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The Governance of Public Enterprises: Challenges in a Brave New World

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Have public enterprises become obsolete policy instruments? Many governments appear to have decided that the answer is yes. Hundreds of public enterprises have been privatized over the last twenty five years. Public enterprises have been replaced as instruments of public policy by other means of indirect intervention such as regulation. Moreover, in many countries, free trade agreements have limited the capacity of governments to use policy instruments such as public enterprises. Small European states joining the European Union have had to adapt their economic policies as Canadian provinces had to adjust to the North American Free Trade Agreement (Bernier, 1988). Privatization has been argued on various grounds among which a lesser performance compared to private enterprises and difficulties of control by government so a limited ability to implement economic policy (Aharoni, 1986; 315-323), in other words, problems of governance. As discussed in the first section of this article, the results of studies on privatization are not, however, as clear as it has often been argued. Privatization might not be the only solution.

Public enterprises still existing today now work in a very different world than the one in which they were created. Public enterprises that were not privatized not only face increased competition but also are asked to make profits almost as if they were in the private sector. They have been asked also to redefine their governance in order to take into account growing demands from various national and international groups and to reconsider if they are still defending some notion of general interest. How could public enterprises that were considered in the past to be very flexible policy instruments have reinvented their governance is the topic of this article. Using three different cases from the Canadian province of Quebec, we want to illustrate that public enterprises can be radically transformed and still be efficient instruments of economic policy today. Three cases are used to show that different paths are possible. Considering enterprises working under the same conditions, we try to isolate the transformation of governance from other intervening variables (Cook & Campbell, 1979).

1. A Brave New World: Life after Privatization

Among the important changes in the role of the state that were brought forward over the last decades has been the idea that various public organizations and activities among which public enterprises should be privatized. The most publicized privatization program and the best documented has been the British one initiated by Margaret Thatcher's government in the early 1980s. Following the British model, governments around the world have initiated privatizations. The idea was presented clearly by Margaret Thatcher who wrote in her memoirs "Privatization, no less than the tax structure, was fundamental to improving Britain's economic performance. But for me it was also far more than that: it was one of the central means of reversing the corrosive and corrupting effects of socialism." She adds "The state should not be in business... But state-owned businesses can never function as proper businesses" (Thatcher, 1993:676). Very inclusive meta-analyses have been published lately on privatization such as Meggison and Netter (2001). Their reading of the literature leads them to conclude that:

1. Privatization has been an important phenomenon. The SOE share of "global GDP" has declined by 4%.
2. Research supports the proposition that privately owned firms are more efficient and more profitable than otherwise comparable state-owned firms. It seems likely that reforms of SOEs would be more effective when coupled with privatization.
3. Voucher or mass privatizations are less efficient than share issues or asset sales.
4. Most governments underprice share offerings.
5. Employment in privatized firms usually falls.
6. In order to maximize performance improvements, there is a need to bring new entrepreneurial management.
7. Initial returns on privatization IPOs are significantly higher than the initial returns on private-sector IPOs.
8. Large-scale programs lead to rapid growth in national stock market capitalization and trading volume.
9. Privatization is often a major spur to modernizing a nation's corporate governance system.

There are also some critics that argue that privatization does not deliver the improvements Mrs Thatcher expected. Meggison et al. (1994) consider that privatization leads to more profits while Martin and Parker (1995) conclude to the contrary. Bhattacharyya et al. (1994) argue that public water utilities are more efficient than private ones. Prizzia (2001) considers that the social benefits of privatization are often mixed and uneven. He concludes that in many cases, the importance of objective and balanced measures of its overall effectiveness and impact on the

affected communities need to be reexamined. For Bishop and Kay (1988), growth and profitability lead to privatization and not privatization causing them. Yarrow (1989) identifies only three success stories out of seven enterprises he studied. Hartley et al. (1991) did not find that privatization guarantees an improved performance. Haskel and Szymanski (1993) studied 12 public enterprises over a 16-year period and found that competition is more important than ownership and that privatization does not raise productivity. The precise impact of privatization is drowned in an ocean of potential intervening variables. Public enterprises are used concurrently with other means, instruments are not substituted for each other, but rather public ownership is more frequently added to an array of existing instruments that have been tried and found wanting (Laux & Molot, 1988).

