase in tourism associated with an improved fiscal balance of 0.4 percentage points of GDP (p-value < 0.1).

Table 7.4 follows the previous exercise but adds in import price changes, also using a country-specific commodity price basket (commodity import price index, or CIPI). A rise in this price would be important, for example, for oil-importing countries like Barbados and Jamaica. While many commodity prices co-move over time, there is some evidence that an exogenous and commodity-driven increase in import prices is associated with systematically

**Table 7.4. Differential Exposure: Import Prices, Export Prices, and Tourism in CCB6 Countries**

	(1) Δ Revenues	(2) Δ Expenditure	(3) Δ Gross Debt	(4) Δ Primary Balance
Δ ln CEPI	-1.23** [0.467]	-2.83** [0.986]	-4.26 [4.446]	0.64 [1.745]
Δ ln CEPI × CCB6 <sup>Commodities</sup>	1.43** [0.499]	2.82** [0.995]	4.47 [4.430]	-0.42 [1.796]
Δ ln CIPI	0.37* [0.176]	0.97** [0.292]	1.46 [1.274]	-0.25 [0.556]
Δ ln CIPI × CCB6 <sup>Tourism</sup>	-0.28** [0.103]	-0.46 [0.282]	-1.59 [1.298]	0.085 [0.325]
Δ ln Tourism	-0.018* [0.007]	-0.004 [0.010]	-0.060* [0.025]	-0.010 [0.013]
Δ ln Tourism × CCB6 <sup>Tourism</sup>	0.039 [0.052]	-0.001 [0.046]	-0.14 [0.174]	0.034* [0.016]
Observations	136	136	132	136

Source: Fiscal outcomes are obtained from IMF (2019b) and transformed into USD using exchange rate data from the World Bank (n.d.). Data on commodity prices from Gruss and Kebhaj (2019).

Notes: All dependent variables are reported as a share of GDP. CEPI: commodity export price index, CIPI: commodity import price index. Regression estimated has the form

$g_{it} = \mu_i + \lambda_t + \beta_0 \Delta \ln CEPI_{it} + \beta_1 \Delta \ln CEPI_{it} \times CCB6^{Commodity} + \sigma_0 \Delta \ln CIPI_{it} + \sigma_1 \Delta \ln CIPI_{it} \times CCB6^{Commodity} + \gamma_0 \times \Delta \ln Tourism_{it} + \gamma_1 \Delta \ln Tourism_{it} \times CCB6^{Tourism} + e_{it}$ , where  $CCB6^{Commodity}$  and  $CCB6^{Tourism}$  are dummy variables for CCB6 countries cataloged as “commodity intensive” and “tourism intensive” respectively. Constant term is not reported and all specifications include country and time fixed effects. Standard errors are reported in brackets and clustered at a country level. Symbols of statistical significance are \*\*\* for 1 percent level, \*\* for 5 percent, and \* for 10 percent level.

greater expenditures in all countries. An increase in import prices does not show a statistically significant impact on the revenues of tourism-based economies, but it does correlate with some increase in revenues for commodity exporters.

As mentioned previously, these are volatile economies in which many other things are going on, including structural changes in deficits. Therefore, the exposure regressions above should not be interpreted as a detailed estimate of magnitudes. Instead, these estimates aim to show that despite the myriad of issues, there are clear systematic exposures that have meaningful macroeconomic impact on the CCB6’s fiscal sustainability. Hedging these exposures is the discussion of the following sections.

### Instrumenting Tourism Flows Using Visitors’ Income Growth

Given the endogeneity of tourism receipts, we will also look for exposure measures using an Instrumental Variables (IV) approach. The instrument we propose is a weighted average of visitors’ GDP growth. That means, for each tourist’s

**Table 7.5. Instrumental Variables Regression: CCB6 Risk Exposure to Tourism Shocks**

	$\Delta$ Revenues		$\Delta$ Gross Debt		$\Delta$ Primary Balance
	(1)	(2)	(3)	(4)	(5)
$\Delta$ ln Tourism	0.97** [0.442]	0.20** [0.087]	-0.42** [0.168]	-0.36*** [0.092]	0.15* [0.084]
First Stage F statistic:	67.29	67.29	75.36	75.36	67.29
Observations	113	113	109	109	113
Countries	5	5	5	5	5

Source: Fiscal outcomes are obtained from IMF (2019) and transformed into USD using exchange rate data from the World Bank (n.d.).

Notes: Fiscal outcomes are used in logs—columns (1) and (3)—and as a share of GDP trend—columns (2), (4), and (5)—(estimated with a Hodrick-Prescott filter). Instrument is computed as in Equation (4) but excluding intra-Caribbean tourism. Namely, we estimate  $g_{it} = \mu_i + \beta \Delta y_{it} + e_{it}$ , where  $\Delta y_{it}$  is estimated on the first stage regression. Constant term is not reported, and all specifications include country fixed effects. Standard errors are reported in brackets and clustered at a country level. Symbols of statistical significance are \*\*\* for 1 percent level, \*\* for 5 percent, and \* for 10 percent level.

source country  $j$ , we weight its  $GDP_{jt}$  by the share of tourists that visit country  $i$  and come from country  $j$ . Note that weights are calculated in a fixed year. In contrast,  $GDP_{jt}$  for country  $j$  lends the time variation to the instrument. To capture the effect of tourism on fiscal outcomes, we calculate weights excluding intra-Caribbean tourism flows, specifically day-trippers and intra-Caribbean arrivals that may not be related to tourism but to other types of business.

Table 7.5 shows the results of the IV regressions. The F statistic from the first stage are all above 10, suggesting less concern about weak instruments.

Results show that higher tourism flows are associated with significantly better fiscal outcomes. Namely, a 10 percent increase in tourism increases revenues by close to 10 percent, or around 2 percentage points of GDP (p-value < 0.05). At the same time, the primary balance as a percentage of GDP could improve by 1.5 points. The effect on the reduction of primary deficits and the improvement of debt stocks is also significant.<sup>7</sup> The penultimate section of this chapter considers this instrument in detail and proposes an indirect hedging strategy for Caribbean tourism, assuming that countries could buy assets that pay out in case of a deceleration of tourism partners' GDP.

### Taking Stock of Exposure Estimations

Taking them as a whole, the results in this section point towards an economically significant exposure of the aggregate fiscal outcomes to changes in

<sup>7</sup> One important limitation of these estimates is that they are not separately identified from the year effects in each country. Reduced form estimates of how fiscal outcomes depend on tourists' income show qualitatively similar results, although not all coefficients were statistically significant.

## BOX 7.1. FISCAL RISKS IN TOURISM-DEPENDENT ISLANDS

By March 2020 sovereign credit rating agencies had already recognized that Caribbean islands would be hit hard by COVID-19. Standard and Poor's (S&P, 2020), for instance, predicted that “sun, sea, and sand” island destinations would be the worst affected from a slowdown in global tourism flows. At the time, they projected three scenarios of a drop in Current Account Receipts (CAR) of 11, 19, and 27 percent vis-à-vis the baseline in 2018. If one were to take at face value the estimates of Table 7.2, the worst scenario made by S&P at the time could be approximated to growth in debt of 2 to 4 points of GDP per year. If the crisis lasts twice as long, it could be twice as hard.<sup>a</sup> Note that our estimates come from periods of normal shocks and the coefficient may not be valid for all years. At the same time, the estimates do not include the potential cushioning effect that remittances might play, since these reduce the drop in CAR.

The implied drops using our estimates are by no means a highly accurate forecast to make today, as the actual shock might be larger than thought in March 2020 or the shocks may last longer. It might also be that the coefficients developed based on more normal times may fall short in the COVID-19 tourism recession, since various other additional channels are at play that normally do not occur in a cyclical downturn.

Having said that, the estimated coefficients are economically meaningful and reflect vulnerabilities. As will be further argued later, some of these tourism risks could plausibly be hedged, if an appropriate market for tourism risk insurance is developed (see “Bringing the Discussion to the Caribbean” later in this chapter).

<sup>a</sup> For instance, let's consider a 27 percent drop from 100 to 83 in tourism receipts. Given the large change the logarithmic approximation may not be fully appropriate. The change in tourism would be  $\ln(87) - \ln(100) \approx 0.31$ ; which is later multiplied by a coefficient of  $-0.12[\Delta \text{Fraction of GDP} / \Delta \ln \text{Tourism}]$  yielding close to a change of 4 percent of GDP in Gross Government Debt per year of such fall.

exports and tourism. The chapter now moves to discussing how to hedge that exposure.

## Theory of Risk Hedging Discussed through Examples

How should countries hedge? This section reviews various theories of hedging, drawing lessons from the risk management practices of salient Latin American commodity SOEs and their governments. In particular, it looks at the similarities and differences in how the SOEs PEMEX (Mexico) and CODELCO (Chile) hedged their at-risk cash flows.

These cases help to distill key trade-offs that smaller SOEs and economies should consider when designing their hedging strategies. The following section will connect the lessons of this current section to present challenges in the Caribbean.

It is important to note that the inclusion of these case studies is not intended as an assessment per se of whether these leading SOEs implemented their hedging strategies particularly well or particularly badly. Nor is it suggested that these companies provide any sort of blueprint to be followed in the CCB6, though there are lessons to be learned from the practical experiences within Latin America and the Caribbean (LAC). The point in comparing the approaches of PEMEX and CODELCO is simply to provide a concrete way to explain the theory.

### A Friction-Less Benchmark

Consider a large multidivisional organization that is able to act as a single agent, at least in financial terms. In our case that would mean a Ministry of Finance (MOF) could, for example, optimize hedging decisions as if the state as a whole were a cohesive unit. That is, the fiscal authority has full control over all bureaucracies and SOEs; acts as the principal, in the sense of internalizing social costs and benefits of hedging; and is not required to report to any political forces. Of course, that is not the case in real countries, but it is a useful starting point—in the way the Modigliani-Miller theorems are for finance—to help understand what drives the departure from the benchmark. It is not a normative benchmark, indicative of what should be, but a scaffolding for further diagnosis.<sup>8</sup>

The first question one should ask is whether there is a need for hedging at all. If the country is large and has other means to smooth government and citizens' consumption in the long run (e.g., a large and effective sovereign wealth fund, or SWF), then costly hedging could possibly be avoided, although hedging and saving capacity are certainly connected.<sup>9</sup> Similarly, consistent access to cheap finance is roughly equivalent to having a large SWF with deep pockets. In practice, though, countries may not have such a savings-driven or credit-driven cushion at all times.

Now, assuming that hedging is necessary, one may need to ask a few additional questions. The general principle here is that prior to buying hedging instruments, one must first take advantage of all possible cross-insurance that may naturally occur within the organization.

This means that it would be inefficient for an organization to fully hedge its revenue against a given risk (e.g., commodity price, exchange rate) if in that same organization some of the costs depend on the commodity price. For instance, it is not unusual for costs in human resources and non-traded

<sup>8</sup> Standard textbooks of international financial management also start by using this friction-less benchmark (e.g., Madura, 2018; Bekaert and Hodrick, 2017).

<sup>9</sup> Borensztein, Jeanne, and Sandri (2013) argues that hedging can reduce the amount of the wealth fund that a country saves, improving consumption and welfare. The quantitative prediction depends also on the price of that insurance.

goods to skyrocket in mining regions when there is a commodity boom and to decline during commodity price busts. A similar thing could happen in tourism booms. This is a natural hedge for revenues, although it is usually partial instead of complete. In practice, companies tend to need external hedging to smooth fluctuations in profits or net balances, not to smooth gross revenues.

But in multidivisional organizations like a government, hedging decisions should also be made on the net outcome of all the divisions. This is another application of taking advantage of all cross-insurance possibilities within the organization. This principle also applies to the allocation of authority in terms of which unit should make the hedging decisions. Hedging is usually made by the headquarters' chief financial officer, not the divisional one.

In summary, the standard theory of a frictionless and unitary organization recommends that hedging take place on profits instead of revenues or costs and that hedging decisions should be made at the centralized "headquarter" level, which in this case is akin to an MOF. This approach is recommended even if the individual positions of the various divisions suffer increased exposure, because hedging tends to benefit from economies of scale—the average cost of hedging per unit decreases if the decision is centralized.

Equipped with this benchmark theory of hedging, we now move to the examples of Chile and Mexico to illuminate the discussion. As discussed, we refrain from "grading" these two countries in terms of how well they fit into this frictionless model. Our goal is to understand the potential reasons why these two countries (and thus other countries) may deviate from this benchmark, in order to obtain new information that will help in the design of hedging programs that take into account the actual characteristics of governments and SOEs, which are certainly not frictionless.

### Overview: A Tale of Two Countries and Their SOEs

In Mexico, government income depends significantly on oil. Direct income from oil exports represents around a third of fiscal revenues. PEMEX produces (or intermediates) roughly a billion barrels of oil per year, with half being exported. This means that each US\$1/barrel drop in the price means lower export revenues of US\$500 million through this direct channel. The exposure through exports is not the whole picture. As one of many examples, oil also impacts debt costs in the country as Mexico's sovereign spreads are correlated with oil prices (Ma and Valencia, 2018). Oil price also impacts economic activity in the sectors supplying oil operations. For Mexico we will concentrate on the centralized hedging program that depends on the MOF, although PEMEX also has a small side contract at the SOE level.

For Chile, copper is the main commodity. Unlike in Mexico, only a fraction of Chile's commodity-related fiscal revenues comes directly from its

**Table 7.6. Salient Differences in Hedging: PEMEX vs. CODELCO**

Item	PEMEX (Mexico)	CODELCO (Chile)
Level of main hedge	Central government	State-owned enterprise
Main tool used	Option (Asian put)	Forward with (little) upside optionality
Hedging provider	Financial markets	Agreement with largest buyer
Salience of hedging cost	Explicit	Implicit in contract
Time span of the hedging instrument	Yearly	Longer term

SOE, CODELCO. Another portion comes through income taxes and royalties on private mining corporations. Roughly speaking, when copper prices fall by a cent per pound in the London Metal Exchange (LME) market for a full year, then fiscal accounts deteriorate by US\$20–40 million per year (0.1 percent of GDP) (see DIPRES, 2019). The Chilean MOF does not have an explicit hedging program at the centralized level.<sup>10</sup> Therefore, we will concentrate on a contract between the copper SOE and a large Chinese buyer in the mid-2000s.

Within this context, Table 7.6 summarizes a few features of the two governments and respective SOEs exposed to commodity risk. The rest of this section expands on each feature of the table and discusses the pros and cons of the approach taken by each country.

## BOX 7.2. MEXICO'S OIL HEDGING PROGRAM

The Mexican deal to hedge oil price volatility one year ahead is becoming increasingly popular, in part because it has paid off on rainy days. This derivative contract delivered cash to the Mexican government in at least three or four of the last 20 years, but the most recent 2020 hedge seems to be the most salient one. The 2020 contract, signed the previous year, was fulfilled at a price of US\$49 a barrel of oil, with the put option yielding around US\$6 billion in payments to the Mexican government (see Kumar and Eschenbacher, 2020). Unsurprisingly, the Mexican government has been exploring an even larger hedging program for 2021, although the higher expected volatility would make this insurance more expensive. Note these are one-year contracts that do not hedge permanent shifts in oil prices.

<sup>10</sup> In Chile the nominal exchange rate vis-à-vis the U.S. dollar moves with the price of copper, following an estimated elasticity of around -0.35 to -0.2. That is, when copper prices drop, the exchange rate absorbs from a fifth to a third of the effect. Therefore, if a large fraction of the Chilean Sovereign Wealth Fund is invested in foreign currency abroad, then this is in fact an implicit hedging mechanism at the aggregate level.



### What to Hedge: Gross versus Net and Headquarter versus Division

As suggested before, a general principle in risk management would be to hedge net exposures instead of simply the gross exposures of revenues. This is because a portion of expenditures may also be exposed to the underlying commodity risk. Similarly, for a multidivisional organization, there would be some natural hedging across the different divisions. For this reason, if external hedging is costly one would prefer to write a contract on the net fiscal balance rather than having multiple hedges on a division-by-division fashion. As previously stated, for multinationals, the headquarters unit should be taking hedging decisions on net, not the subsidiaries. Using the same logic, one would expect that risk management practices for SOEs would be determined by MOFs rather than by the SOEs themselves.

This standard logic stems from models in which the various divisions of the organization act as a single decision-making unit, in order to capture savings in hedging costs and eliminate major inter-division agency problems. If these assumptions are not met, then the optimal hedging strategy will not be the corner solution of a 100 percent centralized hedging (Bekaert and Hodrick, 2017).

We can better understand this by looking at the examples of Mexico and Chile. The first row of Table 7.6 shows that the biggest hedging program for Mexico is made by the central government, not PEMEX. PEMEX employs a smaller hedging program as well, but the bulk of hedging is conducted at the headquarters level. In contrast, Chile's hedging program in the 2000s was made directly by CODELCO, the SOE, via contract with another firm. Of course, the decision was approved by the MOF, but it stabilized the revenues of CODELCO in the first instance.

