The Role of State Owned Enterprises:

Providing Infrastructure and Supporting Economic Recovery

Forfás

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Executive Summary

Introduction

There is renewed interest in Ireland and many other countries in the role that state-owned enterprises (SOEs) can play in promoting economic development, the relationship between SOEs and the State as a shareholder, and the criteria used in assessing options for investing in or disposing of state-owned enterprises.

This issue is of particular interest to Forfás as most SOEs in Ireland are engaged in the provision of essential infrastructure and related services which are vital to the competitiveness of the economy (e.g. electricity, gas, airports, seaports, rail, bus, etc.). Overall, while great progress has been made in upgrading our infrastructure stock, Ireland continues to have significant infrastructure development needs. Having undertaken a significant amount of work on infrastructure priorities and regional development and the potential for greater coordination between Government departments and agencies in the delivery of infrastructure, this paper assesses the critical role that many SOEs play in the provision of infrastructure[1]. In addition to being significant providers of infrastructure, the SOE sector is also an important sector in its own right as it employs over 41,000 people.

Based on a review of available literature and data and consultations with relevant national and international experts, this paper assesses the factors required to ensure that SOEs are:

- providing high-quality, competitively priced infrastructure and services to Irish enterprise; and
- maximising their broader contribution to supporting economic recovery and opportunities for enterprise and innovation.

In light of the forthcoming review of state assets and liabilities[2], it is anticipated that the outputs of this work will help guide, from an enterprise development perspective:

- the rationale for State ownership in SOEs of essential infrastructures and services so as to best achieve their objectives;
- the structuring and management of SOEs to ensure that all enterprises can access world class infrastructure and services at competitive prices; and
- provide a basis for making informed decisions as to further investments or the potential disposal of state assets.

1 http://www.forfas.ie/publication/search.jsp?tp=Infrastructure

2 Details can be found at http://www.finance.gov.ie/viewdoc.asp?DocID=6396. This paper focuses on state owned enterprises and does not consider other intangible assets such radio spectrum, carbon emissions permits, and mineral, hydrocarbon and other licences issued by the state.

Development and Contribution of State-Owned Enterprises to the Economy

The commercial semi-state sector has made a significant contribution to the economic and social development of Ireland since independence. A range of SOEs initiated the provision of essential infrastructure and services that were critical to Ireland's economic development and have played a key role in enhancing skills and entrepreneurship.

The commercial SOEs remain an important part of the Irish economy. They are a heterogeneous group of companies in a wide range of sectors, including monopolies and companies in very competitive sectors; and in both growing and declining sectors. While all company accounts should be interpreted with caution[3], they indicate that:

- SOEs' turnover equated to 5.8 percent of GDP in 2008 and that SOEs employed over 41,000 people directly, or two percent of total national employment in 2008.
- SOEs reported aggregate profits of €430 million after tax in 2008, a fall from €910 million in 2007. SOEs paid share dividends of €170 million to the Department of Finance in 2008 (€484 million in 2007). However, significant subsidies were also paid to some SOEs – for example, CIE received a subsidy of €321 million in 2008. Nonetheless, the bulk of SOE revenues come from fees for goods and services provided to their customers.
- SOEs have significant assets and liabilities. The 2008 annual accounts show that the book value (which may not equate to market value) of non-current assets is €17.44 billion, equating to 9.5 percent of 2008 GDP. This must be set against reported net debt of the companies (€3.98 billion) and reported pension liabilities (€4.32 billion).

While there are statistical challenges in comparing the role of SOEs across countries, Ireland is one of the countries with the lowest levels of State ownership in the OECD across the entire economy. However, the Irish State remains highly involved in the provision of infrastructure and related services. SOEs are responsible for delivering a significant part of Ireland's National Development Plan (2007-2013) and are taking on significant liabilities to enable them deliver on this.

Infrastructure and Enterprise Related Policy Implications

Need for a national policy on the role of state-owned enterprises

It is difficult to discern a definitive national policy on SOEs in Ireland - the practice to date has been to approach issues on a case-by-case basis rather than an overall strategic approach. In Ireland, '*governments have tended to eschew uniform criteria for creating, managing, supervising and holding to account different types of enterprise. As a result, a wide variety of enterprises exists, each with its own funding, reporting, personnel and governance arrangements*'[4]. Internationally, the OECD recommends that '*Government(s) should develop*

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3 For example, the book value of assets may not equate to market values. Pension liabilities are also calculated based on a range of assumptions to calculate the present value of future liabilities.

4 Mac Carthaigh, 2009, The Corporate Governance of Commercial State-Owned Enterprises in Ireland, Institute of Public Administration.

and issue an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy'[5].

Need to evaluate the mission and goals of state-owned enterprises

The Irish and global economy has changed significantly since the establishment of many of our SOEs. In the absence of regular reviews, there are risks that SOEs can drift from their founding goals or that individual SOE goals may not reflect current national economic development needs. There is a need to evaluate:

- the rationale for State involvement in specific markets (founding rationale were generally centred on the existence of natural monopolies, capital and other market failures, externalities and equity concerns[6]) in order to determine what the goals of state-owned enterprises should be – collectively and individually; and
- the roles of state-owned enterprises in terms of supporting wider economic growth - through the timely provision of high-quality and cost-competitive infrastructure. For example, the role of SOEs in terms of making the best use of the telecommunications assets that they own.

Some countries have procedures in place to review the mission, goals and rationale for State involvement periodically.

Potential to implement clearer governance structures

State-owned enterprises are often required to implement multiple and sometimes conflicting objectives, i.e., to achieve loss-making public policy goals (e.g. universal service obligations, uniform tariffs irrespective of the costs of provision) while operating commercially. While there is nothing inherently wrong with an SOE serving multiple goals, this can affect performance negatively if the goals and the relative priority among them are left unclear. Internationally, the evidence suggests there is potential to implement clearer governance structures by:

- establishing a single, competently resourced centralised agency (or unit) which is a model increasingly being adopted across the OECD. This unit, drawn largely from pooling existing resources and expertise, would be dedicated to SOE supervision which could improve the State's ability to exercise ownership efficiently and monitor companies under its ownership; and,
- separating clearly the policy, regulatory and shareholder functions to ensure greater transparency and more conscious decision making where conflicts between goals exist.

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5 OECD 2008; Accountability and Transparency, A Guide for State Ownership

[6] A natural monopoly means that it would be wasteful and inefficient to have duplicate sets of infrastructure assets. Given economies of scale, it is not possible for more than one firm to operate in an industry e.g. electricity transmission wires. Externalities arise when an economic activity affects a third party which had no involvement in the activity. Positive externalities (or spillover effects) (e.g. public education) bestow a benefit on third parties while negative externalities (e.g. pollution) impose a cost on the third party.