Despite the issues raised with the advantages of privatization, it has been the dominant trend. Ownership is only one part of a more complex explanation of performance. Another way of looking at the same issue or a part of a larger explanation is to study the governance of these complex organizations. The implementation of policy objectives poses a dilemma: the policy maker either relinquishes control over the direction of policy to other groups involved in the process, or courts a breakdown in the process if the original initiative must remain intact (Linder & Peters, 1987:469). Implementation entails the choice and deployment of policy instruments. Policy choices are made considering the instruments available for implementation. Governments could be prevented from adopting a policy by the absence of any means to implement that policy (Hall, 1986:232). The choice of an instrument to implement a policy cannot be seen as a mere "technical" question. The adoption of a program by a legislature becomes endowed with separate meaning and force when an agency is established to deal with it. But an agency has a life of its own that can limitedly implement the planned policy. Can the public enterprises remaining play a useful role and prove that they should not be privatized? They remain policy instruments that could be useful if they can improve their legitimacy in their environment by integrating in their governance mechanisms to be permeated by various influences.

Governance is defined here as a configuration of laws, structures, resources, administrative rules and institutional standards which program and condition state services and regulation (Bernier et al, 2003; Lynn et al., 2000). The notion of governance has emerged when governments started to

be seen as problems rather than solutions (Pierre & Peters, 2000: 2). Relations between the state and society have to be reinvented. Such reinvention implies that public enterprises because they are at the intersection between the market and the state cannot escape redesign. Two ways of looking at the governance of public enterprises can be considered. The micro perspective looks at elements such as the management, the board of directors and how strategic planning is done. Perhaps public enterprises do not have to be privatized but properly managed. A business plan that was not available until then could change everything. For example, when Bombardier bought Canadair from the Canadian federal government, a new strategic plan was developed for the organization. Was it the new plan or the privatization that made a difference? Would the plan around the regional jet have been possible without privatization? The other way is to look at the relation a public enterprise has with its environment. It has been generally accepted that the government must attempt to control its enterprises to ensure that, in turn, they fulfill the objectives set for them. Control can be defined as "the regulation of activities to ensure the attainment of goals efficiently and effectively. When goals are clearly stated, the control system is designed to reinforce the objectives by measuring the level of accomplishment and the costs" (at least in theory) (Aharoni, 1986:217).

In practice, government control, public enterprises managers, strategic behavior and goal concentration are weakly correlated (Zif, 1983). Yet, Hafsi (1989) has explained that control is not always lacking. According to his model, relationships between government and the enterprises follow a cycle; evolve from cooperation to autonomy. Public enterprises travel along the life cycle at a speed that is directly related to the power of the firm and inversely related to the characteristics of the institutional setting. The phase of adversarial relations between the state and the public enterprise develops when the latter tries to protect its technical core from outside interference (Thompson, 1967). The cycle studied by Hafsi has to be integrated in a longer time frame that includes the initial crisis where public enterprises are initiated and ends with the second crisis which recreates some liability of newness. Privatization of surrounding public enterprises creates such conditions and pushes managers to cooperate with the state (Bernier, 1989). In this model, the cycle is not deterministic: the stability of the cycle varies with the nature and state of the outside coalition and the degree of resource dependence of the public enterprise. An element to consider is the entrepreneurship of the managers of these organizations (Lewis,

1980). Autonomy without capacity and entrepreneurship is useless. With the assurance that internal administrative tasks are reliably performed, public entrepreneurs can negotiate with the environment comfortably (Marmor & Fellman, 1986:240).