In the standard logic of a single decision-making unit, hedging at the divisional level makes little sense. For instance, the Government of Chile has various other exposures to the price of copper, some from the private mining companies and some through the real and nominal fluctuations of the exchange rate when the relevant LME price moves. Moreover, a copper price boom may also generate an increase in the prices of government inputs, as occurred in 2012 when construction costs for public housing increased. On the other hand, a drop in the copper price may generate an increase in expenditures that serve as automatic stabilizers, like subsidized unemployment, insurance, and other social programs. This could drive an even stronger need for hedging.

### Forwards versus Options: Fair Pricing and Ex Post Regret

Governments may decide to ignore their commodity risk exposures. But if they do not, and wish to manage the issue, they have at least three types of instruments at their disposal. The first is not really hedging but saving and dissaving via a commodity stabilization fund. With this instrument,

### BOX 7.3. CODELCO'S CONTRACT WITH MINMETALS

In June 2005, CODELCO announced negotiations with Minmetals, an important Chinese SOE that buys and trades metals including copper, for a long-term agreement, including joint venture. The agreement, signed in early 2006, encompasses two separate deals and was designed to last 15 years. Central attributes of the agreement are summarized below:

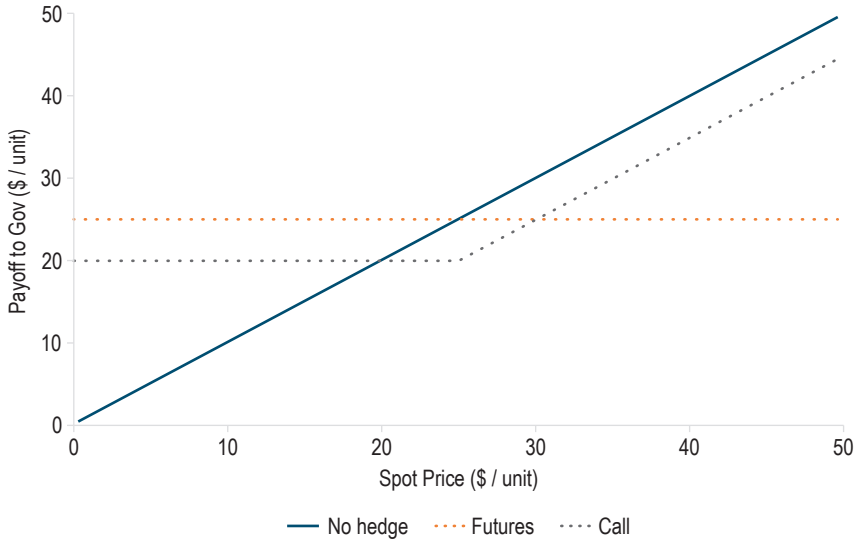
- First, a new company was formed, Copper Partners Investment Company (CuPIC), owned 50:50 by CODELCO and Minmetals in Bermuda.
- CODELCO agreed to sell around 56 thousand tons of copper per year to Minmetals for 15 years.
- CODELCO would sell copper to CuPIC at an implicit price and CuPIC would sell the same copper to Minmetals at the LME price plus a China premium, with both firms equally sharing the profits of this last operation.
- Importantly, the deal did not talk about prices. There was only an implicit price a few cents above a dollar per pound of copper.
- This agreement was complemented by Minmetals putting money upfront via CuPIC. Prior to CODELCO entering into the agreement, CuPIC would invest an initial US\$550 million in CODELCO. This means that the deal not only had a hedging side, but it was also a financing operation for the Chilean copper producer. Moreover, Minmetals would pay only the difference above the pre-agreed price.
- The second deal was for mining development. This was a second parallel contract between CODELCO and Minmetals to exploit a new mine in northern Chile, the Gabriela Mistral mine (aka Gaby). Concretely, Minmetals had an option for 25 percent of Gaby's equity. In the end, Minmetals did not exercise this option.

In this broad introduction to the deal, a few key aspects must be noted. First, the agreement was not designed exclusively around hedging, and it did not provide a simple flat forward price. In fact, the deal had many other attributes that are interesting from a business standpoint, for example a series of joint ventures with one of the SOE's largest, and at the time fastest-growing, customers in the world. But despite these attributes, given the political discussion in the years of a copper price boom, the collective memory of the country focuses primarily on the implicit price bet represented in this contract.

*Source:* CODELCO (2008).

the government saves whenever the commodity price goes above some estimated threshold, to cover for when the price falls below the trend. To be clear, this does not hedge the overall fiscal exposure to the commodity

**Figure 7.2. Fiscal Authorities' Hedging Possibilities**



Notes: Scale of the graph is only for illustrative purposes and does not represent real commodity prices.

risk, but it does help to smooth the flow of resources from abundant years to lean years.<sup>11</sup>

Figure 7.2 visually summarizes the payoffs for hedging a unit of commodity revenue under various types of contracts. If the government does not hedge against commodity price fluctuations, then the unit payoff would simply equal the spot price. This is depicted by the 45-degree line with equality between spot price on the horizontal axis and the unit payoff on the vertical one. Or, as mentioned if the government hedges, there are two major alternatives. One is to buy a forward contract; the other is to buy an option. In this case the option offers upside exposure, which is desirable for a commodity producer. A mirroring instrument could be utilized for a commodity importer.

The forward contract is represented by the horizontal dotted line on Figure 7.2. De facto, a forward contract eliminates uncertainty about the payoff for all scenarios of the price. On the downside scenarios, corresponding to

<sup>11</sup> Daniel (2001) argues that stabilization funds are “flawed” because the international oil price does not have a well-defined equilibrium value. Moreover, risk markets offer alternatives that do not depend on the estimation of a long-term trend for oil prices. Among proper hedging instruments, we have forwards to get an ex ante fixed selling price and nonlinear option instruments. On the one hand, future markets offer the possibility to sell oil at a pre-determined price, ruling out price uncertainty, but also ruling out potential gains that may be realized from high prices. On the other hand, options ensure (at a cost) a minimum oil price but allows the holder of the option to benefit from high prices (by not exercising the option).

the left-hand side of the graph, a forward is obviously preferable to not hedging. It may also be better than an option-like contract, represented by the kinked and dotted line in the graph. This is because one could, in principle, save on the cost of buying this option, a costly insurance. Note that unlike options, the cost of buying a forward contract is not explicit, but implicit. The cost of buying a forward comes from the upside scenarios that the buyer is willing to give up to the seller; in this case, this corresponds to the scenario in which the commodity price increases. The advantage of an option-like instrument is that it only provides insurance for the downside scenarios, but not at the cost of losing the upside. This prevents ex post regret, which is one of the issues with forwards.

Mexico's hedging strategy, conducted by the central government, is based on buying so-called "Asian options" to secure a minimum strike price of oil. The price is set below—but does not depart substantially—from the reference price set each year in the government budget. The Mexican government has hedged against oil price fluctuations since the early 1990 (Potts and Lippman, 1991); however, the current program started in 2001 (Duclaud and García, 2012). Foreign investment banks act as the counterpart to the Mexican options program. Its annual fiscal cost has averaged 0.1 percent of GDP over the period 2001–2016 (Ma and Valencia, 2018), with the government able to hedge roughly 30 percent of its total oil production. The options have only been exercised on three occasions: 2009, 2015, and 2016, in which they paid off for the Mexican sovereign.

An anecdotal yet insightful example is 2009. The previous year, the Mexican MOF and PEMEX secured the rights to sell 330 million barrels in 2019 at a predetermined future price, ranging between US\$66.50 and US\$87 a barrel. The main counterparts were Barclays (220 million barrels) and Goldman Sachs (85 million barrels). A couple of months after the deal, oil prices fell to US\$55 per barrel while the strike price on the contract averaged around US\$70 a barrel (Blas, 2017).

Mexico's Secretaría de Hacienda hedging program also protected public finances from downturns in oil prices during the COVID-19 crisis. In 2020, given the biggest plunge in oil prices in almost 30 years, average oil prices fell below the strike price. As described in Box 7.2 above, the deal is paying off for the Mexican sovereign.

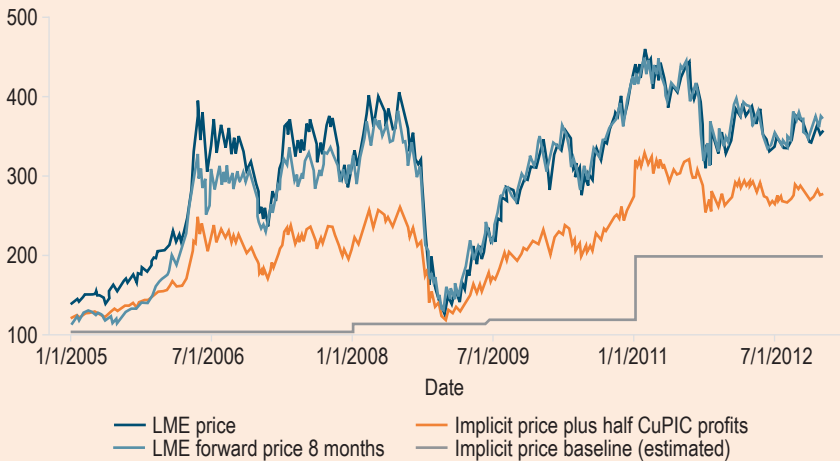
Unlike the Mexican case, the Chilean CODELCO's hedge program was mostly the equivalent of a forward contract. It had a mostly pre-established fixed price per ton of copper, plus a 50 percent upside or downside coming from the profits of a joint venture between CODELCO and the Chinese buyer, Minmetals. In financial terms, this would be comparable to hedging half of the deal with a forward contract, while maintaining the other half with no hedge. It is worth noting that the hedging program of CODELCO did not seem very large—at least in comparison to the Mexican program—but

it was much longer. It also had other non-hedging goals, such as striking a deal with a large Chinese buyer that could provide some type of financing for mining projects. See Box 7.4 for further details on the deal and its outcome. A central lesson from the case is the need for exposures to take into

#### BOX 7.4. CODELCO'S EXPOSURE AND OUTCOMES

CODELCO's contract with Minmetals was 50 percent committed to a forward (implicit) price and 50 percent unhedged. The outcome of the deal is shown in Figure 7.3.

**Figure 7.3. Spot Price, Future Price, and Implicit Unit Payment to CODELCO (in nominal U.S. cents/pound)**



Source: Authors' elaboration with data from Bloomberg (n.d.).

The loss associated with the gap between the traded price and the market price (the LME price and the implicit price plus profits) is positive in all years though smaller for the years of the sub-prime mortgage crisis. The graph also shows that, at the time of the deal in 2005, the eight-month forward price lagged behind the spot LME price. This may have been seen as a temporary phenomenon. In fact, though, the contract was linked to the spot price, and the agreed-to implicit price, including JV profits, was very close to forward prices at that time. But afterwards forward and spot prices clearly diverged for many years, while overall prices of copper increased two- to threefold in the following years.

CODELCO's exposure with this hedge scheme was downplayed as not very large and offset by various synergies. CODELCO president Juan Villarzá said, "One should look at this deal with the right perspective. The contract considers the sale of 57 thousand tons of copper, out of CODELCO's production of 1.8 mil-

(continued on next page)

**BOX 7.4. CODELCO'S EXPOSURE AND OUTCOMES** *(continued)*

lion tons per year. So it commits less than 3.15 percent of CODELCO's production. In addition, spreads are based on the joint venture [CuPIC], in which CODELCO has 50 percent. This reduces CODELCO's risk to less than 1.5 percent [of sales]; that is, it is absolutely minor. The important thing here is that we are opening a different, new source of financing" (CODELCO, 2005).

These points are important, but there are a few notable aspects to consider. First, the relevant risk exposures are for net flows, not sales. This distinction is especially important for companies with thin margins, as was common in the copper sector in the early 2000s. Average earnings before taxes for CODELCO (2001–2003) were only 13 percent of sales. As such, a "minor" 1.5 percent exposure on sales means a much larger 11 percent exposure on SOE profits. On top of that, stronger copper prices required CODELCO to raise wages and pay more for various inputs, as it competed with private mining companies for personnel and other resources. There was also a commodities-wide increase in prices, which means higher oil and energy costs, further increasing the risk exposure of the deal. Second, the portion hedged with a forward-like contract has unbounded losses in a scenario of extreme upsides in the copper price, while gains are bounded, since the price of copper cannot go below zero. Third, even if one believed in the non-hedging benefits of the deal (i.e., financial and marketing), CODELCO could still have offset its risk. A derivative financial contract would have preserved the other benefits of the deal, while offsetting exposures.<sup>a</sup>

<sup>a</sup> While providing this financial hedge for a long-term contract (15 years) might be challenging, the exposure of about US\$50–100 million is well below the size of other financial instruments that are tailored for some tail risks (e.g., catastrophe bonds).

account the length of the contract as well as the relative size vis-à-vis profits rather than sales. Finally, even if there are other non-hedging goals of a specific contract with a Chinese company, the undesirable net exposures of these contracts could have been reversed or at least mitigated using adequate financial derivatives.

In the end, the CODELCO-Minmetals hedging deal did not end well for Chile. Even if ex ante it could have been sold as a reasonable deal, ex post it produced considerable regret, with a large gap between the actual and the counterfactual profits of the company in the following years.<sup>12</sup> The issue received important public attention, and by 2008 congress had a report on the matter. In 2014 the comptroller general also objected to some of the

<sup>12</sup> This chapter does not take a stand on whether the ex ante decision of CODELCO was fairly priced, given the information at the time of the signature. But at the same time and after many investigations, there is no full evidence to the contrary.

effects of the deal. Some of this tension may have happened anyways, but it was all more visible given that the press could easily see the difference between the spot price and what CODELCO was receiving.<sup>13</sup>

### Time Aggregation, Hedging Horizon, and Stop-Loss Clauses

Another difference between the Chilean and Mexican cases is the time horizon of the strategies. The Mexican deal is a year-to-year agreement. This short horizon is not likely to substantially change the net present value exposure to long-term shifts in oil prices. In this sense, the short duration of the hedging contracts is a limitation, but it may additionally be a strength if the firm also has contracts with potential of ex post regret, like a forward price agreement. The CODELCO deal, for instance, was a 15-year agreement. With such a duration, losing 10 percent of a contract in a price difference could equate, in net present value terms, to losing more than an entire year of revenue and many years of the deal's profits. A large and permanent change in a commodity's price amplifies the counterfactual profit/loss (see Box 7.4).

There is also the issue of time aggregation in the hedging instrument. For example, the financial derivative could pay every day or month in which there is a gap between the spot and the contract price, or it could work only on the average of a longer time period. The Mexican case is an example of the former. The Asian options used by Mexico depart from the more standard American or European options because they are exercised only if the average price of the commodity is below a given strike within a predetermined period (in the case of Mexico, one year). This makes these options cheaper to produce and to buy. In contrast, for American options a single event in which the spot price crosses the strike is enough to trigger a payment, making them more expensive than Asian-style options. For the government of

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<sup>13</sup> As an additional nail in the coffin, the armed forces in Chile petitioned the comptroller general for an increase in their budget allocations, which were decreased by the deal. By law, the armed forces received 10 percent of CODELCO's copper sales, but as mentioned these revenues dropped with the agreement between the Chilean and Chinese SOEs. The comptroller general determined that these funds were, in fact, earmarked for the armed forces and ordered CODELCO to pay an additional US\$55 million to the armed forces. While this example is very specific, it is not uncommon for some components of the sales or profits of SOEs to be earmarked for specific expenditures. For instance, when the Chavez regime in Venezuela struck an oil deal with China, they agreed on a special price that was not considered an actual sale of oil. This was, in part, a maneuver aimed at excluding funding to some of the opposing governors of Venezuelan states. By law income was earmarked for the state governments, but they could not get this since the agreement was structured such that oil was not an explicit revenue income of PDVSA, the state oil company, but rather another form of transfer to the Venezuelan state. More closely related to the CCB6, the state-owned mining company in Suriname, Staatsolie, entered into a joint venture with the Canadian company IAMGOLD (see Newsfile Corp., 2020). According to information from the Extractive Industries Transparency Initiative (EITI), the deal does not seem to contain clauses about earmarks for specific expenditures (see EITI, 2019).

Mexico, the goal has been to buffer against deficits in its annual fiscal budget—including the net transfers from or to PEMEX—therefore, these Asian put options appear to be an appropriate alternative.

While a forward contract does not generate additional payments, there are implicit or counterfactual payments corresponding to the difference between the spot price and the pre-agreed forward price. In the case of CODELCO, each shipment had a counterfactual gap. It was not a transfer that happened on average.