As highlighted by NESC (1980), '*…where commercial state-sponsored bodies are required to provide socially desirable though uneconomic services, the extent and cost of such services should be agreed… and an undertaking given that the agreed costs will be met by the exchequer.*'

Potential to implement stronger corporate governance frameworks

Many of the governance challenges faced by large SOEs and large private sector companies are often very similar. Ownership does necessarily equate with control. International experience suggests that there is potential to implement stronger corporate governance frameworks, including:

- developing clearer mandates and improving monitoring by shareholders. This requires the development of specific and transparent mandates to ensure that SOEs have clear objectives and targets which can be monitored and reported on over time. From an enterprise development perspective, additional non-financial indicators that measure the quality and costs of services provided to enterprise relative to trading partners and competitors are important; and
- putting in place transparent mechanisms to ensure that Boards comprise relevant expertise - for example, competency databases as are used in Nordic countries.

Develop clear criteria to guide the potential sale of state-owned assets

Privatisation is not an automatic solution to improving the quality of goods and services available to businesses or the performance of state-owned enterprises. The evidence suggests that if privatisation is to improve the provision of infrastructure and services and the performance of firms over the longer term, it needs to be complemented by policies that promote competition and effective regulation of the industries in question.

The sale of state owned assets cannot solely be guided by how much revenue they will raise. It is important to develop clear criteria to select appropriate assets. It is essential that infrastructure users' interests are protected i.e. by not selling natural monopoly assets (e.g. electricity transmission lines, gas pipelines, broadband ducting, key airports, etc.) or assets to dominant competitors. It is also vital to ensure that investment in advanced infrastructure and regional development is promoted, and that regulatory capabilities are sufficiently advanced to achieve public policy goals in the absence of ownership rights.

The considerable proceeds realised by the Exchequer from previous privatisations indicate that the sale of SOEs (or stakes in SOEs) may make a meaningful contribution to the State's finances. If it is deemed appropriate to privatise a SOE, there is a strong case for opportunistically divesting State assets when conditions in financial markets are favourable.

If the State is to sell any SOEs, it is important that direct costs (e.g. advisory, investment banking, legal fees, etc.) and indirect costs (under-pricing of shares or preferential allocation of shares to employees) are minimised to ensure taxpayers benefit fully from any decision to privatise.

Need to develop contestability in markets

SOEs should not enjoy a competitive advantage simply because of their State ownership. SOEs in formerly non-traded sectors of the economy such as telecommunications, air and inter-city bus transport and energy generation are subject to on-going market liberalisation initiatives and have become a focus for competition policy in recent years. There may be potential to develop greater contestability in other markets currently dominated by SOEs – for example in the provision of urban bus services, rail freight and water services[7].

Greater transparency on subsidies provided and the costs of meeting public policy goals is necessary. In some cases, further potential may exist to hold a tender to assess which firm can offer the desired service at least cost to the taxpayer/consumer (rural waste services, urban bus transport, etc.). In order to maintain competition, the SOEs can be compensated (or taxed) in a market-consistent fashion for the costs (or benefits) they incur due to their state ownership. The benefit of this approach is that the conditions in which SOEs operate can be as closely matched to those faced by private sector competitors as possible.

Need to develop clearer policy towards internationalisation

Ireland's key economic challenge is to reignite productivity and export driven growth. The home market for Irish SOEs is small. In order to reach the scale required to maximise company potential, it may be necessary for some Irish SOEs to expand abroad. Internationalisation of SOEs can enhance the performance of firms through access to technical expertise, market knowledge and resources – offering the potential to increase export earnings, profitability and ultimately dividends for the State.

However, international activities may entail higher risks and potential losses for the State as shareholder. Given constrained resources (e.g. finance, management focus), management may also seek to capture more profitable international opportunities rather than develop the domestic market and use domestic revenues and resources to cross-subsidize overseas projects.

It is important that the board and management of SOEs enjoy the freedom to pursue relevant commercial opportunities abroad provided that they fulfil their mandate domestically. A range of countries have strategies in place that guide the internationalisation of their state-owned companies. There is potential to clarify Irish policy in terms of the international activities of SOEs. Potential may also exist to encourage more overseas owned SOEs to invest in Ireland.

7 Water services are provided by local authorities rather than a formal state owned enterprise.

1. Introduction

There is renewed interest in Ireland and many other countries in the role that state-owned enterprises (SOE) play in promoting economic development. Most of these state-owned enterprises in Ireland are engaged in the provision of infrastructure and related services (e.g. electricity, gas, airports, seaports, rail, bus, broadcasting etc.). At the same time, the sale of State assets may form part of the agenda to restore the sustainability of the public finances.

Based on a review of the available literature and data, and consultation with relevant experts[8], this paper seeks to assess the requirements necessary to ensure that SOEs are:

- Providing high quality competitively priced infrastructure and services to Irish enterprise, where relevant; and
- Maximising their broader contribution to supporting economic recovery and opportunities for enterprise and innovation.

Having undertaken a significant amount of work on infrastructure priorities and regional development and the potential for greater coordination between Government departments and agencies in the delivery of infrastructure, this paper assesses the critical role that many SOEs play in the provision of infrastructure[9]. It is anticipated that the outputs of this work will guide, from an enterprise development perspective, the structuring and management of SOEs, and their potential disposal or investment in new activities and potentially the establishment of new SOEs in future[10].

8 Forfás has received feedback from Donal Palcic and Eoin Reeves (University of Limerick), Paul Sweeney (ICTU), Hans Christiansen (Secretary to the OECD Working Party on State Ownership and Privatisation Practices), Muiris MacCarthaigh (Institute for Public Administration), Brendan Tuohy (former Secretary General of the Department of Communications, Energy and Natural Resources) and the Competition Authority. Forfás is very grateful for the comments provided. Note that the views expressed in this paper are those of Forfás alone.

9 http://www.forfas.ie/publication/search.jsp?tp=Infrastructure

10 This paper is a high level overview of the issues relevant from an enterprise perspective. The issues involved are often complex and cross-cutting and there are many other perspectives from which to approach the role of SOEs.

2. State-Owned Enterprises and their Economic Impact

This section assesses the economic impact of SOEs on the Irish economy and compares this to the relative role of SOEs in other countries.

2.1 Provision of Key Infrastructures and Services

The commercial semi-state sector has made a significant contribution to the economic and social development of Ireland since independence. A range of SOEs initiated the provision of essential infrastructure and services that were critical to Ireland's economic development. In addition to providing critical infrastructures, early SOEs played a key role in enhancing skills (including technical and managerial skills) and entrepreneurship. The current range of activities span from transport and energy infrastructure and services provision, forestry and the national stud, to broadcasting, communications and health insurance.

Over recent years, Forfás has undertaken a wide range of studies that assess the availability, quality and price of key infrastructural services to businesses in Ireland[11]. It should be noted that the degree to which SOEs are involved in the provision of services varies significantly by sector and in some cases sub-sector (e.g., SOEs are the dominant energy supplier for small businesses and households while large electricity users can access private providers). The infrastructures of particular interest to Forfás and the development agencies from an enterprise perspective and that we have assessed include the following:

- Energy;
- Water and waste water (provided by Local Authorities rather than a corporatised state company);
- Waste;
- Transport Services (road, rail, air and sea);
- Broadband and Next Generation Networks.

Individual Forfás studies have benchmarked Ireland's performance in detail. Overall, while great progress has been made in upgrading our infrastructure stock, we continue to have significant infrastructure development challenges. At a high level, the IMD's World Competitiveness Yearbook measures executives' perceptions of the quality of infrastructure.