So, in this way of looking at governance, we have to study the interactions between a public enterprise and its institutional environment. Special position and isolation in some particular apparatus of the state allow some state officials more autonomy than others. Public enterprises could be such organizations. Even in weak states, there are islands of autonomy (Krasner, 1978; Skocpol & Finegold, 1982). Another issue is capacity. Ikenberry (1988) suggests that flexibility, the ability to redeploy resources, is a crucial attribute of state capacity.

2. Public Enterprises in Quebec

Katzenstein (1978) has explained how the availability of different instruments leads countries to different answers to the same problems posed by the world economy. A similar reasoning could be used to stress the limits of the instruments available to the Canadian provinces. In Canada, the instruments of economic policy are divided in a federal system between national and sub-national governments. The federal government controls monetary policy and provides leadership for fiscal policy and regulation. Among the economic policy instruments available to the provinces, public enterprises appear to be crucial. Despite their limited powers, some of the Canadian provincial states have emerged "as mature and complex institutions having the strengthened capacity to govern in the interests of regional communities" (Chandler & Chandler, 1979:8). Province-building, the state-building of provincial governments, is most commonly associated with the post WW II expansion of social policies, the growth of the welfare system and the development of the educational system. The provinces also have a long tradition of involvement in the development of natural resources, energy and agriculture. For Young et al. (1984:796-797), the most valid element of the province-building concept concerns state-owned enterprises. Nowhere was province-building more far reaching than in Quebec. Of all the provinces, Quebec has the most clearly developed and comprehensive industrial policy (Laux & Molot, 1988). From roughly 1960 to 1980, the province of Quebec imbued its state institutions with almost mythical qualities (McRoberts, 1993).

Public enterprises have been used as policy instruments since the 1960s but the policies were not arrived at until late in the 1970s. Quebec's successive governments have chosen this form of intervention because of the lag between interventionist volition and the weaknesses of the resources, particularly human resources. Acknowledging this discrepancy but willing to act quickly, the state chose to delegate responsibilities to autonomous organizations which were to achieve important parts of the activities the state wanted to get done. Consequently, public enterprises have to refer to objectives which they might share but that are ultimately the responsibility of the state (Parenteau, 1980:64-65). They were created to avoid having to establish coherent and comprehensive policies (Parenteau, 1980:195). Symbolically, a problem is taken care of by the creation of a public enterprise. But at the same time, real policy intentions are hidden.

Among the public enterprises created in Quebec, two can be singled out: Hydro-Québec created in 1964, the giant public utility in the electricity and natural gas industries and the Caisse de dépôt et placement du Québec (The Quebec Deposit and Investment Fund, created in 1965). They are the largest public enterprises created in the 1960s. A third one is of interest here, the Société générale de financement (SGF), created in 1962, which was the first industrial public enterprise and from which various entities have been created as subsidiaries. The 1960s in Quebec have been described as the Quiet Revolution, an era of rapid modernization when the state apparatus was rapidly developed to catch up with development elsewhere in North America (McRoberts, 1993; Bernier, Bouchard & Lévesque, 2003). This sub-national state is the only one the French-speaking minority in Canada controls and its development has often been cast in nationalistic overtones. Even today, although it has to be radically transformed, the state apparatus in general and its main public enterprises in particular remain difficult to reform because of the political support it has, something rather unusual in North America (Bernier, 2004). These three public enterprises illustrate how in an era where privatization is a serious option for governments, their governance can be transformed to readapt them to be useful policy instruments.