A final note on timing is that a longer-term contract could always be renegotiated. For instance, Chile had conversations to renegotiate with the Chinese SOE around the time of the global financial crisis, some three years after the deal was signed. But one crucial challenge is the price at which such a contract could be renegotiated. Since the contract did not include explicit stop-loss clauses, the Chinese buyer held the bargaining power. It clearly wanted a higher price than what the Chilean SOE was willing to pay at the time. Interestingly, at the moment of those renegotiations, the spot and future prices were much lower than the previous years. At the time it may have been thought that the era of large deviation between the price of copper and forwards was over, but it was not. In the following years, the counterfactual losses exceeded US\$4.5 billion. In January 2009, however, this may have been much harder to predict, whereas today we have the benefit of hindsight. Should CODELCO have wanted to renegotiate, there was yet another challenge: political framing. Even if the firms were to have agreed on an amount of, say, US\$500 million to renegotiate, it would have been very hard for CODELCO to get approval from congress for a “paycheck” to a Chinese company. Such a project could have produced an ex post net present value of a couple billion dollars for the country, but the political frictions, especially in the middle of a recession, may have prevented it. Thus, one additional challenge of long-term forward contracts is that renegotiating them could be politically challenging.

### **Wrapping Up the Tale of Two Countries and Their SOEs**

When calculating risk exposures in the first section of this chapter, we concluded that even if Caribbean countries are similar in geographic characteristics, they tend to have very different exposures based on their respective economic structures. Those concentrated in commodities and those concentrated in tourism face different sources and magnitudes of risks. In addition, there is exposure coming from energy imports, which will also affect them differently (depending on how import-intensive they are in energy).

Despite these differences there are a few lessons relevant for the CCB6 to be gleaned from the hedging strategies of CODELCO and PEMEX. One is that, if possible, hedging should be enacted at the consolidated government level and should be based on net flows, not sales. Second is that one should



be mindful of ex post regret in forward contracts, especially when contracts are long term. Finally, it is worth emphasizing that if a country enters into a particular business that generates new exposures, governments may be able to diversify against the additional exposure, for example, through financial instruments.

## Bringing the Discussion to the Caribbean

After visiting salient Latin American examples of hedging practices, this section directs the focus back to the Caribbean, offering a discussion of potential applications. The focus here is more exploratory and aims to serve as a starting point for new avenues for risk management.

As mentioned in the previous section, the best-case scenario would be to hedge risks sustained by the consolidated government as a whole, and do so using some kind of option, instead of committing to a fixed future price. This general advice may not work for every country, but it presents a normative benchmark. This section discusses a few characteristics of the Caribbean economies that should shape the choice of hedge, both in terms of supply and demand.

## Supply and Demand for Hedging in the Caribbean

### *Size and Supply*

Size matters in securing a competitive supply of hedges. Depending on the scenario, a large hedge may be advantageous, but a small hedge could be appropriate as well. On the one hand there are some fixed costs that facilitate access to a reasonable price for hedging or insurance in financial markets. For example, Mexico buys oil price insurance every year, but this is possible because the total size of the deal is attractive enough for financial intermediaries in Wall Street (or the equivalent markets). Additionally, CODELCO and Minmetals are among the largest producers and buyers of copper in the world. In this scenario, the size helped to diffuse the cost of lawyers, contracts, and issuance across many units of hedging. This line of thought suggests that to implement hedging, as in other economic matters in the Caribbean, some coordination across Caribbean economies is necessary to achieve critical mass.

On the other hand, being small is not necessarily bad in terms of all aspects of hedging. For example, a small deal can facilitate finding counterparts to take the mirroring position in a hedging contract for a longer-term fluctuation in prices. For an economy like Mexico, for example, it could be hard to buy insurance to hedge long-term exposure to a long-run change in oil prices. It is not clear who could be a credible counterpart for such a large deal nor how that contract could be enforced, say, a decade from now. In contrast, a smaller Caribbean economy may find it much easier to find a

credible counterpart, for which the exposure of the small economy would appear relatively small and manageable.

### *Size and Demand for Hedging*

Size also impacts the relative demand for hedging, or at least the demand a country should have with respect to alternatives. In fact, size matters for the relative merits of “self-insurance” vis-à-vis true hedging of risk. By self-insurance, we mean either the aggregation of the idiosyncratic risk of small geographies that moderates the total risk or the use of intertemporal saving such as an SWF or access to finance as a mechanism to smooth shocks.

In the case of larger countries (for example, one with 10 million people), the sizable idiosyncratic shocks to the economic activity of 40 thousand or even 400 thousand people do not necessarily mean an aggregate economic or fiscal problem for the overall country. According to the law of large numbers, some of the effects within the country may cancel out if the country is large enough, and the individual shocks in each segment of the country are not so closely correlated to one another. This insurance derived from a diversity in the cross section of regions of a country may help to smooth the fiscal accounts, from both revenue and expenditure shocks.

But for smaller economies, cross-sectional self-insurance and time series-dependent self-insurance through saving are harder to achieve. Again, this is due to the same law of large numbers argument, in which smaller countries are subject to proportionally larger shocks. In this case, the precautionary amounts saved in an SWF need to be higher than for other economies, so as to keep constant the probability that a shock of a given magnitude depletes the fund. Overall, the insurance demand arguments suggest that the relative merits of hedging vis-à-vis self-insurance are quite compelling for the Caribbean.

### *Covariance: Volatility and Correlation*

In most economic models the demand for hedging relates to covariance, which can be expressed as the product of the volatility in terms of standard deviation of the shocks and the correlation of shocks. Both are important in the Caribbean.

Volatility is, in fact, sizable for tax revenues. For instance, Reyes-Tagle, Silvani, and Ospina (2021) find that this “volatility is linked to high revenue dependency from income taxes in CCB [Caribbean Country Department of the IDB] countries given their exposure to external environment performance (tourism, oil prices, natural disasters, etc.), which impacts directly on GDP.” Ossowski and Gonzáles (2012) and Reyes-Tagle, Silvani, and Ospina (2021) also find that revenue volatility affects the six countries of the Caribbean Country Department, with an even higher impact on commodity-driven countries than tourism-dependent ones.

Correlations are also meaningful. Unlike earthquakes that may impact a single country, hurricanes may impact more than one country in the region with a similar strength, making it difficult to smooth consumption only among countries in the Caribbean. COVID-19's combined shock to tourism and oil prices is an extreme case, in which every country in the subregion was hit hard. Standard oil price shocks might present a different scenario for the Caribbean, with different countries facing negative correlations in their exposures to oil price risk. The latter might be more suitable for a cross-hedging arrangement between countries within the region.

### *Other Reasons behind Quantity and Type of Hedge*

Hedging practices may not only be valuable to smooth fiscal outcomes and consumption. They could also facilitate international finance flows of countries in various ways. At the firm level, Donders, Jara, and Wagner (2018) show that commodity firms that hedge are able to obtain cheaper debt finance in the bond market. In a related point at the macro level, Borensztein, Jeanne, and Sandri (2013) found that hedging some of the commodity risk can help countries' finances through at least two channels: first, by reducing the amount of precautionary saving, and second, similar to the firm-level case, by helping issue cheaper debt, since defaults at a given level of debt become less likely.

Yet another issue that suggests the Caribbean might need additional hedging is the interaction of the political economy with the frequency of loss events in which insurance pays out. For instance, in the case of Mexico, oil price fluctuations tend to be large, and therefore in two decades the country had received three or four payments. This success can make hedging practices politically more appealing. In contrast, for a shock that comes once every century, it would not be strange for politicians to vote against an insurance for disasters they rarely, if ever, observe. Technically, if politicians misperceive the probability of disasters, then they could inefficiently underinvest in insurance.

### **Hedging Weather and Climate Exposure**

As suggested before, economies in the Caribbean are well-known victims of extreme natural disasters.<sup>14</sup> For this reason, these economies tend to be beneficiaries of transfer schemes offered by multilateral financial institutions to aid in the case of a disaster (e.g., the IDB's Disaster Risk Management Portfolio and the World Bank Group's Disaster Risk Financing and Insurance [DRFI]

<sup>14</sup> According to the World Risk Index made by the UN (2012), economies with more relative vulnerability are those bordering the Caribbean and Pacific Ocean (e.g., Chile, Central America), while landlocked countries and those on the Atlantic coast tend to have lower vulnerability.

Program).<sup>15</sup> While the more salient interventions from these efforts are transfers to countries in or near to the years in which they face the shocks, various challenges face the CCB6 in hedging exposures.

One challenge is fostering further development of hedging efforts, for example through some kind of catastrophic bond along the lines of Mexico's program.<sup>16</sup> Beyond all the previously mentioned concerns, it is useful to note one potential impediment to the development of further hedging efforts in the Caribbean. If countries in the region think that buying more insurance reduces their likelihood of receiving World Bank/IDB transfers in case of a disaster, then they may be disincentivized from buying insurance of their own.<sup>17</sup> To mitigate this bias against buying more insurance, strategies to address these perceptions should be considered. For instance, the programs offered by multilaterals could commit to not reduce payments to Caribbean countries that increase their self-hedging efforts, or to limit such reductions.

Yet another dimension of hedging relates not to the shock itself or to money transfers, but to reducing the future physical sensitivity to a given shock. For instance, when rebuilding a bridge that has been wiped out by a hurricane, one has two choices: rebuild the bridge in a similar fashion (and quality) as before the hurricane, or rebuild it to be more resilient. The first approach is cheaper but does not reduce the sensitivity to future shocks. The alternative is more expensive but would lower the sensitivity of physical infrastructure to future natural disasters. It would also save public expenditures on those future rainy days. In that sense, building stronger bridges is a kind of real hedging against risks.<sup>18</sup>

It would be important that multilateral programs aimed at disaster recovery look also to these investments that create real hedging against shocks. One could also use these arguments to invest in clean energies, which reduce the relevance of oil import fluctuations.

<sup>15</sup> See <https://www.worldbank.org/en/programs/disaster-risk-financing-and-insurance-program> and <https://www.iadb.org/en/research-and-data/regional-policy-dialogue/disaster-risk-management-network>.

<sup>16</sup> See <https://www.gob.mx/shcp/prensa/comunicado-no-018-gobierno-de-mexico-y-banco-mundial-emiten-bonos-catastroficos#:~:text=El%20Gobierno%20de%20M%C3%A9xico%2C%20a,un%20plazo%20de%204%20a%C3%B1os>.

<sup>17</sup> This challenge is akin to the usual case of conditional cash transfers in public economics. For example, if poor people perceive that obtaining a better job or hiring wage would result in a sizable reduction in subsidies, then they may internalize this as a large implicit tax for their labor income, limiting labor supply (see Hoynes and Schanzenbach, 2012). The standard textbook prescription is to have a soft exit for social programs in which people lose much less than a dollar of benefits for each dollar of additional labor income.

<sup>18</sup> Del Valle, de Janvry, and Sadoulet (2019) show that it is also important to set up an infrastructure that enables disaster relief funds to be shared with the population.

### Oil Import Risk as Well as Risk Sharing within the State

One reason many governments and multinationals depart from the idea of centralizing hedging is an imperfect monitoring system, including a budgetary fight across divisions. For example, when key performance indicators (KPIs) and monitoring omit exposures, then the lack of hedging could have real effects for managers and divisions. This point is not a normative ideal, but an explanation as to why some organizations may depart from the benchmark of central hedging (Bekaert and Hodrick, 2017).

A standard issue in the management of SOEs is the presence of implicit subsidies and transfer prices, for example in the case of energy prices. In Barbados, the government fully transfers the increased cost of oil to the companies, without subsidies. In contrast, Trinidad and Tobago and Jamaica work in the opposite way. In the case of Suriname, massive energy subsidies are provided to the relevant SOEs in the event of increased costs.

Beyond the fragmentation of KPIs and implicit subsidies and transfers, a deeper problem is that in those economies that import oil the consolidated government has meaningful exposures to oil price increases. Box 7.5 illustrates this using the example of Venezuela's PetroCaribe. The Venezuelan-sponsored PetroCaribe agreements in 2005 reflected an underlying need to smooth oil import shocks for many Caribbean economies. Since these oil price shocks are likely to be recurring over time, the challenge is to provide a mix of financing and/or oil price insurance in a way that reduces distortions and is more foreseeable *ex ante* for oil importers.

For instance, one could think about financially coupling the large Mexican hedging program—a put option on the price of oil—with a smaller but mirroring call option, which could help oil-importing countries in the sub-region. Alternatively, Caribbean economies could consider joining together to achieve critical mass in hedging some oil positions. Given the productive structure, within CCB6 countries there is a natural hedging motive for a portion of oil revenues. The challenge is to have an efficient and reliable structure that does not require *ad hoc* negotiations between the countries. Objective measures should trigger payments. Another challenge for these financial alternatives is that they tend to be more appropriate for smoothing short-run fluctuations than for permanent or long-term shifts in oil prices—a more challenging issue.

In special and qualified cases, some organizations have introduced real hedges, as opposed to financial hedging. For example, an organization that has to pay for oil, like an airline, would buy shares of an oil-producing company. In some very specific cases, this might prove effective in overcoming the imperfect supply of long-term hedging against oil prices (Manuela Jr., Rhoades, and Curtis, 2016; Almansur, Megginson, and Pugachev, 2020). An immediate recommendation for such a tool is not clear, neither should this option be completely dismissed for all scenarios. This should be considered

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**BOX 7.5. PETROCARIBE AS AN ALERT TO THE NEED TO SMOOTH OIL IMPORT SHOCKS**

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In the last several decades, Caribbean countries that import oil suffered significantly when the price of oil boomed. Starting around 2005, countries facing limited access to international finance signed all sorts of ad hoc deals with the Venezuelan government under the umbrella of the so-called PetroCaribe agreements. Under that scheme, Venezuela provided cheaper oil, barter schemes, or some sort of trade finance for oil, depending on the country.

Like other members of the Venezuelan deal, Jamaica purchased oil at close to market value, but paid only a percentage of the cost upfront, with the rest paid over 25 years at a 1 percent annual rate of interest on the implicit loan. It also signed a parallel deal for a joint venture with Venezuela for the oil refinery Petrojam. A decade later Jamaica had paid off most of the oil financing. While in theory the funding was earmarked to specific uses, due to fungibility of money, it ended up also funding other activities in the country (CIJN, 2019). In the Dominican Republic, a relevant portion of public debt was owed to PetroCaribe (Oxford Analytica, 2015). In Guyana, the 2009 deal included a barter scheme in which Venezuelan oil would be exchanged for Guyana's rice, at a 20 percent premium for the latter (Wenner, Rogers, and Clarke, 2016).

In summary, these deals usually interlocked many contracts simultaneously. Moreover, according to Bryan (2009), a relevant portion of the deals were based on diplomatic and other nonfinancial motivations rather than being a pure loan or hedging program. With the benefit of hindsight, we now know these types of arrangements were not sustainable, in part because they depended on a specific Venezuelan regime that received oil rents and was channeling them for very particular purposes. This observation does not mean that the ultimate goal of smoothing payments for oil importers is a bad idea; quite the opposite. The above experience of PetroCaribe should not be used as a blueprint for further smoothing of oil problems in the Caribbean, but it does provide evidence of demand for a scheme to smooth oil price volatilities. The challenge now is to provide these hedging and financing schemes, but in a cleaner, sustainable structure that distinguishes between hedging objectives and other goals. Improving access to finance and hedging in the Caribbean could also help to prevent distortions in Caribbean regional diplomacy.

as another alternative in the toolbox, suitable for cases in which financial hedging might be extremely difficult. If an analogous agreement is implemented in the Caribbean, it would be important to do so when oil prices and valuations of the oil-producing companies are not perceived to be very high. That means one needs to build a sense of political urgency before and not during the storm. Such an agreement could mean investing a fraction of a Caribbean SWF into oil companies or any other asset

that correlates negatively with the oil expenditure shock faced by the oil-importing economies.<sup>19</sup>

### How to Hedge Tourism Exposure?

Hedging against commodity price fluctuations or climate-induced shocks is key for the CCB6. Related, but distinct, are the exposures of non-commodity-exporting countries economically dependent on tourism, either directly or indirectly. One pervasive issue in the Caribbean is how the structure of taxation is different when a country exports tourism. On the one hand, these countries cannot tax the commodity that is exported. On the other hand, corporate taxation of tourism businesses can become quite complex, for example due to tax-holiday shopping by large resorts or the emergence of Airbnb. Caribbean countries may need to overhaul their taxation systems in a way that is able to capture more of these rents, though a portion of the benefits and indirect taxes will accrue to the labor market through the trickle down of tourism.

The above point is not a direct suggestion about hedging instruments, but it could impact their demand. This is because the tax system could in principle smooth an economic boom. For instance, both Chile and Mexico may cool the economy by saving a portion of extra revenues during a commodity boom, while building up funds which can be used for busts. But given the abovementioned constraints to tourism taxation, these smoothing mechanisms may have more challenges in the Caribbean, at least among tourism-dependent economies.