11 http://www.forfas.ie/publication/search.jsp?tp=Infrastructure

Figure 1: Perceptions of the Quality of Distribution, Air Transport, Water Transport and Energy Infrastructure (Scale 0-10), 2010

OECD-27 Ranking:
Distribution: 23rd
Air: 23rd
Water: 20th
Energy: 24th

Source: IMD World Competitiveness Yearbook, 2010

Ireland's distribution infrastructure – including road, rail, air and sea transport - ranks poorly: Ireland's score in air transport and water infrastructure has improved in recent years but remains below the OECD average. The quality of energy infrastructure is also perceived to be poor.

Given Ireland's spatial pattern of development (i.e., a number of small low density cities and high rural population dispersal), addressing these infrastructure and services needs and broader national economic and social well-being objectives requires a careful balance between private and public initiatives and appropriate and transparent policy and regulatory frameworks. For example, despite retaining regulatory powers and some NDP funding, the sale of the State's primary telecommunications assets in 1999 has limited the State's ability to ensure advanced broadband services are available.

2.2 Economic and Financial Impact

Commercial SOEs remain an important, albeit declining, part of the Irish economy, equating to 5.8 percent of GDP (by turnover) in 2008 and employing approximately 41,200 people or two percent of the total in employment (see table 1 and figure 2 below). They are a heterogeneous group of companies in a wide range of sectors, including monopolies and companies in very competitive sectors; and in both growing and declining sectors.

Company accounts should be interpreted with caution – in particular, the book value of fixed assets and pension liabilities depend heavily on critical assumptions. Table 1 below is for illustrative purposes only on the scope of commercial State-owned enterprises in Ireland rather than as a commentary on company financial performance.

Table 1: Mapping of State-Owned Enterprises, 2008 Annual Accounts

Company	Staff	Turnover €	Profit/Loss (after tax) €	Dividends (Subsidies) €	Net Debt €	Value of non-current assets €
Energy and Natural Resources						
ESB Group, of which[12]	7,870	3,488,352,000	273,298,000	123,010,000	-2,088,000,000	7,581,737,000
ESB Power Generation	1,308	1,487,025,000	199,000,000			1,364,500,000
ESB Networks Transmission	3,617	902,066,000	49,000			919,700,000
ESB Distribution						4,458,900,000
ESB Customer Supply	544	2,126,972,000	-74,000,000			146,000,000
ESB International	1,354	794,206,000	99,000,000			
Bord Gáis	911	1,379,122,000	130,248,000	27,941,000	-1,203,036,000	2,821,599,000
Bord na Mona	2,064	401,567,000	15,552,000	12,249,000	-55,964,000	302,430,000
Eirgrid	225	290,432,000	9,216,000	0	-36,971,000	3,846,000
Coillte	1,250	249,500,000	9,200,000	2,600,000	-161,200,000	1,414,783,000
Irish National Stud	78	7,945,792	-2,475,391		-5,720,900	16,135,453
Transport						
CIE Group , of which[13]	11,848	789,121,000	-310,900,000	-321,093,000	-48,278,000	2,624,676,000
Bus Éireann	2,837	299,676,000	-47,938,000	-41,846,000		153,544,000
Dublin Bus	3,825	203,668,000	-103,307,000	-85,629,000		171,527,000
Irish Rail	4,906	221,476,000	-222,679,000	-193,618,000	-129,172,000	1,577,232,000

[12] The sum of the ESB business units shown in the table does not equal the figures for the ESB group as a whole. For example, 1,047 staff are classified as 'other' in the accounts rather than attached to a specific unit. The figures for turnover for the ESB Group are less than the sum of the business units due to inter-company flows amounting to €1.82 billion. The figures for the value of non-current assets for the business units of ESB are taken from the ESB Group Summary Regulatory Accounts which are provided to the Commission for Energy Regulation.

[13] The sum of the three CIE companies does not equal the figures for the CIE Group as a whole. The discrepancy is accounted for by the CIE holding company, other smaller interests (e.g. CIE Tours International and CIE Property Division). For example, the CIE central holding company employed 280 people in 2008.

Company	Staff	Turnover €	Profit/Loss (after tax) €	Dividends (Subsidies) €	Net Debt €	Value of non-current assets €
Dublin Airport Authority	3,200	631,627,000	49,046,000		-188,040,000	1,457,750,000
Irish Aviation Authority	666	166,683,000	12,238,000		-2,640,000	112,468,000
Shannon Free Airport Development Company	335		-5,678,000			133,839,000
Dublin Port Company	166	70,597,000	23,499,000	5,108,000	-33,655,000	274,902,000
Port of Cork Company	126	26,295,911	3,340,732	0		95,499,560
Port of Waterford	52	12,234,555	3,002,260			47,519,049
Dun Laoighaire Port	42	10,974,742	3,842,696	0	-6,801,353	67,739,768
Shannon Foynes Port	48	10,877,368	938,682		-16,691,133	51,411,496
Galway Port	18	4,347,455	452,024	0	-595,411	12,571,519
Drogheda Port	16	2,463,451	-190,644	0		24,322,623
New Ross Port Company	10	1,338,072	135,577	0	-1,729,129	10,779,914
Dundalk Port	16	1231970	-576493	0		5478565
Wicklow Port	3	231,547	-34,581	0		1,632,508
Communications						
An Post	10,970	850,043,000	33,215,000			211,465,000
National Lottery	92	840,081,000	267,756,000			
RTE Group	2,351	440,760,000	-19,750,000	-201,066,000		115,453,000
TG4 (formerly TnaG)	86	4,030,000		-36,390,000		8,381,000
Finance						
VHI	913	1,025,400,000	-65,000,000			46,700,000
Aggregate: SOEs	43,278	10,705,255,863	430,374,862		-3,978,493,926	17,443,119,455
Aer Lingus (2009) 25% Stake	3,923	1,205,700,000	-130,100,000		335,900,000[14]	980,952,000

Source: Latest Company Accounts for the financial year 2008

In 2008, the commercial SOEs reported aggregate profits of €430 million after tax, a fall from €910 million in 2007. The sector paid share dividends of €170 million to the Department of Finance in 2008 (€484 million in 2007). However, significant subsidies were also paid to some SOEs – for example, CIE received a subsidy of €321 million in 2008 while RTE received licence

[14] Gross cash balances of €828.5 million exceeded net debt of €492.6 million.

fee income of €200 million in respect of its public service remit[15]. Nonetheless, the bulk of SOE revenues come from fees for goods and services provided to their customers.

As SOEs account for a large share of economic activity (5.8 per cent in 2008), they have significant purchasing power in the domestic economy. This has a multiplier effect for sub-suppliers and local service providers. SOEs have also traditionally played a key role in setting salary levels for certain professions across the economy.

Commercial SOEs have significant asset bases. The 2008 annual accounts show that the book value of non-current assets of the SOEs is €17.44 billion or 9.5 percent of GDP. Clearly, this must be set against net debt of the companies (€3.98 billion) and the large pensions liabilities of some SOEs (€4.32 billion). As some SOEs have significant investment plans, their borrowing requirements are likely to rise substantially over the coming years.