Hydro-Québec¹

During the 1960s, “in the case of public enterprises, the most notable achievement was, of course, the nationalization of the private electrical companies, which were owned and managed by English Canadians, and their incorporation into Hydro-Quebec” (McRoberts, 1993: 132). Hydro-Québec as it exists today was created after the 1962 general election when the nationalization of the private companies it was to replace was the only issue. It has been after that for 20 years a public utility dominated by engineers. The introduction of high voltage lines that were then unique in the world and large dam projects were celebrated. One of the popular improvements has been the electrification of the entire territory and reduced rates for most customers. For Mc Roberts (1993: 133), “Hydro-Quebec still remains the main instance of the successful conversion of the working language of a major economic enterprise from English to French.” The rates have been among the lowest in North America since the nationalization. Large projects on the Manicouagan river and after that in the James Bay area were presented as proofs that French-Canadians were capable to be more than blue collar workers. A more turbulent era in the history of the public utility starts in the 1980s when the government hoped for more economic rationality for the organization. A few power outages, more difficult relations with the employees and the passage of time tarnished the reputation of the enterprise (Hafsi, 2001). Nevertheless, Hydro-Québec has continuously been used as an instrument of regional development and as a source for Keynesian intervention in the economy. At the end of the 1970s, the public utility was responsible for roughly 25% of all investments in Quebec. Although a very successful public relations operation during a severe ice storm in 1998 rejuvenated the reputation of the organization, it dropped again around the project of building a gas power station known as the Suroît projet in recent years. The project had to be abandoned because of the opposition of environmental groups. Hydro-Québec had to rethink its governance in terms of its relations with its institutional environment. At the same time, Hydro-Québec increases every year the profits it gives back to the state.

¹ On Hydro-Québec’s governance, for a more complete explanation, see “Mutation de la gouvernance du secteur de l’énergie: de nouveaux défis pour Hydro-Québec, by Simard, Louis, Dupuis, Alain and Luc Bernier, Cahiers du Cergo, TELUQ_ENAP, 2004-4.

One important change in the governance of Hydro-Québec has been the creation in 1997 of an autonomous regulatory body, the Régie de l'énergie, that authorizes the strategic planning of Hydro and the rates it can charge to its various customers, encourages citizens participation in debates and builds a counter-expertise. In 2000, the mission of the Régie was modified. Production of electricity was deregulated, only transportation and distribution remain regulated in order to adapt to the deregulation of electricity in North America that allows for competition. The new rules of the game imply for Hydro-Québec a restructuring of its activities in three semi-independent entities. At the same time, Hydro-Québec has been able to reach an agreement with the aboriginal tribes that live in Northern Quebec where the future projects will be built. Also, competition has been introduced for production and private companies are able to compete and sell their production. The changes in the governance of Hydro-Québec have been sufficient that there is no public support for the privatization of the public enterprise (Bernier, 2004)

The Caisse de dépôt et placement (CDP)²

The CDP was also a huge success for many years, although in the 1960s and 1970s its administrators were rather cautious in their investments. It built a good reputation on the markets although a state actor was initially suspicious in the world of finance. The CDP was even asked to manage pension money for third parties (Pelletier, 2002). At its peak, the CDP managed 250 billion Canadian dollars. This public enterprise manages the pension money for all Quebecers and various pension plans for public employees. It always had a dual mandate of managing the assets and of economic development. Initially it became an important purchaser of Quebec government bonds thus reducing the government's dependence on English speaking institutions (McRoberts, 1993: 135). Over the years, this public enterprise has had to manage several deposits related to the activities of the Quebec state: car insurance for example. It has had over the years an excellent record on returns on investment on the assets it managed. This, until the technology bubble ended and September 11 created turmoil on the market. It undertook then a review of its governance, seriously considering changing the length of the mandate of its CEO and who is nominated to its board. It has returned to profitability over the last two years.

² Based on a preliminary work done by Danièle Bordeleau of the Cergo.