Another interesting approach is evidenced in the policy efforts of Barbados to mitigate the effect of COVID-19 on income from tourism. Starting in July 2020 Barbados introduced a new program<sup>20</sup> offering a yearlong work visa targeting the growing work-from-home populace that would consider relocating, assuming a good internet connection. This pioneering effort, nicknamed Work from Paradise, is yet to produce results, but seems a reasonable move to promote economic activity.

Lastly, we speculate on a new hedging instrument. In practical terms, one possibility would be to create a financial instrument that pays out when GDP growth in visitor countries decelerates or turns negative. This follows along the lines of the econometric instrument used in the first section of this

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<sup>19</sup> The portfolio ought to be very diversified across various companies and does not require the small Caribbean economy to have ownership over the asset. It can simply own shares of companies with good corporate governance, or other assets that negatively correlate with long-term movements in the commodity of interest. As mentioned before, while a large fraction of the Chilean SWF is invested in fixed-income securities, almost all of it is denominated in foreign currency. Given the negative correlation between the main commodity's price (copper) and the Chilean exchange rate, the SWF could generate some additional gains when the terms of trade are not in Chile's favor.

<sup>20</sup> See <https://www.barbadoswelcomestamp.bb/>.

chapter, as when visitors are poorer, visits tend to decrease. If such an asset were available for purchase, tourism-dependent countries in the Caribbean could invest part of their portfolio in these securities. One could also envision a joint effort to tailor specific financial derivatives that could provide insurance if a country's visitors face an income shock.

## Conclusion

The CCB6 faces recurring fiscal problems, aggravated by the challenges of SOEs. This chapter has discussed how hedging tools could alleviate transitory fiscal problems resulting from fluctuations in key international variables affecting the current account of CCB6 countries, specifically commodity exports and tourism, as well as increases in oil prices for importers.

Before further conclusions, it is important to re-emphasize that the hedging strategies discussed here are neither for dealing with structural problems nor for hedging the costs of extreme disasters, such as a hurricane that wipes out a large share of the country's capital stock. Structural problems need structural solutions that deal with trends instead of fluctuations. Hedging exposures only serve to help these long-term outcomes if the smoothing they induce removes other distortions, including inefficient policies that sometimes happen in booms (Tornell and Lane, 1999) and busts.<sup>21</sup>

Based on estimates of the overall exposure of the fiscal accounts to fluctuations in commodity prices and tourism, we discussed various principles of hedging. Chile and Mexico provide useful case studies of two forms of hedging. Ideally, hedging should be done on profits instead of revenues or costs and should be implemented at the level of the central government, instead of via each individual SOE, ministry, or municipality. This helps to take advantage of the natural cross-hedging possibilities. Sometimes centralized implementation is not possible because of the many agency and political problems. In such a scenario, it is advisable to first solve these governance problems and then later hedge at the centralized level.

Beyond the use of SWFs to smooth government expenditures, this chapter also discussed two broad families of proper hedging instruments. Some were forward-like contracts that set up a fixed price for the transactions in the future. In contrast, option-like contracts are asymmetric and behave like an insurance. In case the future spot price of a commodity is advantageous, then options do not pay anything. But if the future spot price is worse than a given reference level, then the insurance component kicks in, offering a payment in such a bad state of affairs.

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<sup>21</sup> There is some evidence that oil booms may have the risk to increase permanent spending in public employment or produce lower productivity of spending/public employment (Larraín and Perelló, 2019; Caselli and Michaels, 2013; Martinez, 2019).



Amidst all the possibilities for hedging, the optimal hedging tool must solve some political economy trade-offs. On the one hand, committing to a forward price has serious potential for ex post regret, even if the decision would have had positive net present value ex ante—that is, when signing the hedging contract. Politically, it is very challenging to justifying an ex ante reasonable hedging decision, especially when, ex post, citizens can see the counterfactual foregone gains. This chapter illustrated the challenges when an SOE that exports metal saw the international price of its commodity going well above the pre-agreed forward contract, aimed to last for more than a decade and a half. Ex post, it would have been preferable not to sign such a fixed-price contract.

On the other hand, option-like contracts that offer insurance against a disadvantageous commodity price are less likely to face ex post regret, but they have other political costs. For example, they have to pay an upfront price for these insurance contracts. That means the costs of these insurance fees should enter explicitly in the annual government budget, which usually requires approval by congress.

Viewed from a different political economy angle, insurance against very volatile risks, which tends to offer more frequent and salient payments, might be easier to defend in congress. Even while insuring against an enormous risk that happens once a century might be the efficient thing to do, one could think that real politics may be more shortsighted. It might be more likely to insure against much milder shocks that are more frequent, and therefore more salient and easier to defend during the budget process. In any case, for a given time frame and a given risk, this chapter argued that option-like contracts might be preferable as a way to prevent ex post regret.

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# The Way Forward

### Diagnosis

The present book seeks to contribute to a better understanding of the role and management of state-owned enterprises (SOEs) in the Caribbean, with a focus on the Bahamas, Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago (collectively referred to as the CCB6). This book is part of a growing body of literature that aims to assess and diagnose the main challenges and limitations to SOE reform efforts, in particular the public policy debate regarding optimal design for SOE governance (OECD, 2015; World Bank, 2014) and fiscal governance rules (Musacchio and Pineda Ayerbe, 2019). This work tackles a much deeper issue than how to reduce inefficiency in SOEs, focusing also on the fiscal impact of SOEs in the region and on the necessary *ex ante* and *ex post* rules and procedures to minimize related fiscal risk.

SOEs in CCB6 nations are unproductive, unprofitable, and poorly managed. We see SOE inefficiency and fiscal mismanagement as going hand in hand and creating vicious circles that lead to lose-lose outcomes. While the root causes of SOE inefficiency can be found in institutional aspects that go deep into the history, culture, and political system of each country, the consequences of these inefficiencies have a very real, direct effect on national welfare today, as persistent underperformance of SOEs constitutes a major source of fiscal risk. Additionally, the fact that governments in CCB6 countries have little fiscal room, and they are the product of parliamentary elections that require broad coalitions, implies that they can use SOEs as vehicles of patronage or as opportunities to generate employment. This means that, more often than not, SOEs perform quasi-fiscal operations which lead them to operate with losses. Those losses then also contribute to fiscal risk.

This book follows earlier efforts by the Inter-American Development Bank (IDB) to diagnose, quantitatively and qualitatively, the risks that SOEs pose to governments in Latin America and the Caribbean (LAC), which are synthesized in numerous country reports that focus on public companies. This research constitutes the first in-depth study of the causes and consequences of SOE underperformance in the CCB6 economies and the first one to provide tailored policy recommendations. To achieve this, the authors rely on an original and unique dataset of firm-level SOE performance indicators, the IDB CCB6 State-Owned Enterprises Database. The data was collected from the financial statements (oftentimes not publicly available) of public firms and made comparable across countries and time. This was combined with macroeconomic indicators, as well as national accounts data from various sources. The value added by this information is immense, and the dataset will be available for future studies of public companies in the Caribbean.

The first part of the book describes how the macroeconomic context of the CCB6 economies, the economic effects of the COVID-19 shock, and the financial performance of SOEs together amplify the existing fiscal struggles of the region. As small island nations with economic activity concentrated in tourism and/or commodities, the CCB6 countries are highly vulnerable to climate shocks and exposed to global business cycles with little fiscal room to face them. They have a long history of high debt and low growth, driven mostly by procyclical spending during good times and countercyclical spending during crises. This tendency to run budget deficits, paired with the high level of consumption in the region, leads CCB6 countries to borrow heavily from abroad on a regular basis. The high spending during booms in CCB6 countries is driven partly by a focus on employment creation, oftentimes through the establishment of new SOEs, and by interest payments on their sizable debts. This means that even in the best of times the Caribbean economies have severely restricted fiscal space.

The past decade has revealed the severity of this vulnerability to external shocks and global crises. First, the global financial crisis of 2008–2010 hit the tourism-driven economies in the Caribbean hard, due to the industry's reliance on North American and European travelers; tourism was, in fact, the last sector to recover once the crisis passed. Then, the end of the commodity boom in 2014 revived old fiscal struggles, particularly for commodity exporters (Guyana, Suriname, and Trinidad and Tobago). Thanks to the cumulative impact of these shocks, the Caribbean region faced a collapse in fiscal revenues that led to a sharp increase in fiscal deficits and debt. The real economy did no better. Total factor productivity (TFP) growth has been null or negative since the mid-2000s, unemployment rates are relatively high, and economic informality and brain drain are recurring issues.

The COVID-19 pandemic was the latest and largest of these shocks, generating a worldwide public health emergency and subsequently a deep global economic crisis. The domestic and external measures imposed by most countries to isolate their populations were particularly damaging for the export-driven Caribbean nations. The balance of payments deficit increased dramatically as tourism activity ceased, remittances contracted substantially, and demand for natural resources became more volatile and significantly smaller. In addition, governments in the region are facing increased expenses for mitigation programs to buffer the economic shock of the isolation measures, but they have less fiscal space than in previous years due to the decreased economic activity and the high debt levels accumulated in the last decade.

The COVID-19 shock pushed governments in CCB6 nations to choose fiscal stimulus for crisis mitigation, but with limited success. This is because the fiscal multipliers are smaller than usual due to the imposed lockdowns on various economic activities, making government spending less efficient, but also because these Caribbean countries lack the financial resources (domestically) to stimulate their paralyzed economies. In addition, even more spending will likely be required for the recovery phase, which now seems far away—especially because the tourism industry and commodity sectors were hit so strongly. Access to international capital markets is also challenging as the global nature of the crisis and uncertainty regarding the duration of the shock has triggered a flight to safety for investors. As a result, the CCB6 economies are experiencing twin deficits that have increased their macroeconomic fragility.

In this context, SOEs have become extremely costly for the governments of CCB6 countries. This book argues that SOEs are too numerous in the CCB6 countries, especially relative to population sizes, and too large relative to their domestic economies. In addition, they are financially very weak, often facing losses, and therefore too dependent on fiscal transfers. While the poor financial performance can be attributed to many operational factors, this book's contributors argue that it is ultimately grounded in the symbiotic relationship between SOEs and their respective central governments, and that both fiscal and corporate governance play a big role. Public companies benefit from the soft budget constraints that allow them to keep operating, and in return they perform quasi-fiscal operations, such as employment creation, or provide public services at subsidized prices.

This interdependence has generated a vicious cycle. Governments inject cash into mostly underperforming SOEs. As a result, these companies become even more inefficient and unprofitable. This is partly due to distorted incentives, but also to the quasi-fiscal operations with which they are charged. For instance, additional hiring inflates the companies' payroll expenses and lowers their profitability. Therefore, SOEs will require more injections of capital to be able to sustain their operations. These transfers become regular operations and end up as fixed costs to these governments.



In spending beyond their means, SOEs have become overly dependent on government transfers, creating a large fiscal burden that has accumulated over the years. Even worse, our research indicates that neither the creation of SOEs nor their operations have contributed to an increase in the capital stock or improvement by any measures of productivity. On the contrary, as CCB6 nations have accelerated the creation of SOEs in the last five to ten years, both productivity and the capital stock have declined. That is, governments have been increasing expenditures on SOEs that are not, at the end of the day, contributing to economic growth.

The fiscal burden that SOEs pose to CCB6 governments is extremely high. As shown in Chapter 2, net of fiscal transfers SOEs cost on average 2.3 percent of GDP, and as much as 7.4 percent of GDP. As a consequence, CCB6 governments face at least three types of fiscal risk emanating from SOEs: cash-flow risk, contingent liability risk, and bailout risk. The first one stems from the discretion that SOEs enjoy requesting additional (emergency) funding to complete a project, start a new one, or simply cover their costs. Even in countries with budgeting regulation, SOEs can exceed their budgets with hardly any accountability, thus enjoying a *de facto* soft budget constraint. In addition, since SOEs operate in key sectors, are used for political purposes, and have become “too big to fail,” governments cannot credibly threaten to discontinue the funding. Not surprisingly, SOE managers have been found to take excessive risks and behave complacently.

An additional side effect of the soft budget constraint that SOEs enjoy is the contingent liability risk they pose. Just as with fiscal transfers, there is little to no monitoring of SOE liabilities. In most countries SOEs can freely issue debt for large projects, which is implicitly or explicitly guaranteed by the government. The risk is, of course, that very high total SOE liabilities as a share of GDP will turn into government liabilities. This leads to the third type of risk to governments: bailout of the SOEs; the larger the company, the larger the bailout risk. Ultimately, some might be too big to be bailed out. In summary, there exists a serious problem of fiscal governance of SOEs.

These problems, however, are not new. The second part of this book presents a historical narrative of the origins of the “Caribbean fiscal curse,” and the contributing role that SOEs have played. We argue that the fiscal problems of CCB6 nations stem not from colonial institutions but rather from the behavior of governments since independence. Specifically, CCB6 nations tried to make up for colonial inequalities by using public spending and SOEs to provide subsidized goods and services (especially education and health) and to bolster employment. This quickly generated overspending and persistent (and growing) fiscal deficits, which led to several balance of payments crises, regardless of the colonial institutions, the type of post-colonial governments they had (e.g., Guyana with a command economy vs.

Barbados or Bahamas with a more market-friendly economy), or how agitated or peaceful their independence history has been. In other words, the initial deficits originated shortly after independence and then led to the current vicious cycle in the CCB6. While there were some attempts to fix these issues during the 1990s, following the catastrophic 1980s decade, significant or persistent fiscal deficit reductions were never achieved. The ability to obtain external credit or restructure their debt through IMF programs has prevented these countries from undertaking serious austerity measures in a persistent manner. SOE creations, in fact, accelerated in the late 1990s, right after privatization efforts took place, highlighting the structural nature of the vicious circle described in this volume.

In its recommendations, the book dives deeper into changes in the institutional framework necessary to improve the fiscal and corporate governance of SOEs and reduce fiscal risk. CCB6 countries lack clearly defined legal and regulatory frameworks to delimit government ownership or to standardize the legal forms and procedures to govern SOEs. The existing regulatory frameworks, while oftentimes good on paper, interfere with transparency and clarity in the objectives of the SOEs and, in practice, present significant deficiencies such as power imbalances, asymmetric information, and a variety of agency and accountability problems. Ultimately, SOEs in the Caribbean are poor performers even after adjusting for size and other external factors. We argue that part of their financial underperformance stems from the weaknesses of the institutional framework for the monitoring of SOEs.

The establishment of SOEs is completely ad hoc, determined often solely by the line ministry. There is neither an independent committee nor deliberation on or approval of the new SOEs from other bodies. In fact, proposed SOEs do not even undergo an assessment of financial viability. In addition, there is no standard legal form for SOEs across the region (or even within each country) or clear criteria behind the legal status they obtain (i.e., is the company for profit? Do they follow corporate law or administrative law? Are they regulated as agencies or as autonomous entities?). There are also no harmonized codes of corporate governance or frameworks of monitoring and evaluation that allow for comparisons between countries and firms. In line with this lack of clarity and benchmarks, the region also presents low transparency indices and very high corruption levels (primarily personal interest and nepotism), especially in SOEs.

Given the small sizes of the CCB6 countries, the weight of the SOEs relative to the size of their economies (or population) is larger than in most other countries of the world. This means that the consequences of (poor) governance and regulation have a relatively large impact, especially when it comes to fiscal risk, economic development, and attracting foreign direct investment (FDI). While good governance guidelines exist in the region, they are oftentimes hard to implement due to scale issues; there are little resources to

implement, monitor, evaluate, and adjust these practices. In addition, there is excessive regulation, some of it due to ever-changing international standards that regularly incorporate new environmental and social concerns. While international best governance guidelines are desirable, these guidelines would impose burdensome fixed costs for these public companies (which are relatively small globally), distorting incentives and increasing the likelihood of inefficient performance and unethical behavior.

There is also excessive regulation within each country. For instance, in considering formal procedures for appointing board members, sometimes eligibility is too restrictive (especially considering the small potential pool of good candidates), complex, or confusing (i.e., the job postings and the profiles of the current board members are not published). Therefore, rules are either not adopted or not applied in practice, which explains the stagnation in transparency (see Chapter 6) despite much-publicized anti-corruption campaigns in the tourism-driven economies. In fact, as some public scandals depict, there are instances of substantial political interference in board processes, conflicts of interest in SOEs, and deeply rooted corruption practices.

All in all, the challenges are immense. While most of them are historical, some are new and even global in nature. The diagnostics paint a grim picture both in terms of macroeconomic (fiscal) stability and microeconomic (SOE) management and performance. However, this also means that numerous opportunities for improvement exist and that even small changes can have large positive impacts. While we acknowledge uncertainty regarding economic recovery post-pandemic, especially given the recent warnings about new waves of contagion, we remain confident in our recommendations for key areas for reform and implementation of best practices. Many of these we believe could be adopted by the CCB6 relatively easily. The main messages are summarized below and a few case studies provided to serve as a reference.