The commercial SOEs are key investors in infrastructure provision and are responsible for delivering a significant part of Ireland's National Development Plan.

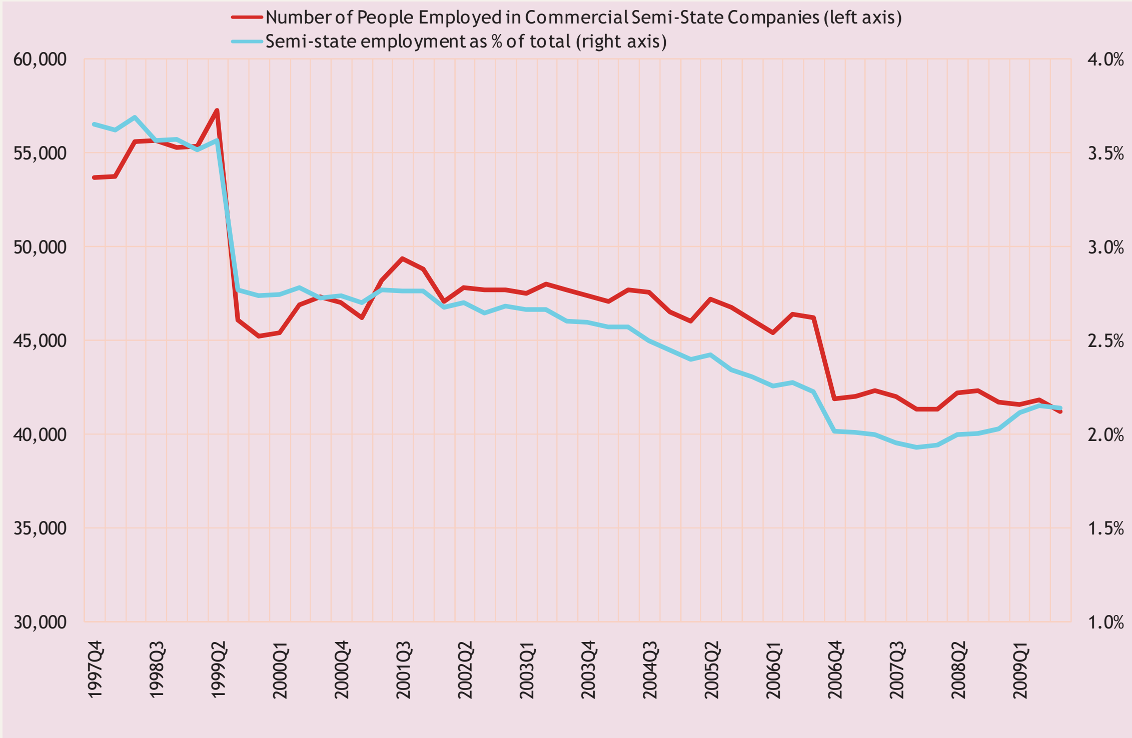
- The cost of strategic energy infrastructure has traditionally been borne by the utilities and the State-owned enterprises continue to invest significantly in electricity and gas distribution and transmission infrastructure and generation capacity under their capital programmes. Of the €8.5 billion investment set out in the Energy Programme of the National Development Plan for the period 2007-2013, the SOEs' plans accounted for circa €7 billion under the State Energy Companies Sub-Programme.
- The National Development Plan envisaged investment of €1.8 billion in the three State airports operating under the aegis of the Dublin Airport Authority (DAA); and approximately €450 million in the commercial ports from the resources of the companies concerned. The NDP has also funded the renewal of our national rail network and the upgrading and expansion of bus fleets in recent years.

In terms of employment, the importance of the sector has declined in recent decades. From the late 1980s, employment in SOEs declined in absolute terms and as a proportion of total employment. The number of people employed has declined from nearly 90,000 in 1980 to 70,000 in 1988 and to 41,200 in Q3 2009[16]. This represents 2.1 percent of total employment in Q3 2009, down from 3.6 percent in 1997. The decline in share of employment was due in part to the rapid rise in private sector employment in the past decade and a decline in SOE employment as a result of a combination of privatisations and employment reductions in the remaining SOEs. Since 2007, SOE employment as a percentage of national employment has grown marginally as a result of lower rates of job losses in SOEs.

15 Subsidies to state owned companies increase the scale of the budget deficit and Government debt. Financing SOE losses also diverts resources from other public tasks.

16 The figures reported by the CSO differ from the aggregate of full time equivalent employees reported in the latest company accounts.

Figure 2: Employment in State-Owned Enterprises (and as percentage of total employment) 1997-2009 Q3



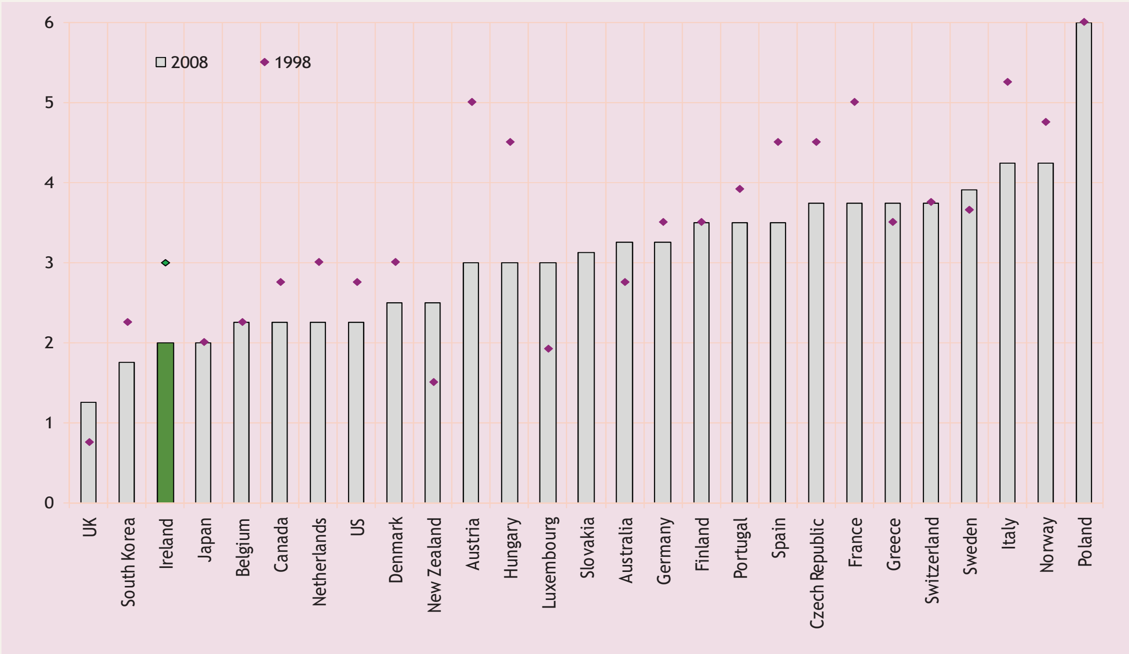
Source: Central Statistics Office

2.3 Importance of State-Owned Companies in Ireland and Internationally

A range of challenges exist when trying to compare the role of state-owned companies across countries, in part because the definition of state-owned enterprises varies from country to country.