Before the end of the technology bubble, the CDP had a rate of return of 20% on its investment. Part of it was due to large investments in the new economy. The question then was how to do better? Involvement in China and Hollywood began. A sense of invincibility existed among managers. Then, it had two years of negative returns: - 4.99 and -9.57 %. 8.5 billion dollars were lost during those two years. When things turned sour, the initial reaction was to reconsider how the organization had been governed for a number of years. A new world required a radical change in the organization. Confidence had disappeared and a new skill set was required internally to work on more sophisticated markets. Suddenly, the CDP was seen as a huge failure in Quebec. One of the issues raised was that the board of directors did not know what was going on. Another issue was that the board could not fire the CEO because he had a mandate for ten years from the government. Another issue that was considered was that the regulations over how to invest the money had been abandoned over the years. Initially, stock in private companies could not represent more than 30 % of the total assets. It had been moved to 70%. Was that too much? A new governance system was established. In the end, the role of the board of directors was reconsidered and the independence of the members strengthened. The focus on third parties was changed for a reorientation and a focus on the institutional clients that were the core business. The Caisse looked for new models such as the Norwegian Petroleum Fund for example of how to reorganize its activities. Managing by projects has become a tool of management. Above everything else, the team of managers was radically changed. Several managers who had allowed the CDP to achieve the impressive results before the crisis were considered obsolete and fired. The questions about the existence of the CDP have stopped. Other organizations from around the world now visit the CDP to learn lessons.

The Société générale de financement (SGF)³

The SGF was, from the start in 1962, a conglomerate built of various industries already active in Quebec. Its purpose was to strengthen the small French-Canadian industrial sector (McRoberts, 1993; 133). It has oscillated since then between traditional industrial sectors and the willingness to launch new industrial sectors in promising technologies. Its evolution has been iterative from one investment to the next. It has been the policy instrument for variations on Michael Porter's

³ Idem

ideas of strategic groupings of enterprises in targeted industrial sectors. These industrial sectors have varied over time. Investments have been grouped in the recent years in chemistry, energy environment, mining metallurgy, forest products, biology, agriculture and transformation and communications. The smaller public enterprises that existed in the past in these sectors have become subsidiaries of the SGF. As explained in its annual report of 2003 dated June 30, 2004, the SGF is an instrument of industrial policy that is to improve the competitiveness of the Quebec economy.

The SGF invests money in partnerships with venture capital firms or the union's Fonds de solidarité (Bernier et al., 2003). It is often involved in investments considered too risky for traditional banks or in projects considered important for the Quebec economy. It has also been the instrument to attract foreign investments, in aluminium smelters for example benefiting from reduced rates by Hydro-Québec. It is impossible to tell whether the new restructuring of the SGF will be the right one. Since its early days in the 1960s, the SGF has been a mixed enterprise before becoming a public enterprise. Its involvement in enterprises has been dictated sometimes by political reasons rather than by sound financial practices. Internal turmoil has made the development of this public enterprise difficult on several occasions over the years. Its governance problem is a lack of a clear vision of where to go. The governance problem has been a poor strategic planning and the incapacity to maintain an arm's length relation with the government. Too long, the investments have been dispersed in too many small enterprises to have a structuring impact on the economy. In this case, it is not clear whether it can focus to have an impact or whether it should be abolished. It is not clear either whether it has attracted over the years always "the best and the brightest" to be its managers.

3. Privatizing or Reforming Governance

Reforms of the governance of public enterprises were required. Often, they are considered impossible by advocates of privatization but the three cases presented here illustrate that radical change is possible. Some of the difficulties public enterprises ran into over the last few years could have been avoided by stronger boards or more efficient mechanisms of control.

Privatization has often been possible because public enterprises have not developed support in their institutional environment.

Being a public rather than a private enterprise does not imply less performance either. During the great blackout in August 2003, clients of the public utility realized that they avoided the crisis that covered the North East of the continent sections where private companies produce electricity. The CDP offers in its annual reports comparisons with various indexes or pension funds in North America and is doing relatively well most years. Hydro-Québec changed its relation with its institutional environment. The CDP cleaned up its act internally. The SGF has to define a mission for itself. Large private conglomerates have faced a similar predicament. The SGF has been following a path too iterative to contribute to the capacity of the state to promote economic development significantly.