## Recommendations

This book proposes three simple yet effective strategies for the CCB6 economies to help alleviate the negative fiscal impact of SOEs:

1. Consolidation
2. Introduction of ex ante rules and procedures
3. Ex post monitoring of SOEs with periodic checkups

It is important to note, however, that each of these recommendations does not exclude the others. We are thinking of them in a holistic way that requires these reforms to be implemented in packages that include combinations of all of them. Thus:

1. *Consolidation* is broadly defined as a specific plan to firm up financial budgets, with the aim to reduce financial losses and debt. At the macro level, it refers to the tightening of the government's primary balance. At the micro level, it refers to keeping SOEs spending within their budgets.
2. *Ex ante rules*: In order to achieve consolidation and sustainability (and reduce debt), consolidation plans need to be complemented with comprehensive ex ante rules that facilitate the implementation of the plan and guarantee the plan's longevity. Specifically, these rules harden the budget constraint as they not only introduce procedures for approval, but also specific timelines of when budgets are submitted and approved, not allowing ad hoc requests of additional funding throughout the year. These rules also apply to the procedures SOEs follow to request funds for capital projects and can introduce timelines for reporting progress for such expenditures.
3. *Ex post monitoring* refers to the rules and procedures bureaucrats and SOE managers follow to report budgetary execution, capital projects process, and SOE financials in general. These ex post monitoring rules require timeliness in the submission of reports, periodic checks (e.g., quarterly capital budget execution or semi-annual or quarterly financials for SOEs), and a system of "carrots and sticks" (incentives and punishments) for ministries, agencies, and SOEs that do not comply with them. In order to promote transparency, these ex post reports have to be audited, overseen by the Congressional Budget Office, and when possible, should be available to the public.

The use of these three strategies to harden the budget constraints of states or provincial governments has been widely studied in the literature of fiscal federalism and these strategies have proven necessary for well-functioning fiscal decentralization. In addition, they are general and flexible enough to be applied at both the macro and micro levels.

One policy recommendation suggested throughout the book is the value in borrowing relevant best practices from other countries. While some Caribbean problems seem unique to the region, it is still advisable to start with existing solutions rather than invent new ones. In fact, the proposed strategies are common practice in many countries around the globe. The following sections explain each strategy and how it can be applied at the macro or micro level. In addition, we provide evidence of successful cases in LAC (like hedging in Chile and Mexico or centralized agency monitoring in Peru) and the OECD, with particular attention to the Korean model of performance evaluation.

### Macro-Level Consolidations

The CCB6 economies are currently stuck in a high-debt, low-growth spiral. To get back on the debt sustainability, and hopefully growth, track, the

standard austerity measures apply: there needs to be lasting fiscal consolidation in the region. There is strong evidence that expenditure-based consolidations are more effective and less costly (output-wise) than tax-based ones,<sup>1</sup> likely because they require larger efforts from the government and thus exhibit more commitment and credibility, but the Caribbean countries with very large adjustment needs might need to do both. After an initial (large) fiscal adjustment,<sup>2</sup> the Caribbean economies should focus their efforts on increasing output growth, which will also improve their fiscal position and guarantee sustainability. However, we also acknowledge that running primary surpluses might not be enough for the most heavily indebted CCB6 countries due to the high burden of interest payments. In any case, fiscal consolidation is important as it signals a commitment to improving the current standing and to not default on loans. Ultimately, to successfully reduce debt ratios, improve creditworthiness, and become fiscally sustainable, countries will need to adopt deeper reforms.

In addition, CCB6 countries need to use their fiscal resources wisely and implement reforms that will increase their productivity; this means, among other things, not pouring resources into SOEs for the purpose of short-term political gains, as this will only serve to perpetuate long-term fiscal imbalances. Fiscal rules are the natural place to start and will provide the markets with the right signals. Balanced budget, debt, expenditure, and revenue rules have helped countries stay on the sustainability path in the past. As illustrated in Chapter 1, since passing the Fiscal Responsibility Act in 2010, Jamaica has been able to substantially reduce the fiscal deficit and the public debt-to-GDP ratios while accumulating foreign reserves. In addition, these rules can help manage the complex relationship between governments and SOEs. Fiscal rules, however, will need to be accompanied by the right fiscal strategy that balances the short-term consolidation needs with the longer-term growth goals. Other reforms include (but are not limited to) tax policy, public sector and SOE administration, and debt management.

COVID-19 has intensified the challenges already facing CCB6 economies and made the need for action even more urgent. For this, and any other large, unexpected shocks, we advocate for smart containment and smart mitigation measures.<sup>3</sup> The main idea is that governments should act fast on

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<sup>1</sup> See Alesina and Ardagna (2010), Alesina and Perotti (1997), and Alesina, Favero, and Giavazzi (2019).

<sup>2</sup> Ardagna (2004) finds that for OECD economies the success of the stabilization is driven by the size and not by the rate of growth of output.

<sup>3</sup> This implies temporary cuts in capital expenditures, reduction of the public wage bill, reviewing and potential decapitalization of inefficient SOEs, and accessing emergency funding from multilateral organizations. In the long-term, the crisis demonstrates the need to revisit procyclical spending and low savings in favor of consumption smoothing. See Andrabi et al. (2020).

urgent matters whenever new information is less relevant for determining the course of action. Otherwise, a Bayesian approach that uses today's information (and all other available data points) should be taken.

This book also stresses the potential role of SOEs in helping governments during the containment and mitigation phases. Because of their large size and wide scope, SOEs have a comparative advantage in providing services for (pandemic or other) relief. For instance, state banks could carry out financial relief measures for households and small and medium-size enterprises (SMEs), while other public companies that provide key inputs or services (i.e., water or electricity) could offer short-term subsidies. However, we suggest that state involvement, either directly or indirectly through SOEs, be temporary. Governments should be particularly careful to not foster long-term dependency given the dangers discussed regarding use of SOEs to perform quasi-fiscal operations.

Finally, given that the CCB6 countries are significantly exposed to shocks in tourism and exports, to which fiscal outcomes are sensitive, and given that they have no other means of consumption smoothing (i.e., a sovereign wealth fund or unlimited access to credit), we propose the use of risk-hedging mechanisms. In theory, hedging would be done in a centralized way (i.e., through the Ministry of Finance [MOF]) and on profits rather than revenues or costs. However, in practice, there is no *ex ante* first best, and the chosen strategy will come from an appropriate cost-benefit analysis. In fact, many variations exist that differ in terms of the level of the main hedge (from the SOE to the central government), the tools used (options, futures, forwards, etc.), the duration of the hedge (short or long term), and so on, so strategies vary dramatically even within Latin America. Chapter 7 discusses the differences between the Mexican (PEMEX) and Chilean (CODELCO) hedging strategies. For the Caribbean, implementing these strategies may require coordination between countries—the size of the deal matters.

### **Consolidation, Ex Ante Rules, and Ex Post Monitoring in SOEs**

Common practice to exact behavioral change in SOEs and their managers is through conducting *ex post* reviews of their performance and their financials, imposing sanctions, and even carrying out judicial prosecution of managers for corruption or embezzlement. Yet, these mechanisms may be effective at punishing, but not at getting to the outcomes governments want from SOEs. More often than not, *ex post* monitoring will punish managers rather than correct the course of the SOE. Thus, this problem requires *ex ante* solutions. That is why we recommend imposing administrative procedures that control the actions of agents *ex ante*, such as formal timetables and formulas determining when and in what quantity financial resources will flow to and from SOEs (Moe, 2012), as well as more detailed and frequent reporting of activities, timelines for the reporting of goals and outcomes, and so on.

In terms of ex post reporting, the next sections summarize some of the best practices for SOE monitoring. First of all, we recommend having a centralized monitoring agency run by technocrats or professional managers and with authority to enforce the ex ante rules and to impose penalties for underperformance or late reporting ex post. Throughout the book contributors argue that the SOE monitoring unit should be part of the MOF because this ministry ultimately bears the risk of having to bail out these firms. Also, this unit should take control (with the MOF) over the design of new SOEs to prevent the use of these firms for purely political objectives in a financially unsustainable way.

Second, centralized SOE monitoring agencies “can introduce ex ante approval of SOEs’ strategic and investment plans, including medium- and long-term debt plans. These plans should be strategic in the sense that they consider future market conditions (for example, three to five years ahead). These plans should also include a detailed plan for capital expenditures and should include calculations of the expected debt levels and the potential liabilities this debt could generate for the government’s balance sheet” (Musacchio and Pineda Ayerbe, 2019, 26–27).

Third, the book provides examples of the kind of detailed financial reporting that is required to monitor SOE activities, from capital project execution reports to regular cash-flow statements and financial disclosures of debt and contingent liabilities, including profit-and-loss statements and balance sheets. It also shares some of the best practices in terms of corporate governance and management performance monitoring.

There is a need for deep SOE reform in the CCB6, to help companies achieve their desired outcomes and help governments reduce fiscal risk and deficits. Chapter 4 describes the best international practices regarding SOE corporate governance and highlighted those most applicable to the CCB6. As the OECD Guidelines on Corporate Governance of State-Owned Enterprises illustrate, these practices have proven adaptable to different environments, so they will work regardless of the different legal traditions of the countries. Many have already been successfully applied in Latin American countries, so their applicability in the Caribbean is fairly safe to presume.

The main challenge lies in balancing the autonomy of the companies, needed for efficiency in operations and smart financial decisions, with their public accountability. The latter is required given that they often provide public goods and services and generate fiscal risk to the governments. For this reason, some of the proposed best practices are not regarded by private firms since this public accountability is not needed. We also acknowledge that change takes time and substantial political will and, even when socially desirable, it could prove too costly (both politically and economically) in the short run. It is, however, a tricky dilemma since the status quo also comes with fiscal risk that could prove even costlier than giving up SOE control (i.e.,

if companies need large cash injections or bailouts). It should be clear to policymakers, however, that there is no trade-off in the long run; reducing fiscal risk and improving SOE efficiency are both necessary conditions for economic development.

As mentioned before, we propose a combination of ex ante administrative controls and ex post monitoring and evaluation. Ex ante controls on governance, procurement, budgeting, and debt issuance have been successful in increasing transparency among SOEs in Latin America, reducing agency problems, information asymmetries, conflicts of interest, and corruption. At conception, SOEs should be designated by simple and clear governance structures that explain the rationale of the company and the role of the government in its operations. In other words, governments should justify the presence of each SOE in their portfolios and be willing to act if the company is not performing according to expectations. Additionally, rules should be developed that establish ownership and management, and effectively separate the two.

Perhaps the most important rules are those that increase transparency. For SOEs to effectively improve, there needs to be accountability and a public record of their operations. Similar to private firms, SOEs should, at the very least, have internal and external audits and publish their financial statements. Given that they are government owned, however, the level of transparency expected in democratic regimes is greater than that of private companies, and all relevant information (from board composition and remuneration to financial health) should be made publicly available.

Other popular administrative controls include strict timelines for disbursing funds and reporting outcomes, guidelines for budgeting, minimum credit rating requirements for bond issuance, and approval from (at least) the MOF in order to borrow. Rules that improve governance are also desirable, though governments should first assess how much regulation is reasonable for each SOE. Governance-focused rules include ensuring effective rotation in SOE boards, limiting political interference in board decisions, strict guidelines for procurement, and the existence of checks and balances. For instance, Mexico's PEMEX needs authorization from ministries and other agencies before procurement and large investments. The following section summarizes all the corporate governance and legal reforms proposed in this book. For further detail, refer to Chapters 4, 5, and 6.

### *Corporate Governance and Legal Reforms of SOEs*

In Section II of this book the contributors acknowledge that in order for these ex ante rules and ex post monitoring to lead to fiscal (and SOE budget) consolidation, there needs to be a revamping of both the legal persona of SOEs and their corporate governance. That is, the financial underperformance of SOEs in the Caribbean region is tied, to a large extent, to institutional



underperformance. Governments have demonstrated insufficient capabilities in setting SOE objectives, planning accordingly, executing the plans, monitoring their evolution, and evaluating the relevant outcomes. In Chapters 4–6, Bernardita Escobar, Tamira La Cruz, and Yery Park conduct an in-depth study of the existing institutional frameworks that govern and regulate SOEs and provide recommendations to align current SOE corporate governance practices in the CCB6 to international best practices. Here we summarize the most relevant (yet simple) reforms for corporate governance and legal frameworks that are applicable as *ex ante* administrative controls.

The goal of corporate governance reforms is to improve the *ex ante* rules for SOEs and to improve transparency and efficiency of the SOE sector using *ex post* monitoring rules related to reporting, auditing, and so on. Chapters 4, 5, and 6 examine this by stating that corporate governance reforms are needed to:

1. *Develop a better system for designating new SOEs:* Include enough checks and balances to prevent any single ministry or agency from being able to create companies at will.
2. *Clarify the objectives of each SOE:* This will matter for incentives as well as for the regulatory framework (see below) and for the performance evaluation (see next section).
3. *Request technical assistance* to develop harmonized codes of corporate governance for SOEs, borrowing from international best practices.
4. *Promote transparency regarding board and executive members of SOEs:* Their résumés, affiliations, remuneration, and patrimony should be publicly disclosed. In addition, job postings should be open to anyone (including nonresidents) and published on websites.
5. *Implement mechanisms to avoid less-than-honorable practices:* For instance, as in private companies, anti-corruption training regarding conflicts of interest, material interest, independence, etc., could be a requirement for all employees. In addition, board members should be asked to sign a conflict-of-interest policy and/or statements of material interest prior to joining.
6. *Separate the chair of the board from the CEO* in large SOEs, through a two-tier governance structure.
7. *Produce frequent (and ideally also standardized) management reports* for cabinets and parliaments. These would allow for cross-country comparisons.
8. *Adopt transparency standards similar to private companies,* starting with publishing financial statements under the same standards as listed companies (to facilitate comparison and evaluation). They should also be subject to internal and external audits, as discussed further in the following sections on monitoring and evaluation.

On the other hand, the reforms to the legal and regulatory frameworks that regulate SOEs help to provide ex ante more clarity of the goals and expectations of the SOEs. Thus, the volume recommends that governments and/or their SOE units follow these guidelines:

1. Classify SOEs according to four different categories and assign each to a corresponding (ideal) legal framework (see Table 8.1). This would level the playing field between nongovernmental companies and SOEs, making incentives more explicit and thus increasing SOE competitiveness.
2. In any case, even if the above separation does not work, it is important that commercial and noncommercial SOEs be subject to different legislation that establishes what should be done with any surplus produced by SOEs regardless of category.
3. Similarly, SOEs that have market competitors need to be incorporated under private law. This will automatically expand their potential financing sources and lead to closer monitoring.

Last but not least, countries need to be committed to good corporate governance of SOEs. As the meaning of this evolves over time, as do the objectives and scope of SOEs, governments will need to devote special attention to their corporate governance practices while keeping abreast of new developments. In addition, as international regulatory requirements and expectations change, CCB6 countries could have a joint agency or committee so that the burden (of frequently updating practices to comply with international standards) is split among all of them.

When government controls are too tight, as we discuss in previous chapters, they create room for bargaining, and thus the soft budget constraint problems are likely to persist. This is highlighted by the Petrobras corruption scandal in Brazil, in which the government overrode minority stakeholders'

**Table 8.1. SOEs by Type and Their Ideal Legal Framework**

SOE Type	Examples	Proposed Legal Framework
With (mostly) commercial objectives	Water, electricity	Same as private enterprises (corporations)
NPIs (not-for-profit institutions)	Health care, education, social housing	Same as foundations
Serving a common interest or benefit to a group of enterprises	Chambers of commerce	Same as private trade associations or research institutes
Regulatory	Energy regulators, supreme audit institutions, standards boards	A separate unified legal form, like Suriname's Wet op Landsbedrijven

rights by making strategic decisions and later extracting resources from the firm. Thus, controls on SOE corporate governance should be complemented with controls on fiscal governance. We have previously described the benefits of fiscal rules for countries with high fiscal deficits and high levels of debt. Essentially, the idea is that there should be a system of checks and balances so that neither the SOEs nor the government can take advantage of the other party.

Ex post monitoring and evaluation are essential for healthy organizations in keeping incentives in place and promoting accountability. But most importantly, these practices help track the performance of SOEs. In the CCB6 economies the problem is not the inexistence of monitoring, but rather that the system is *decentralized*: monitoring is conducted by sector and by different line ministries and agencies. This creates a “multiple principal” problem further complicated by the resulting information asymmetries between the SOE and the multiple monitoring agencies. Besides the usual moral hazard, the monitoring agencies face collective governance issues including competing interests, freeriding, and duplication in monitoring; lobbying by principals; and ultimately more autonomy and less monitoring of SOEs. Moreover, all agencies have different standards and thus require different types of reports, which makes comparisons and benchmarking (both at the national and international levels) very difficult.