The scope of public enterprise in Ireland (as defined by the pervasiveness of state-ownership across business sectors and the proportion of sectors in which the state controls at least one firm) has fallen significantly in recent years. By this measure, Ireland is one of the countries with the lowest levels of State ownership in the OECD (3rd lowest), having fallen from 11th in 1998. Public ownership of commercial enterprises has declined in many OECD countries between 1998 and 2008.

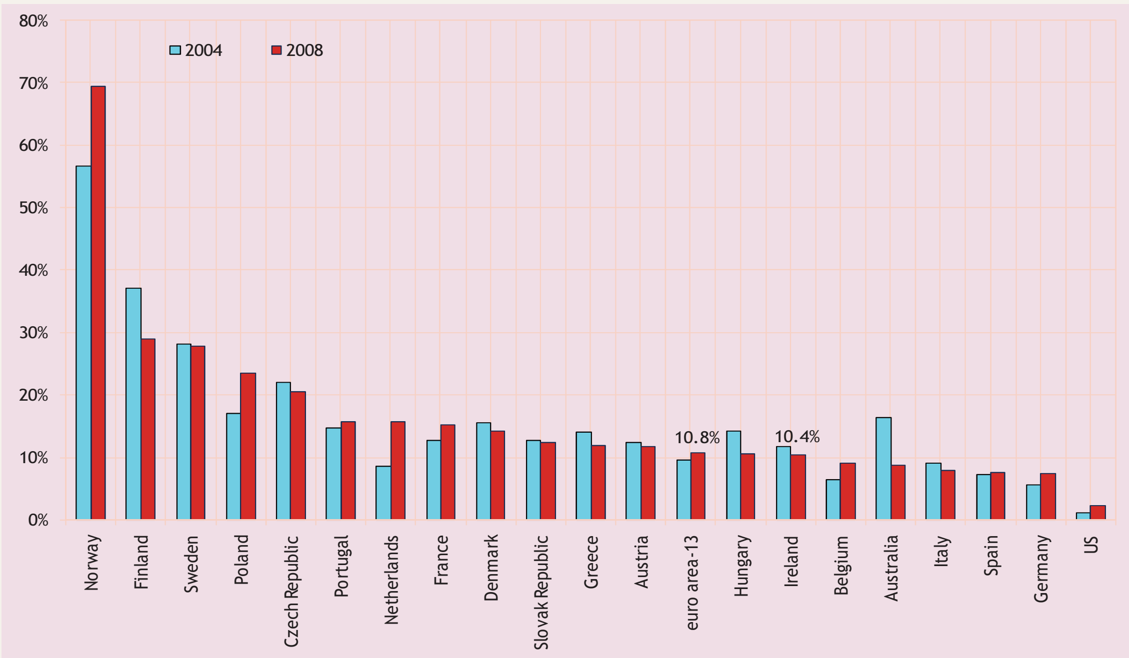
Figure 3: Scope of Public Ownership Index (Scale 0-6), 2008



Source: OECD, Integrated Product Market Indicators

The scope of public ownership is also relatively low in Ireland when measured as general government ownership of shares and other equity as a percentage of GDP.

Figure 4: Shares and Other Equity held by the Government (as a percentage of GDP), 2008



Source: OECD.Stat Extracts, Financial Accounts

Figure 4 above shows government share ownership as a percentage of 2008 GDP. Ireland has a similar scale of public ownership to the euroarea-13 average[17]. OECD data indicates that the Irish State held €18.987 billion in shares and other equity (except mutual funds shares in 2008), a fall from €23.884 billion in 2007 because of falls in the value of quoted shares[18].

In addition to State-owned enterprises, the State is also an investor in equities through the National Pension Reserve Fund, with the objective of maximising long-term returns to meet as much as possible of the costs of social welfare and public service pensions from 2025 onwards. Through the NPRF, the State has significant holdings in broad asset classes such as equities, private equity, bonds, property and currency with a total value of €16.1 billion at the end of 2008[19]. The value of equities held by the NPRF at the end of 2008 was €10.16 billion. Of the €18.987 billion in shares and other equity held by the State, the balance is accounted for by commercial SOEs.

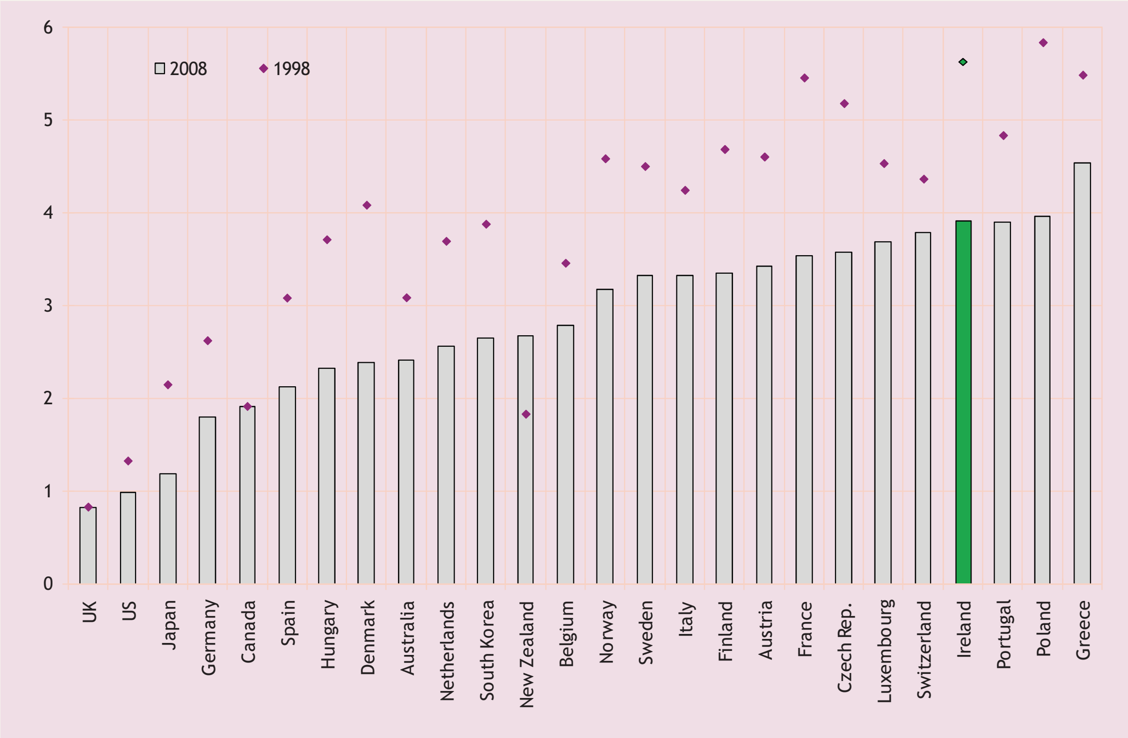
SOEs are not spread thinly across economies. The largest concentration of SOEs is generally found in public utilities, telecommunications and sometimes in the banking and hydrocarbons sectors. Conversely, few countries have a significant presence of state-owned enterprises in competitive, industrial sectors (e.g. manufacturing, construction), retail service provision (e.g. shopping, hospitality) or primary activities except for extractive industries such as oil and gas. In Ireland, despite the relatively low levels of State ownership across the entire economy, the Irish State remains relatively highly involved in the provision of infrastructure and related services.