The governance level is the level where public enterprises differ from the private sector. At lower levels, operations whether they are done in the private or in the public sector are relatively similar. A public or a private airline company has to respect the same regulations and customers expect the same services. From interviews we conducted with 37 managers in 9 public enterprises in Quebec among which the CDP and the SGF before the events required drastic changes, we gathered the information presented in this section (see Bernier, 1998). The information is presented here as an illustration that a lot of work had to be done considering the governance of these public enterprises.

Four organs control various aspects of the operations of a public enterprise in Canada: the government, the Parliament, the auditor general and its board of directors. Parliamentary control is so limited and overlapping in a British-like system with far more effective governmental control. The sponsoring minister has, at least in theory, a staff of experts but in several cases, the controllers have less expertise than the managers of the public enterprises, there are fewer of them and they are often overburdened. In theory, the board of directors is expected to represent the public at the higher governmental levels, protect it from environmental influences, and represent government interests to the management. In several cases, the existence of the board could be explained by conservative political pressures insisting that governmental intervention in

the economy should be questioned by people from the private sector. There have also been cases where boards have been used as tools of patronage. Boards are eventually captured by the executives. What these directors are supposed to decide is another question. According to Jacques Parizeau, the government did not influence the people it delegated to the boards of directors of its public enterprises.⁴ Nevertheless, they could be useful if efficient to coordinate economic policy through "interlocking directorates." (Bernier & Burlone, 2000).

As Meggison and Netter (2001) suggest in their literature review on privatization, it is likely that reforms of public enterprises are more effective when coupled with privatization. We have not interviewed managers of public enterprises who considered that being privatized was a good idea. The possibility of privatization generates a willingness to cooperate with the state. Also as Meggison and Netter noted, new entrepreneurial management makes a difference (Bernier, 1998). Privatization alone does not generate an improvement in performance—competition and reform also do.

Conclusion

Lévesque (2003) suggests that public enterprises have changed the nature of their intervention. They are less in natural resources or manufacturing and more into financial services. It is true in Quebec where the other public enterprises involved in natural resources have been integrated in the SGF and now act in partnership with the private sector (Bernier & Garon, 2004). Hydro-Québec has become over the years a more commercial enterprise. Prices of electricity have risen to cover for the deficits of the state. The CDP has secured its financial role which is critical for an aging population that will need pension revenues. The SGF could become a better instrument of industrial policy.

⁴ Jacques Parizeau is an economist who has been successively professor of economics, economic advisor for the Prime Ministers of Quebec during the 1960s, Minister of Finance between 1976 and 1984 and Premier of Quebec. He wrote "L'auteur de ce texte a siégé pendant 7 ans au Conseil d'administration de plusieurs de ces sociétés d'Etat comme représentant officiel du gouvernement. Il ne se souvient pas d'avoir jamais reçu d'instructions quant au rôle qu'il devait y jouer. Des demandes d'instructions se terminaient habituellement par des formules du genre: "Faites pour le mieux."" from "Une société d'Etat: pourquoi faire?" Montréal, Le Jour, April 26, 1975.

Managing public enterprises is a complex business. By privatizing some of its public enterprises, the state of Quebec has simplified its management of public enterprises. The political system lacks an understanding of the requirements of the technocratic system that makes a public enterprise work. Public enterprises have to secure good working relations with this system through the informational roles played by managers. Selznick (1949) built his explanation of the TVA saga around the grassroots it developed. To the contrary, we have found very little of the policy community we expected in Quebec. Public enterprises have had the time and the opportunities to develop grassroots. They did not do so. There are no organized interest groups or political parties that are strong proponents of public enterprises. Trade unions, scholars, clients have not demonstrated a strong support for them. In the brave new world of governance, they have to get permeated by external influences.

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