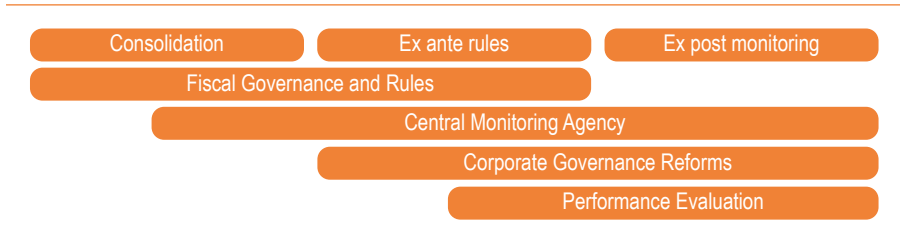
## Combining Best Practices

So far, we have discussed our three recommendations (consolidation, ex ante rules, and ex post monitoring) and briefly described their success in different countries. While there exist many ways to implement them, we have selected the following as best practices: fiscal rules, centralized monitoring, corporate governance reforms, and performance evaluation. Figure 8.1 illustrates how each of these fits into the broader recommendations. The aim of this section is to dive deep into the centralized monitoring agencies, using examples in LAC, and the performance evaluation system adopted in South Korea.<sup>4</sup>

### Centralized Monitoring Agencies and Fiscal Risk Control

Introducing and enforcing consolidation, ex ante rules, and ex post controls requires an agent of change and an enforcer. That is why, following best practices in the Western Hemisphere, we recommend that CCB6 countries either create an SOE unit within the MOF or that they strengthen their

<sup>4</sup> Note that the other two—fiscal governance and rules, and corporate governance reforms—have been extensively described in the previous section.

**Figure 8.1. Recommendations and Best Practices**

existing SOE units so that they have more “teeth” to implement the reforms we recommend.

Most countries in LAC (and the OECD as well) use decentralized monitoring systems, under the rationale of sectoral expertise. Musacchio and Pineda Ayerbe (2019) show that SOEs in LAC that have adopted centralized agency monitoring improve fiscal governance and perform better financially. This section describes the centralized monitoring model and its advantages and disadvantages and reviews the empirical evidence on SOE performance under this system. It also provides details of the Peruvian case. Some of the advantages of centralized agencies are:

- They operate as vehicles of professionalization in the monitoring of SOEs; by centralizing financial and budget execution information, they improve monitoring efficiency and transparency. They can also centralize IT operations for monitoring all firms in the portfolio and standardize software for control and financial reporting. This allows, among other things, for benchmarking and easier comparisons between firms.
- They have better talent management practices than when governments decentralize the monitoring and management of SOEs. Most agencies have technocratic bodies managing them and, in many cases (such as Chile or Peru), the agency itself appoints and monitors management of SOEs. Thus, these agencies develop experience (and expertise) in SOE management. They can also take a centralized approach to hiring, firing, compensation, and training of executives and staff of all SOEs in the portfolio. For instance, they can centralize the training of auditors for all SOEs in the portfolio.
- If the holding company or central agency is legally a private entity subject to corporate law, it can restructure firms and hire and fire workers with more flexibility than SOEs that are treated as government subsidiaries following administrative law. This book provides many examples of how during booms governments easily expand SOEs, but then are unable to reduce their sizes during the bad times (and thus they become a source of fiscal risk).

- They can help reduce the fiscal governance problem by introducing strict ex ante planning procedures and timelines for requesting budgetary support. The best practice is to request budget and capital projects approvals from congress once a year and to restrict additional discretionary funding outside of these approvals.
- They are good at monitoring SOEs to minimize the risk of unexpected bailouts and to reduce the government's capacity to (mis)use SOEs for quasi-fiscal objectives. When sophisticated agencies manage approvals and monitor the execution of investment plans (and budgetary execution in general), the possibility of unexpected shortfalls in necessary funds to finish SOE projects is reduced. Ad hoc fiscal governance between SOEs and the government is subsequently reduced as well. For instance, if central agencies oversee and approve SOE expenditures and investments they can also regulate when SOEs receive funds and how SOEs make such expenditures.
- They reduce the soft budget constraint through borrowing controls. According to Ter-Minassian (2019), the MOF should define an aggregate debt ceiling for each sector (approved by the parliament) according to how much each SOE can take on in terms of debt service. Yet, she suggests that in order to reduce the discretion in the process of approving new borrowings there should be a framework in which SOEs are scored according to capacity to pay debt, using a variety of criteria that include interest burden, leverage, percent of foreign to local debt, the size of contingent liabilities, and the operational profitability of the SOE (Ter-Minassian, 2019, 66).

All these advantages help to significantly reduce the fiscal risk that SOEs pose, particularly cash-flow risk and bailout risk, through increased transparency (less asymmetric information) and reduced uncertainty regarding the financial state of these companies. In addition, centralized monitoring not only helps governments avoid surprises in SOE operations, but it also helps the companies stick to budgets and timelines (thus enhancing productivity) and protects them from government abuse as all operations (i.e., inflows and outflows) are reported. Nevertheless, we acknowledge that using central agencies to monitor SOEs has some limitations.

First, central agencies are usually not politically powerful enough to stop the government from controlling SOE tariffs, so they may not fully eliminate the fiscal governance problem of SOEs. That is, governments may still charge SOEs with quasi-fiscal operations. However, interventions likely would be less ad hoc, and some of them even reported and discussed in congress, but it is unlikely that the use of central agencies would be sufficient to eliminate them entirely.

Furthermore, in countries like the CCB6 nations with a high and increasing number of SOEs, these agencies might soon find themselves overwhelmed.

The responsibility of monitoring an increasing number of SOEs, the complexity of the information they must process, and the projects they have to monitor may become too much for their technocracy. That is, the information asymmetry problems that exist between the companies and their monitoring agencies increase as the number of SOEs increases. Thus, it is advisable to keep the number of SOEs monitored by these central agencies relatively low and to avoid including under their supervision highly complex firms that require very specific expertise.

Finally, large SOEs that are very strategic in nature are usually left out of the purview of these centralized agencies due to a lack of the necessary political clout needed to control these large firms (e.g., think of large oil and gas companies). Therefore, governments that adopt centralized agencies to monitor SOEs usually leave large, strategic firms under the monitoring of the MOF and the relevant sector ministry. In any case, while centralized agencies might not be able to solve all issues regarding power imbalances between the companies and the governments, the benefits outweigh the limitations.

Empirical evidence from Latin America demonstrates that countries in which governments have implemented centralized agencies to monitor SOEs produce better overall results for these firms (as a percent of GDP), including lower liabilities as a percent of GDP. In addition, SOEs monitored by centralized agencies tend to have fewer years with losses than SOEs in countries where there is no centralized monitoring. In China and other Asian economies there is also evidence of better financial performance (fewer losses) and less fiscal dependence of the government on SOEs after centralized agency monitoring is introduced.

Based on both theory and practice, we argue that the optimal mandate of centralized agencies should be focused on a combination of the following objectives:

1. Representing the government as an owner in the SOEs in which it is a direct shareholder or controller
2. Nominating members to the board of directors of SOEs
3. Approving and, when necessary, revising the mission and strategic and development plans of SOEs
4. Determining debt ceilings and creating rules for SOEs to get approval for new debt issues (Ter-Minassian, 2019)
5. Approving and revising SOEs' annual budgets before they are presented to the MOF
6. Approving quarterly financial reports, which should include updates on the physical progress of projects in SOEs' development plans and progress against key performance indicators
7. Leading SOEs to have social responsibility metrics and annual reports of such practices

8. Introducing and maintaining state-of-the-art processes at all levels of holding and affiliated firms to streamline SOE management
9. Ensuring compliance with the code of best practices of corporate governance
10. Centralizing procurement when possible

The design of centralized agencies varies across countries, yet a compilation of best practices by Ter-Minassian (2019, 67–68) highlights the following mandates.

For budgeting:

- The governing body should prepare SOEs' annual budgets for review and approval in a standardized format that is consistent with international accounting standards. The budgets should be sufficiently detailed and have explanatory notes to allow a thorough assessment by the oversight body.
- The budgets should include detailed projections of revenues, operational expenditures, relevant financing costs, proposed investments, and information on the amount and type of financing required.
- The reports should specify any assumptions made for variables such as commodity prices, the exchange rate, and interest rates, as well as SOE-specific factors including demand factors for the SOE's products, relevant tariffs, the size and composition of its workforce, and cost considerations resulting from wage increases or the prices of other key inputs. These assumptions should be subjected to sensitivity analyses and combined stress tests, with the results being presented in the budget report along with any proposed actions for navigating worst-case scenarios.
- The budgets should also contain a section on explicit contingent liabilities that provides estimates of their expected values, the probability of their realization, and the amount of capital reserves needed to remain solvent.

In terms of monitoring, reporting, accounting, and controls, Ter-Minassian (2019) recommends the following:

- Preferably real-time monitoring of the execution of their budgets and detailed monthly or quarterly reports to the oversight authorities. There should be a single standardized reporting system to allow all SOEs to submit these reports electronically.
- The SOEs usually prepare their financial statements according to the same accounting standards that are applicable to private companies, allowing performance comparisons with domestic/foreign private competitors.

However, a separate set of statements should be prepared according to a public accounting format, such as the International Monetary Fund's Government Finance Statistics, so as to allow their consolidation with those of the entire region/state/country.

An agency setting best practices for reporting in Latin America is Fonafe, a holding company created in 1999 that monitors the performance of most Peruvian SOEs, except for the oil company Petroperú. Fonafe executes the role of owner of the Peruvian state and implements corporate governance and management best practices in these companies. It also controls the minority shareholder positions the government has in 18 firms and oversees the winding-down procedures of SOEs with persistent losses that the state considers beyond repair.<sup>5</sup>

To pursue these objectives, Fonafe requires SOEs to submit detailed ex ante reports, as well as file a variety of reports and detailed plans ex post. Regularly monitoring progress in this way allows Fonafe to avoid surprises in the execution of the budget or in the execution of large capital projects. As has been discussed at length in this book, these surprises are what, in many countries, permit SOEs to request funds from the government in an ad hoc fashion. That is, rather than basing the monitoring of its SOEs purely on an ex post basis, Fonafe uses the detailed ex ante planning and the frequent reports to monitor execution of and avoid deviations from these plans. This then minimizes the need for sporadic funding to SOEs throughout the year and reduces cash flow and contingent liability risks.

For instance, SOEs that report to Fonafe have to submit the following plans:

1. *Five-Year Strategic Plan:* In these plans, the management and directors of the firm set out the firm's objectives and the key performance indicators that will be used to measure progress against said objectives. The board is responsible for approving these plans and submitting them to Fonafe in October (every five years). Fonafe can make modifications to the plans annually as long as the modifications are approved by the board.
2. *Annual Management Plan:* This plan outlines the annual progress of the firm and includes a Strategic Plan Progress Report that tracks whether the firm is on track to accomplish the goals set out in the Five-Year Strategic Plan.
3. *Annual Operating Plan:* This plan outlines how the objectives set out in the Strategic Plan will be accomplished year by year. It is submitted

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<sup>5</sup> For details of best practices, and the shortcomings, of Fonafe in Peru, see Ter-Minassian (2018).



before the end of December each year. The plan outlines progress made that year towards goals and KPIs already stated in their scorecards. The Operating Plan is sent in with the Annual Management Plan.

4. *Budget Plan*: The specifics of the budget have to be submitted for approval to Fonafe and approved by the board before December 31 every year. The budget must align with the Strategic and Operating Plans and should be consistent with the fiscal objectives of the government (e.g., helping to prevent deficits).
5. *Quarterly Management Report*: These include detailed financials (balance sheet, profit-and-loss statement, cash-flow statement, and capital projects reports) and track the execution of the Operating and Strategic Plans. These quarterly reports can then roll up into the annual reports.
6. *Annual report* on the implementation of the code of best practices of corporate governance.
7. *Semi-annual report* on the implementation of the Internal System of Controls, which is a system of controls designed to facilitate the monitoring of performance in all companies in the Fonafe holding. This system includes a series of risk management controls, information security protocols, and a system to prevent corruption.
8. *Semi-annual report on corporate social responsibility* that can be part of the Quarterly Management Report and can roll up into annual reports.

The financial reports of Fonafe are a good benchmark for comparison purposes, as they are detailed and follow international accounting practices. They include detailed financials (balance and profit-and-loss statements), a statement of budget execution, a report on the execution of capital projects, and cash-flow statements. Furthermore, these reports are made publicly available on Fonafe's website and all of the financial reports follow international financial reporting standards (IFRS). Having an adequate system for monitoring is essential as it increases transparency and can shape incentives. These monitoring gains are maximized when complemented with an evaluation system for SOEs.

### **Performance Evaluation System in Korea: Carrot and Stick**

This section provides a detailed description of the performance evaluation (PE) system of SOEs developed in the Republic of Korea (henceforth Korea). The main idea behind this section is that having ex post reporting and a system of punishments for underperformance is not enough. There have to be incentives for SOE managers to execute plans, avoid unplanned financial losses, and to reduce fiscal risks overall. For that, there have to be transparent incentives ex ante for SOE managers and there have to be positive incentives to perform well on a variety of measures, from financial performance to budget and capital project execution to customer satisfaction with the goods and services provided.

This section provides what we think is the state-of-the-art PE system. Our intention is for this to serve as inspiration and/or general guidelines for the CCB6 and other countries rather than a template to be copied verbatim.<sup>6</sup> The aim is that the incentives mechanisms and scorecards are adapted in a way that complies with the institutional peculiarities of each country. Moreover, this system should not be regarded as a static solution; in Korea as well as in the Caribbean PE requires continuous adaptation and updating.

Korea has been using PE since 1984<sup>7</sup> as a tool to increase economic efficiency of SOEs (and reduce government interference) by making them accountable and responsible for their performance. The PE system gives public companies ex ante autonomy but holds them accountable for the ex post outcomes. The rationale is that the evaluation itself increases motivation in managers and sparks competition among public agencies, who also learn from each other, while the feedback enables improvement towards the next evaluation. Ultimately, the system enhances transparency in the management of public companies as the evaluations are made publicly available. The Korean model has proven very successful in improving governance and performance of SOEs over the past 30 years and has been used as a model in many corners of the world.

SOE evaluation systems have existed in Korea since 1968. While the systems have evolved over time, resulting in improved and simplified methodology (among other things), the most significant reform was introduced in late 1983. The Framework Act on the Management of Government Invested Institutions (FAMGII), which granted SOEs legal autonomy, is considered the basis of the current system. The idea was to replace government control, which was presumably one of the main drivers of underperformance, with monitoring through periodic evaluations. The PE has since undergone expansions to incorporate quasi-governmental organizations (QGOs) and reforms to increase SOE autonomy and is currently governed by the Act on the Management of Public Institutions (AMPI). While the government is still able to set the main objectives and targets for SOEs, autonomy in SOE management seeks to help SOEs make fast decisions when needed. This model also grants the SOEs management teams flexibility in hiring, setting the budget, and procurement contracting. In turn, the law specifies that performance results should be reported annually and lays out guidelines for salary structure (i.e., how bonuses or cuts are to be assessed).

The key component of the Korean PE model is a system of indicators (i.e., KPIs). Table 8.2 shows the current model, which was adopted in 2014.<sup>8</sup>

<sup>6</sup> For this reason, we have excluded the specific formulas used to compute the scores. These can be found in KIPF (2019).

<sup>7</sup> While the PE system was introduced in December 1983, there had been SOE evaluations in place since 1968.

<sup>8</sup> Table 8.2 illustrates the benchmark case, but ultimately the evaluation indicators and weights are adjusted depending on the type of institution.

It consists of two main categories, business management and major project, which have several quantitative and qualitative indicators. Quantitative indicators are highly objective and make for easy comparisons (i.e., how far the company was from the goals set), but they fail to consider special circumstances which might justify an SOE's deviation from an objective. Qualitative indicators, on the other hand, bring more flexibility to the evaluation but are more subjective and introduce inconsistencies in the evaluation process. After several waves of modifications to the evaluation indicators and weights, the current evaluation system strives to find a balance between ease of interpretation and burden of compliance.