17 Euro area-16 minus Cyprus, Malta and Slovenia.

18 This measure of the depth of State ownership is quite volatile from year to year for most countries, reflecting movements in equity markets.

19 National Pension Reserve Fund Commission, Annual Report and Financial Statement, 2008.

Figure 5: Government Involvement in the Infrastructure Sector (0-6), 2008



Source: OECD, Product Market Indicators

This index measures the extent of public ownership of shares in the largest companies in key economic sectors such as telecommunications, transport and energy. By this measure, Ireland is one of the countries with the highest levels of State ownership in the infrastructure sector in the OECD (26th), having fallen from 27th in 1998. Public ownership of commercial infrastructure enterprises has declined in many OECD countries, including Ireland, between 1998 and 2008.

3. Role and Development of SOEs in Ireland

There have been 69 substantial commercial enterprises in existence at some point since the first such organisation was established in 1927[20]. This section reviews the development of SOEs in Ireland and enterprise policy towards SOEs.

3.1 Overview of the Development of SOEs in Ireland

Upon independence in 1922, the Irish economy was agrarian and undeveloped relative to Western European standards. The State assumed a direct role in promoting economic development as a matter of urgency. The first commercial public enterprises were established in 1927. These were the Dairy Disposal Company to acquire bankrupt creameries and rationalise the diffuse sector; the Agricultural Credit Corporation to provide credit for the agricultural sector to modernise; and the Electricity Supply Board to generate electricity from the river Shannon.

The formation of public enterprises was often ad hoc but this reflected the urgency of the task facing the fledgling State in terms of enhancing national wealth and harnessing the resources of a country lacking in basic industries. The establishment of SOEs was driven by a desire to initiate strategically important economic activities which private enterprise had either failed to initiate or to operate on a sufficiently extensive scale. State ownership was designed to encourage exploitation of economies of scale and ensure that monopoly profits would accrue to the State - rather than private operators.

During the period of protectionism between the mid-1930s and late 1950s, new state enterprises were established in the drive towards self-sufficiency in agriculture and industry. New SOEs operated in sectors such as food (the Irish Sugar Company), banking (the Industrial Credit Corporation), air transport (Aer Lingus in 1936 and Aer Rianta in 1937), chemicals (Ceimici Teo in 1938[21]), road and rail transport (Coras Iompair Éireann in 1944), steel production (Irish Steel), and peat production (Bord na Mona in 1946). A complex range of pre-independence legislation governing Irish ports and harbours was consolidated following World War II and the 1946 Harbours Act provided the legislative basis for the port companies[22].

The dismantling of protectionism and adoption of outward-looking policies (e.g. exposure to global free trade and preparation for entry to the single European market), with an emphasis on seizing export opportunities and the attraction of foreign direct investment, marked a dramatic shift in the focus of industrial policy. However, a number of commercial SOEs were also founded in the 1960s and early 1970s – for example in sectors such as broadcasting (RTE), fertilizer production (IFI), shipping (British and Irish Line) and gas distribution (Bord Gáis).

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20 Mac Carthaigh, 2009, The Corporate Governance of Commercial State-Owned Enterprises in Ireland, Institute of Public Administration.

21 Ceimici Teo was set up to make industrial alcohol from a potato surplus that did not materialise. Its industrial alcohol was compulsorily purchased by the oil distribution companies and was added to petrol.

22 Mac Carthaigh, 2009, The Corporate Governance of Commercial State-Owned Enterprises in Ireland, Institute of Public Administration.

The establishment of SOEs in the 1980s was attributable to the corporatisation of functions which had previously been fulfilled by Government Departments. SOEs were formed in response to a growing demand for specialised services which Government departments traditionally provided. For example, Telecom Éireann (telecommunications) and An Post (postal service) were established in 1984, and Coillte (forestry) formed in 1989 on the grounds that activities previously performed by departments were better suited to a commercial environment.

The period since 1990 has seen a significant degree of privatisation activity as Ireland followed the global trend of reducing direct government provision of goods and services. The Irish state withdrew from sectors including steel, sugar, shipping, telecommunications and banking (albeit temporarily). While some privatisations were more contentious than others – most notably that of Aer Lingus – many proceeded without major disruptions. In the process, the State or parent companies has realised proceeds amounting to an estimated €8.37 billion (see table 2 below).

Table 2: Proceeds from the Sale of State-Owned Enterprises

Year	Company	Value of Stake(s) sold by Government (€millions)
1991	Greencore	€210.7
1991	Irish Life	€602.1
1992	British and Irish Line	€10.8
1996	Irish Steel	€0
1999	Eircom	€6,399.9
2001	Industrial Credit Corporation	€322.3
2001	TSB	€408.4
2001	Agricultural Credit Corporation	€154.6
2001	Irish National Petroleum	€20
2006	Aer Lingus (sale of 60% stake)	€240.9
	Total	**€8,369.7**

Source: Sweeney, Selling Out?, 2004; Palcic and Reeves, 2010, Costly Business: Privatisation and Exchequer finances in Ireland.

More recently, State ownership in the financial sector has increased as the State has taken large equity positions in a range of distressed banks.

3.2 Government Policy towards SOEs

It is not clear that Ireland has had a definitive statement of Government policy on state enterprises.

In 1980 the National Economic and Social Council (NESC) published a report on Enterprise in the Public Sector which sought to enable state-owned enterprises to maximise their contribution to economic growth while conforming with the need for public information and accountability in relation to their activities and the requirement for central policy making in relation to the allocation of public funds. The 1984 White Paper on Industrial Policy was critical of costly investment errors[23] of some state-owned firms and stated that social objectives should not act as justification for internal inefficiency. This arose from concerns that State-owned enterprises in Ireland were gradually becoming more associated with producer dominance, high costs, indifference to consumers, regulatory capture and subsidy seeking – rather than development corporations which acted in the national interest. Board and management teams were also perceived as weak and dominated by public sector trade unions.

While many industrialised countries were embarking on programmes of liberalisation and privatisation in the early 1980s, the thrust of SOE policy in Ireland was on commercialisation and introducing greater pressure on management to improve financial performance (e.g. labour shedding and plant closures in response to commercial realities). However, the fiscal crises of the 1980s and political developments initiated a programme of liberalisation and privatisation in Ireland.

The creation of the single European market opened up enormous opportunities for Irish firms and put a greater policy focus on switching from protecting state enterprises to improving competitiveness in order to take advantage of emerging opportunities. The European Commission has been particularly active in promoting competition through the application of competition law and setting strict limits on the amount of State aid member states can provide to SOEs.

In more recent years, instead of the state enterprise model, governments have tended to favour regulation and the use of markets to achieve public policy objectives through a combination of regulation and subsidies. Since 1990 a number of new regulatory bodies have been established which influence the operations of commercial state enterprises. These include regulators for the energy sector (Commission for Energy Regulation since 1999), aviation (Commission for Aviation Regulation since 2001) and telecommunications sector (Commission for Communications Regulation since 2002). The Competition Authority established in 1991 also performs regulatory functions across many sectors of the economy. Some of the Department of Transport's regulatory functions in relation to bus and rail in the Greater Dublin Area have recently been devolved to an independent agency, the National Transport Authority in 2010[24].

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23 From the mid-1970's onwards, the performance of state enterprises received increased attention as individual companies such as Irish Shipping, Irish Steel and Ceimici Teo ran into financial difficulties and as significant cost overruns on some capital investment projects became apparent.

24 The National Transport Authority was established on 1 December 2009. The Authority currently has responsibility for the procurement of public land transport services nationally. It also has

4. Infrastructure and Enterprise Related Policy Implications

The primary purpose of this section is to assess the requirements necessary to ensure that State-owned enterprises are:

- Providing high quality competitively priced infrastructure and services to Irish enterprise; and
- Maximising their contribution to supporting economic recovery and opportunities for enterprise and innovation.

4.1 Develop a National Policy on the Role of State-Owned Enterprises

It could be argued that over the years the role of commercial SOEs has not received the attention the companies merit by virtue of their economic importance. It is difficult to discern a definitive national policy on SOEs in Ireland - rather policy towards state-owned enterprises has been to approach issues on a case by case basis rather than an overall strategic approach to the State's expectations and involvement in the sector[25]. This has benefits in ensuring that the specifics of each area are dealt with in a detailed way, such as in relation to ports policy, but can also mean that not all areas are dealt with in a systematic and regular way. In many cases, the Government's role in setting policy direction and as regulator for a sector, in addition to providing some of the services or infrastructure directly, further complicates the issues the State has to deal with as a shareholder. This is more reason for the State to have a clear statement of policy and expectations in relation to State companies and/or their role in the provision of essential services or infrastructures.

In a review of the governance of commercial state-owned enterprises in Ireland, Mac Carthaigh concluded that '*…in seeking to maintain flexibility, governments have tended to eschew uniform criteria for creating, managing, supervising and holding to account different types of enterprise. As a result, a wide variety of enterprises exists, each with its own funding, reporting, personnel and governance arrangements*'[26].

Internationally, the OECD recommends that 'Government(s) should develop and issue an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy[27].' Key issues that such a policy might address are outlined below.

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responsibility for strategic transport planning and the provision of an integrated transport system in the Greater Dublin Area.

25 By contrast, the State of Queensland regulates Government Owned Companies under the 1993 Government Owned Corporations Act and provides clear guidelines on many aspects of performance. They can be found at http://www.ogoc.qld.gov.au/goc-policies/index.shtml.

26 Mac Carthaigh, 2009, *The Corporate Governance of Commercial State-Owned Enterprises in Ireland*, Institute of Public Administration.

27 OECD 2008; Accountability and Transparency, A Guide for State Ownership

4.2 Evaluate the Mission and Goals of State-Owned Enterprises

The Irish and global economy has changed significantly since the establishment of many of our State-owned enterprises. It would be useful to re-evaluate the rationale for State involvement in these firms in order to determine what the goals of SOEs should be – collectively and individually. Unfortunately, much of the debate to date on the role of State-owned firms has concentrated on their ownership/ structure rather than the achievement of clearly set public goals.

The most frequently cited reasons for State involvement in commercial activities are:

- **Natural Monopoly**: This refers to a situation in which the technical requirements of an industry or economies of scale are such that only one supplier may profitably exist (e.g., railways lines, water and electricity distribution). However, when a natural monopoly exists, the supplier is able to extract high monopoly profits by charging high prices. Under such circumstances, there is a strong case for a SOE to be set up and controlled to prevent abuse of such a natural monopoly. The alternative is to regulate a private natural monopoly. The standard justification for the existence of SOEs is that they are designed to overcome market failures arising from natural monopolies while being superior to regulatory alternatives.

  Ireland's demography and geography (low population, low population density, and island status) ensure the presence of some natural monopolies. However, technological developments have weakened some traditional natural monopolies. For example, technological advances have made restrictions on new entrants unenforceable in some industries (e.g. telecommunications, broadcasting and insurance) and made small production units more efficient in others (e.g. energy where smaller electricity generating plants are now more efficient and commercially viable than in the past).

- **Capital Market Failure**: Another important justification for SOEs is capital market failure, where private sector investors are unable or unwilling to finance projects that may have high returns in the long run but carry high risks in the short term. It is argued that capital markets have an inherent bias towards short-term gains and tend not to favour risky, large-scale projects with long gestation periods. Therefore, the State has funded the establishment of state-owned companies to address capital market failures – one example is the State funding of the project to dam the River Shannon and build an electric power station at Ardnacrusha in 1925 to provide electricity. In some cases, governments have funded development banks to finance risky, long-term ventures, rather than set up and run SOEs itself.

  Underdeveloped capital markets following independence inhibited private entrepreneurs from raising funding on a scale necessary to build profitable firms in capital-intensive sectors such as energy and transport[28]. The presence of more advanced capital markets in Ireland and internationally and the presence of a greater number of international development banks means that this rationale is less relevant today than at the foundation of the State. It is also notable that the lack of access to Government capital to support additional investment or contingent liabilities has increasingly been used as a justification for the withdrawal of the State from

28 Lane, P., 'The Role of the State' in O'Hagan, J (ed.) The Economy of Ireland: Policy and Performance of a European Region.

commercial activities. Recent events have reversed this trend in the banking sector. The current inability of some Irish banks to raise finance in capital markets has required the State to take large ownership stakes in the key banks.

- **Externalities**: Private sector investors may not have incentives to invest in industries which benefit other industries without being paid for the service. Positive externalities bestow a benefit on third parties through the production of a good or service. Where the production of a certain good creates external benefits, a free market in provision results in too low a level of production and there is a case for State provision. In other cases, the free-rider problem can inhibit private markets from providing goods even when they are clearly in demand. A prime example of such public goods is street lighting or national security hence they are provided by the State. This rationale also justifies State investment in education and research and development. In the past externalities were used to justify interventions in basic inputs industries such as steel and chemicals.

  The rationale for state investment in enterprise arising from externalities needs to be assessed on a case by case basis. For example, there may be a case for State provision of a next generation broadband network to cater for the bandwidth needs of industries in the future as it could yield significant positive externalities for the wider economy and support the development of new products and services, innovation and regional development[29].

- **Equity**: Profit-seeking firms in industries that provide basic goods and services may refuse to serve less desirable customers, such as people living in poverty or those living in more remote regions. State involvement may be justified if the provision of the good or service is desirable on a universal basis in order to support equality, regional development and other economic and social goals. Examples include the provision of water, postal services, public transport and basic broadband (e.g. the national broadband scheme which is rolling out basic universal broadband coverage to rural areas which are not commercially viable for private operators).

  Despite Ireland's growing population, Ireland has low levels of urbanisation and population density which support this rationale. However, regional differences in economic performance are not significant in Ireland relative to the large disparities evident in some other countries. Income inequality is around the EU average.