The entire evaluation process, from the goal setting to the evaluation results and bonuses, takes up to three years and is organized as follows. One year prior to the evaluation (Y-1), the Ministry of Economy and Finance (MOEF) defines the goals and confirms the evaluation guidelines using information that the CEOs of the SOEs submit. The AMPI requires that the CEOs of the SOEs establish mid- to long-term goals for at least the next five years. These are then confirmed by the SOE boards of directors and submitted to the MOEF, who also drafts the PE manual. During the evaluation year (Y), SOEs operate according to their set objectives. In Y+1 SOEs send in performance reports and the evaluation process begins. Specifically, SOEs are evaluated by a group of experts, who prepare a scorecard based on the PE indicators and weights (see Table 8.2) and may perform on-site inspections. After the committees and groups designated by the MOEF to evaluate SOEs have finalized the PE, they announce results and distribute bonuses.<sup>9</sup>

### *The Scorecard*

As shown in Table 8.2, overall, qualitative indicators comprise 35 percent of the PE, while quantitative ones comprise the other 65 percent. For each qualitative indicator, a general evaluation is conducted and a grade ranging from A+ to E is given based on both overall performance and year-over-year improvement. The grade is then converted to a score between 20 and 100 based on a conversion scheme.<sup>10</sup> Quantitative indicators, on the other hand, are rigorously evaluated according to the methods listed in Table 8.3. For every method, numerical scores are computed following a specific predetermined formula. The comprehensive evaluation scores are then calculated by multiplying each individual score by its corresponding weight and then adding up all qualitative and quantitative scores. Finally, the Ownership Steering Committee assigns a final grade using a six-category scale as shown in

<sup>9</sup> A very precise timeline of the process can be found in KIPF (2019), together with the different roles and responsibilities of all entities involved in the process.

<sup>10</sup> A+ (100), A (90), B+ (80), B (70), C (60), D+ (50), D (40), E+ (30), E (20) (KIPF, 2019).

**Table 8.2. Performance Evaluation Indicators for SOEs in Korea**

Category	Evaluation Indicator	Weight	
		Qualitative	Quantitative
Business management	1. Management strategy and social contribution: <ul style="list-style-type: none"> <li>• Strategy planning</li> <li>• Public evaluation</li> <li>• Government-recommended policy</li> </ul>	2	4 5
	2. Task efficiency		8
	3. Organization, personnel management, and accomplishment	2	
	4. Finance budget management and accomplishment <ul style="list-style-type: none"> <li>• Finance budget management</li> <li>• Self-effort accomplishment</li> <li>• Finance budget accomplishment</li> <li>• Quantitative cost management</li> </ul>	6 3	6 2
	5. Payment and welfare benefit <ul style="list-style-type: none"> <li>• Payment and welfare benefit</li> <li>• Total payment increase rate</li> <li>• Labor management</li> </ul>	6 3	3
	Subtotal	22	28
Major project/ core business	Major project planning (qualitative), accomplishment (quantitative), comprehensive evaluation	13	37
Total		35	65

Source: KIPF (2019).

**Table 8.3. Methods for Computing Scores of Quantitative Indicators for SOEs in Korea**

Method	Description/Score Calculation
Goal setting	$20 + 80 \times (\text{performance} - \text{lowest goal}) / (\text{highest goal} - \text{lowest goal})$ The general method for calculating highest and lowest goals is multiplying a certain ratio to the base value
Goal setting (deviation)	Similar to above, but highest and lowest goals are calculated adding or subtracting the standard deviations from the base value over the past five years
Global comparison	Adopts goal setting (dev) method but considers the performance of global businesses when setting highest and lowest goals
Long-term goal setting	Compares short-term (1–3 years) performance to long-term performance Long-term goals are either set by ministries or taken from the standard of developed countries. Short-term goals are decided based on the scope of the long-term projects.
Goal achievement	A method to measure the degree of achievement: Degree of achievement = achievement / goal
Beta distribution	This method calculates the base value by using specific weights on highest and lowest values from previous years. It then measures the probability that current performance falls distant from base value.
Trend	This method uses regression analysis to calculate the base value and then measures the probability that current performance falls distant from base value.

Source: Authors' elaboration based on KIPF (2019).

**Table 8.4. Final Performance Evaluation Grades for SOEs in Korea**

Grade	Definition
Superb (S)	Institution has effective management and achieves very high performance
Excellent (A)	Institution has effective management and achieves high performance
Good (B)	Institution has good management and achieves acceptable performance
Fair (C)	Institution has fair management and achieves fair performance
Poor (D)	Institution has fair management and achieves unsatisfactory performance
Very poor (E)	Institution has poor management and achieves poor performance

Source: Authors' elaboration based on KIPF (2019).

Table 8.4. This is based on comparison of the institution's current performance to past performance and to the performance of similar institutions.

### Implications

Since the main purpose of the PE system is to inform measures and policies, systematization and persistence are key. PE results are used in various ways, but the primary application is to determine and award incentive payments. Based on the PE scores, SOE executives and employees may receive performance-based bonuses as approved by the Ownership Steering Committee and the MOEF.<sup>11</sup> The bonuses are quite generous, with maximum performance incentives of 120 percent and 100 percent of the base salary for CEOs and standing directors, respectively. Financial risk taking, such as large debt ratios, tends to reduce these bonuses. In addition, other carrots and sticks may also be utilized. The best institutions are able to obtain awards, often-times some form of recognition and increases in bonuses. The worst ones, on the other hand, may face layoffs of top executives (usually the CEOs). Penalties for misreporting, cheating, or failing to submit the management reports on time range from warnings to bonus cuts.

### Policy Options and the Future

This chapter has highlighted a variety of policy tools that governments can use to reduce fiscal risk and improve both fiscal management and the performance and monitoring of SOEs. The menu of policy options is long, and we are aware that some of the tools require that politicians be willing to bear the costs of the reforms. Still, we think that most of these policy options lead to win-win outcomes, as they reduce fiscal risk and *the uncertainty* associated

<sup>11</sup> In fact, the entire PE process involves the MOEF, the Ownership Steering Committee, several ministries, the Evaluation Commission of SOEs and QGOs, and the KIPF Research Center for SOEs.

with such fiscal risk. That is, to a large extent the problem of not doing anything is that fiscal risk is not only large and economically significant, but it is also largely unpredictable. We hope that governments in the Caribbean region see the reduction in uncertainty and fiscal risk as a preferred option over the status quo, which provides them with little fiscal room and includes SOEs with high (and unpredictable) fiscal costs.

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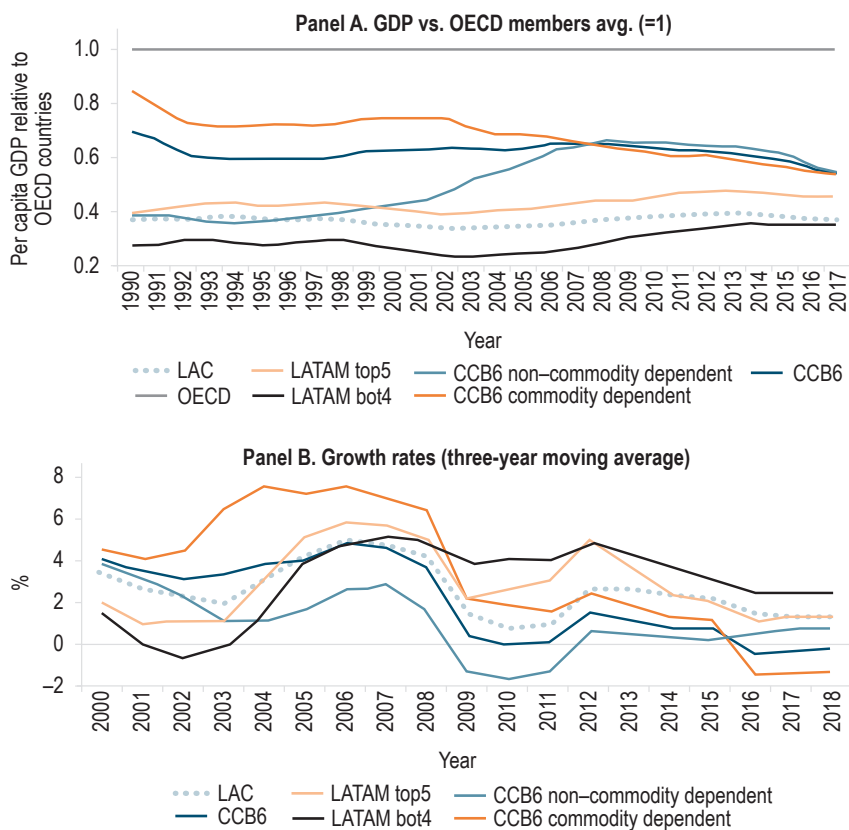
# Appendices





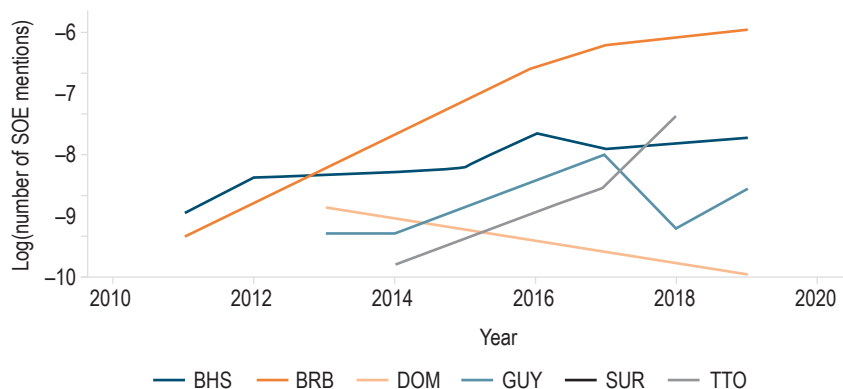
# Appendix to the Introduction

**Figure A0.1. GDP per capita and Growth Rates in CCB6 Nations Relative to Latin American and OECD Countries (1990–2017)**



Source: World Bank (n.d.).

Note: LAC: Latin America and the Caribbean; "LATAM top5" includes Brazil, Mexico, Argentina, Colombia, and Chile; "LATAM bot4" includes Uruguay, El Salvador, Honduras, and Nicaragua.

**Figure A0.2. Mentions of SOEs in Article IV Consultation Reports, by Country (log scale)**

Source: Authors' calculations using text from IMF Article IV Consultation Reports for each country.

Notes: The vertical axis is the natural log of the share of words in the report that mention SOEs. By definition all the observations with zero mentions are left out of the sample. In this graph the straight lines may imply interpolations instead of truly aligned data points for the same country.

When looking at the text analysis data in panel format, with each line representing a country over time (Figure A0.2), one could confirm that Barbados has been steadily rising, with Bahamas having a relevant but flatter pattern over time. Guyana and Trinidad have increased their mentions of SOEs too.

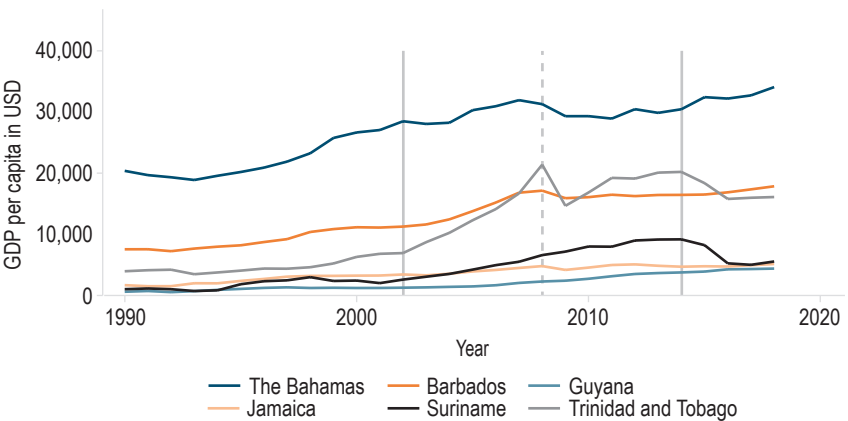
Two caveats are in order. First is that mentioning SOEs in a country report does not necessarily mean the IMF is worried about SOEs in that country. It may well be that the report is simply mentioning them. But at the same time, it is known that the SOEs in Barbados and the Bahamas have been relevant issues from a fiscal standpoint. Second is that we believe that the annual fluctuations in these new time series of SOE mentions in IMF reports should be taken with a grain of salt, and the focus should be on the broad trends rather than year-to-year variations.

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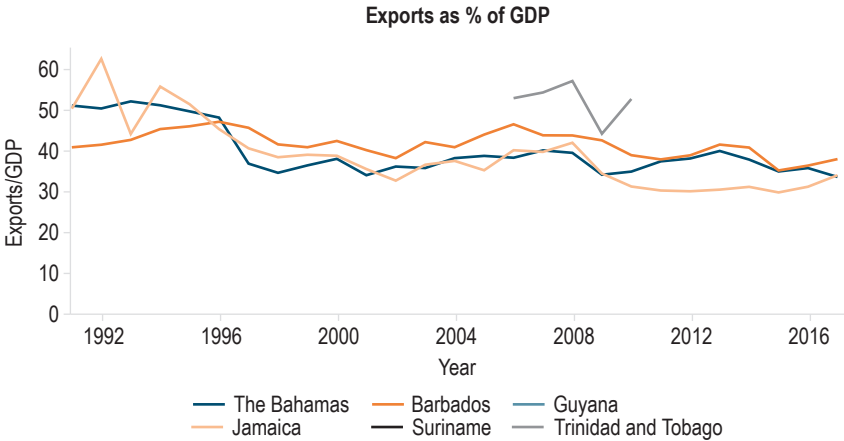
# Appendix to Chapter 1

**Figure A1.1. GDP per capita in US\$**



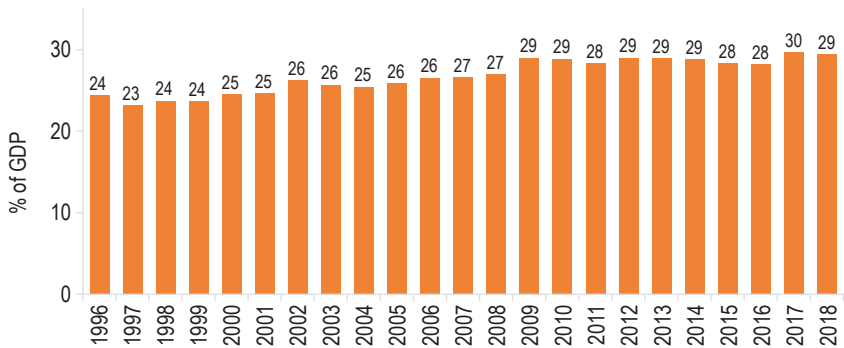
Source: IMF (2020).

Figure A1.2. Exports as a Share of GDP



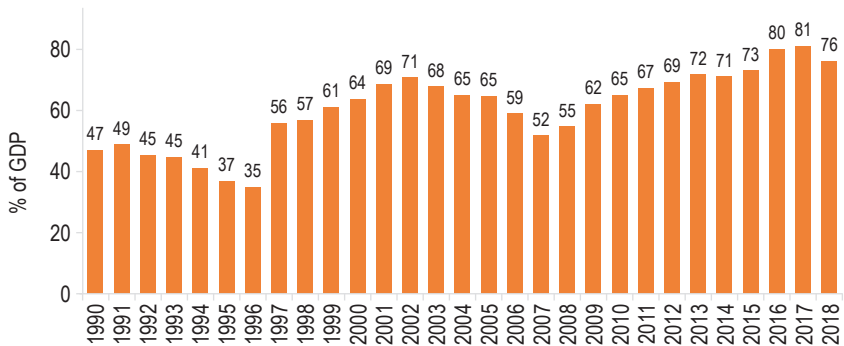
Source: IMF (2020).

Figure A1.3. Government Expenditure as a Share of GDP in the CCB6

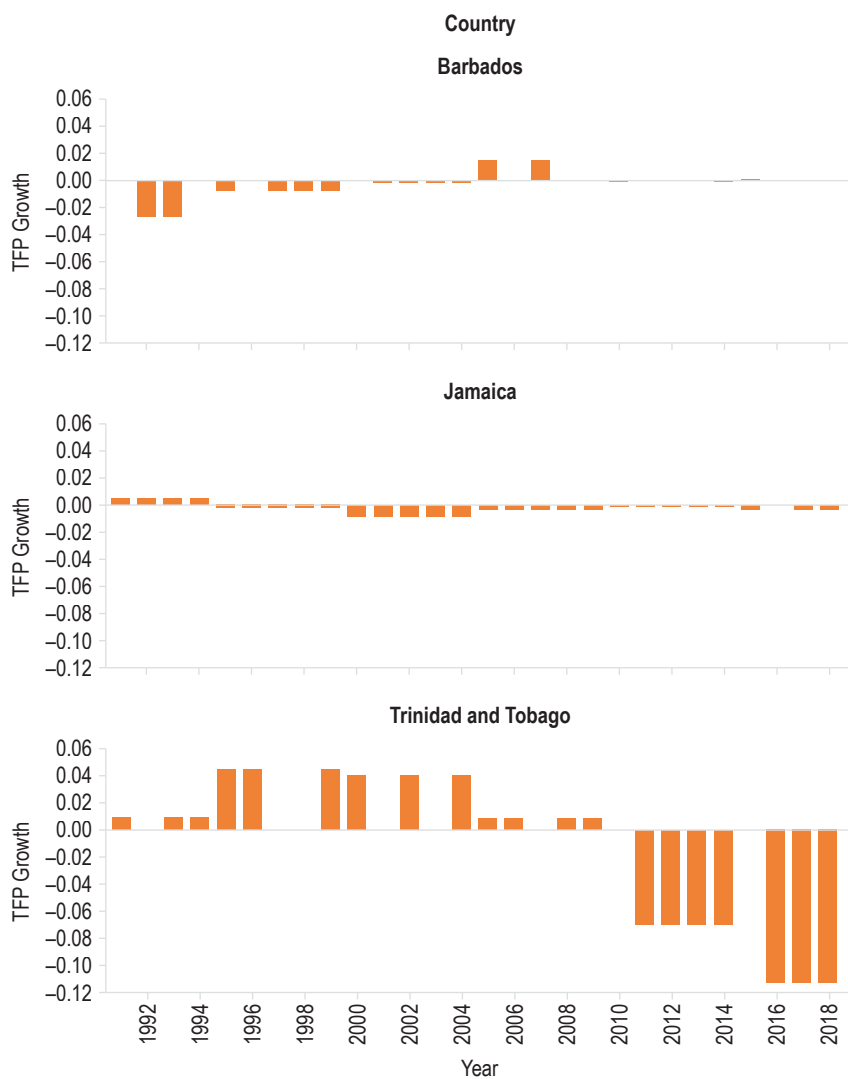


Source: IMF (2020).

Figure A1.4. Debt-to-GDP Ratios in the CCB6

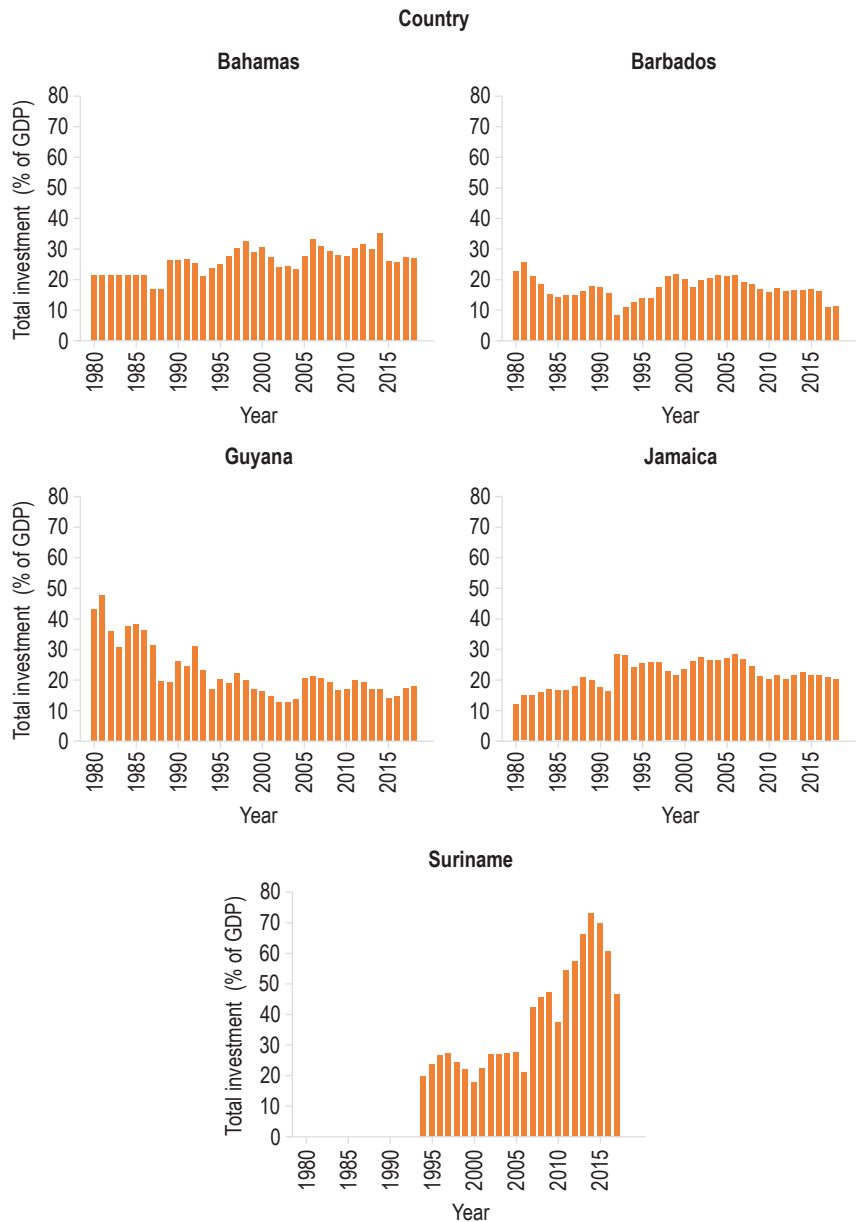


Source: IMF (2020).

**Figure A1.5. TFP Growth (1992–2018)**

Source: IMF (2020).

Figure A1.6. Total Investment as Percent of GDP



Source: IMF (2020).

## References

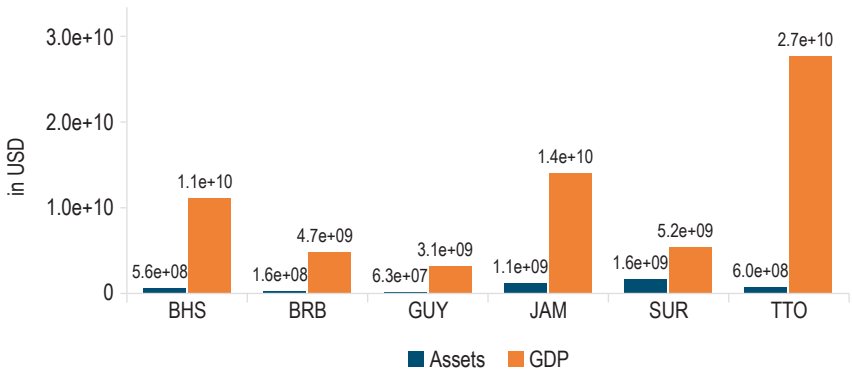
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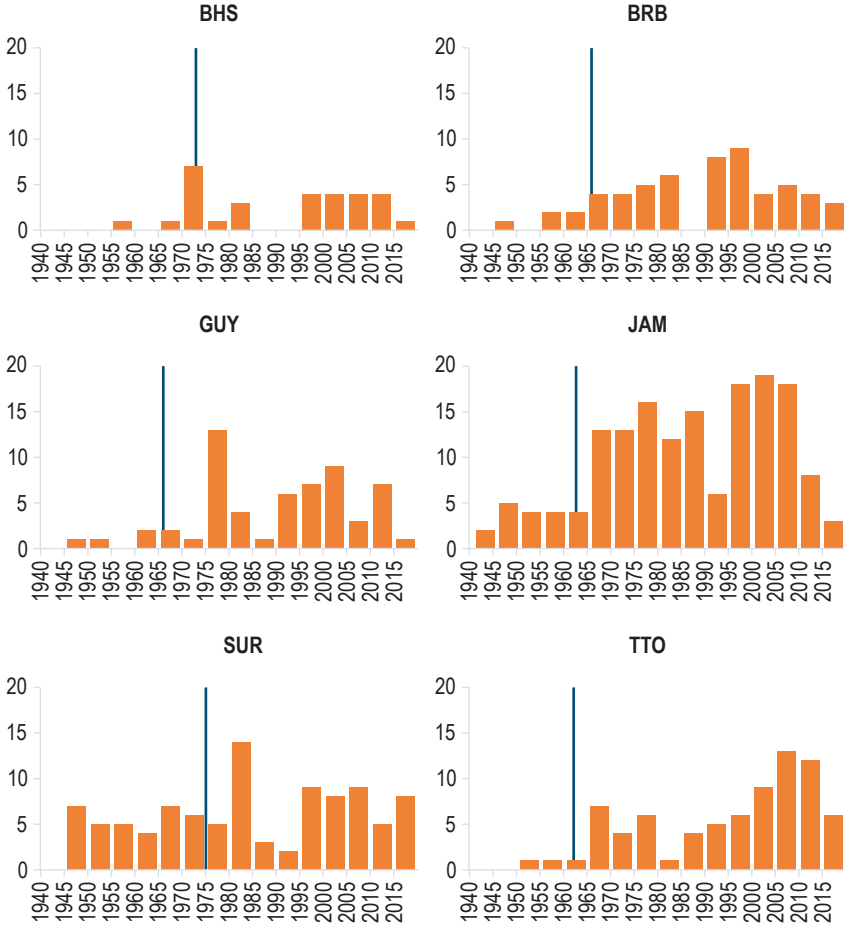
# Appendix to Chapter 2

**Figure A2.1. Total SOE Assets and GDP in CCB6 Countries (2014)**



Source: IDB CCB6 State-Owned Enterprises Database.  
Note: The choice of 2014 was due to data availability.

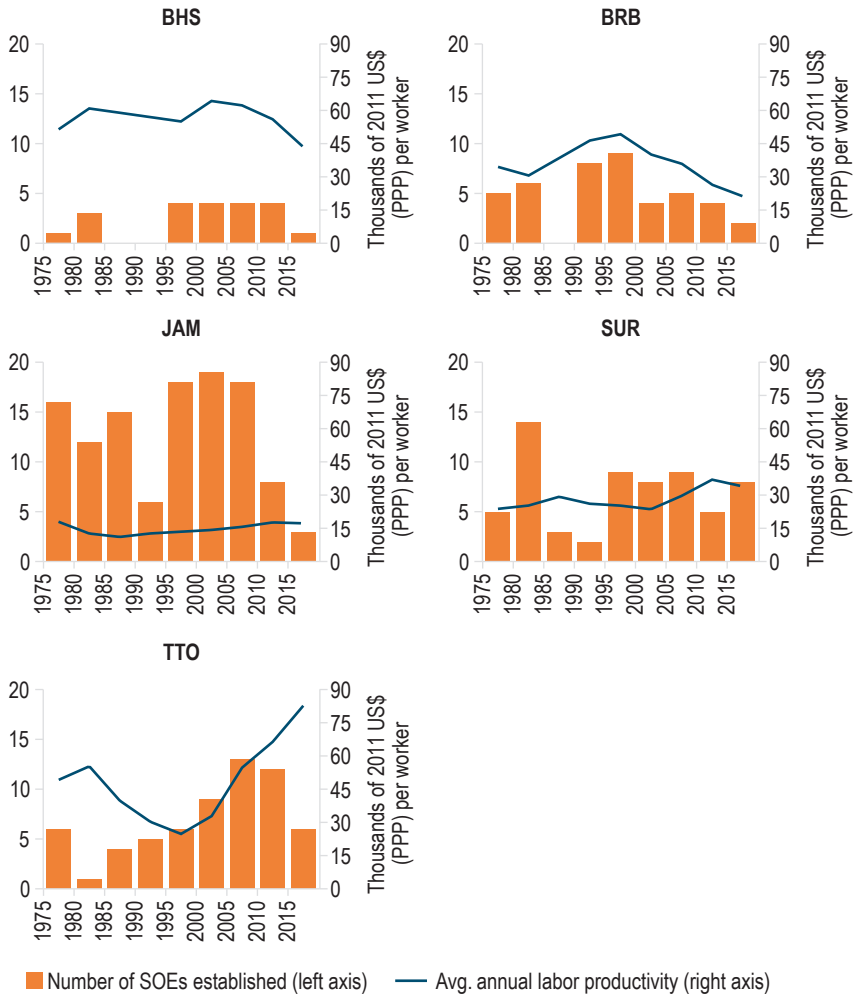
**Figure A2.2. SOEs Established per Quinquennium in CCB6 Countries**



Source: IDB CCB6 State-Owned Enterprises Database.

Note: The blue line denotes the year of independence in each case. All the figures remain in a five-year frequency.

**Figure A2.3. Trends in SOE Creation and Labor Productivity (in five-year intervals)**



Source: IDB CCB6 State-Owned Enterprises Database; Feenstra, Inklaar, and Timmer (2015).

Note: Labor productivity is measured as the real GDP (in thousands of 2011 US\$ at chained PPP) per worker. Data from Guyana is not available.

**Table A2.1. Correlation between Share of Gross Fixed Capital Formation to GDP and SOE Creation in CCB6 Countries (1990–2018)**

Country	GFCF	D.GFCF
BHS	0.32*	0.21
BRB	−0.26	0.07
GUY	−0.21	−0.09
JAM	0.42*	0.16
SUR	0.22	−0.08
TTO	0.06	−0.01

Source: IDB CCB6 State-Owned Enterprises Database.

Notes: \*  $p < 0.01$ . We computed the Pearson linear correlation coefficients between SOE creation and gross fixed capital formation (GFCF), and between SOE creation and the first difference of gross fixed capital formation (D.GFCF) for each country and tested whether these were significantly different from zero using a t-test.

## Robustness Check

Since the Poisson regression assumes that the conditional mean and the conditional variance of the errors are the same, and count-data tend to suffer from *overdispersion* (i.e., the conditional variance of the errors is large than its conditional mean), we estimate as a robustness check the negative binomial model. This model generalizes the Poisson regression model by including a dispersion parameter ( $\alpha$ ) to control for the possible overdispersion. Allison and Waterman (2002) suggest that one way to include fixed effect in this framework could be estimating an unconditional model with dummy variables to capture all the individual effects, so we perform this estimation including country and time dummies.

Then, we present the results of a likelihood-ratio test on the estimated dispersion parameter ( $\alpha$ ), which null hypothesis is that this parameter is equal to zero, and if not rejected, the overdispersion phenomenon is not present and the Poisson model is better than the negative binomial model to estimate this variable.

In Table A2.2 the results of the negative binomial model are presented. The incidence ratios are quite similar to those presented in the Poisson model, as well as the evidence on the significance of the coefficients. Moreover, there is no rejection of the null hypothesis of the likelihood-ratio test on the parameter  $\alpha$  in any of the models, which means that the presumption of the presence of overdispersion phenomenon can be ruled out, and the Poisson model is still a better approach than the negative binomial adjusted model.

**Table A2.2. Generalized Negative Binomial Regression of the Number of State-Owned Companies Established by CCB6 Countries per Year (with country and time fixed effects, 1982–2018)**

VARIABLES / Incidence Ratios	CCB6 Countries	CCB6 Commodity-Dependent Countries	CCB6 Non-Commodity-Dependent Countries
General elections (t-1)	0.960 [0.172]	0.733 [0.217]	1.318 [0.389]
General elections (t-2)	1.246 [0.206]	1.115 [0.309]	
D.Current account balance to GDP (t)	1.024* [0.013]	1.045** [0.017]	0.977 [0.037]
D.Current account balance to GDP (t-1)	1.035*** [0.013]	1.055*** [0.016]	1.032 [0.037]
Real GDP growth (t)	0.996 [0.021]	0.974 [0.030]	0.997 [0.051]
Real GDP growth (t-1)	0.980 [0.021]	0.964 [0.029]	0.993 [0.048]
Constant	0.369 [0.181]	1.693 [0.789]	0.129** [0.133]
Alpha	0.066 [0.081]	8.63e-08 [0.0001]	1.13e-08 [0.00004]
N	222	111	111
LR test of Alpha=0	0.79	0.000	0.000
p-value	0.187	0.500	0.500

Note: Robust standard errors in brackets, \*\*\* p < 0.01, \*\* p < 0.05, \* p < 0.1.

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## Appendix to Chapter 4

**Table A4.1. Number of Statutory SOEs by Type in CCB6 Countries**

Country	Type of Entity	SOE Type	Commercial Orientation			Total Non-Financial SOEs
			Commercial	Noncommercial	Financial	
Bahamas	Corporate body	PCS	11	8	3	19
	Corporation	PCS	1	1	1	2
	Quasi-government	SS	0	4	0	4
	Statutory body	SS	0	1	0	1
	Statutory corporation	SS	4	1	2	5
Barbados	GBE commercial	PCS	12	12	3	24
	Statutory body commercial	SS	6	5	1	11
	Statutory body noncommercial	SS	2	26	2	28
Guyana	Public corporation	SS	12	3	1	15
	Statutory agency	SS	13	33	2	46
Jamaica	Limited liability company (LLC, Ltd.)	PCS	40	21	5	61
	Statutory body	SS	37	65	7	102
Suriname	Foundation	SS	12	45	5	57
	N.V. 100%	PCS	16	3	2	19
	N.V. joint stock	PCS	6	1	3	7
	SOE law	SS	9	18	3	27
Trinidad and Tobago	Undefined	ND	85	32	24	117
	Statutory authority	SS	5	4	0	9

Source: Author's elaboration using the IDB CCB6 State-Owned Enterprises Database.

Note: "GBE" refers to Government of Barbados Enterprise.