It is important that we review the role of state-owned enterprises in terms of their original developmental roles which are largely based on the criteria set out above. It is also critical that we review their roles in terms of supporting wider economic growth - through the provision of high quality and cost competitive infrastructure and maximising opportunities for enterprise and innovation. SOEs have also played valuable roles in terms of wider skills development and the development of a more sophisticated sub-supply base.

In some cases, it is likely that the State holds legacy investment in SOEs that it would be unlikely to take if these enterprises were being established today due to the

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29 A number of countries have determined that fibre connections are critical to developing a digital economy and are committed to strong public intervention to ensure this utility becomes widely available in a timely and cost competitive fashion, and in some cases are investing directly in the market.

internationalisation of the economy, erosion of natural monopolies, deeper capital markets, technological developments, etc. Some countries have procedures in place to review these issues periodically.

One stringent example is the German budget law which requires the Government to examine and put forward a positive argument for the companies to be retained in State ownership. This process is required every 2 years and the automatic commencement of privatisation follows if the case for continuation of state ownership is not accepted in the budget bill[30]. Therefore, in theory there is no difference between arguing for the creation of new SOEs and the continuation of existing SOEs. Such a requirement logically needs to be backed by standardised evaluation criteria and processes. The UK takes a similar approach to the question of whether continued state ownership of companies is justified rather than proceeding on a status quo basis.

On an ongoing basis, as new investments are being made in existing and potentially new SOEs, it is important that these investments are assessed based on the degree to which they meet a specific rationale for the State undertaking the investment. Particular attention is required for:

- SOEs engaging in diversification strategies which appear outside their core mandate and the rationale for state ownership as set out in section 4.2;
- SOEs buying emerging private sector competitors; and
- SOEs with converging mandates which are increasingly offering similar products and services.

It is also vital that the State is able to coordinate the activities of its SOEs to ensure that they are making use of the assets that they own. For example, the State already has the components of a significant and extensive telecommunications network including the infrastructure owned by ESB Telecom, Bord Gáis, CIE, National Roads Authority and Waterways Ireland. Plans to create a one-stop shop are welcome. Delays in providing integrated access to State-owned telecommunications infrastructure have not enabled the State to maximise the value of the assets it owns.

4.3 Implement Clearer Governance Structures

It is important to recognise that many of the problems/ complexities faced by large SOEs and large private sector firms are often very similar (e.g., banks). Internationally, the challenges in terms of management of SOEs concern the following:

- The **principal - agent problem**: SOEs are not run by their owners. Unable to monitor them perfectly, the owners cannot tell how much of performance is due to managerial failure or external factors. This means managers may not have strong incentives to maximise efficiency and the value of the business and may put in sub-optimal efforts.
- The **free-rider problem**: SOEs have numerous owners (all citizens). No individual owner (citizen) has the incentive to monitor the SOE managers as the benefits from

30 OECD, Working Group on Privatisation and Corporate Governance of State Owned Assets, 2009, Privatisation in the 21st Century: Recent Experiences of OECD Countries Report on Good Practice. See Box 5 for further details.

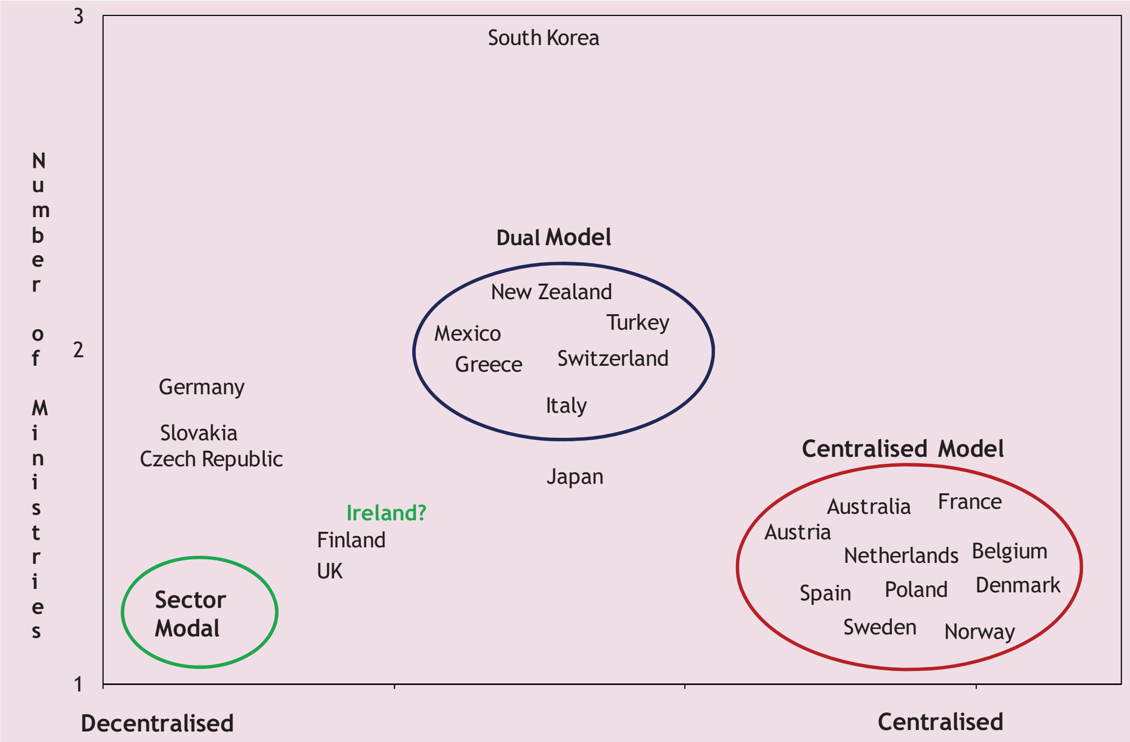
monitoring will accrue to all owners while the costs are borne by the individuals who do the monitoring.

- The **soft budget constraint**:
  - Being part of the State, SOEs may ultimately be able to secure additional financial assistance if their operational performance is poor, investments do not deliver an adequate return and/or they are unable to meet their liabilities – including significant pensions liabilities for some companies. This safety net may have a detrimental impact on management practices or alter risk appetite.
  - Because State-owned companies are unlikely to be subject to insolvency proceedings or the threat of takeover by a rival firm they are removed from the kinds of competitive forces that face private companies.
  - Similarly, the fact that their capital raising activities are often backed up (explicitly or implicitly) by the State, means that these companies are protected from the full operation of the capital market and the discipline which this can impose on management and the board of directors.
- Accountability and performance may also be hindered by ambiguity surrounding the interaction between SOEs and the political system. Problems arise due to poorly defined non-commercial objectives which are imposed on SOE management, and an absence of transparency in setting goals and evaluating outcomes. Cross-subsidisation between units of SOEs which are monopolies and business units which operate in competitive markets can also damage overall economic efficiency by distorting competition.

Although the State and its citizens own SOEs, the ownership function can be carried out in different ways. The OECD suggests that there are three ownership models: the decentralised model, and the centralised model and the dual model[31].

31 OECD Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries (Paris: OECD, 2005)

Figure 6: Ownership Models in OECD Countries



Source: OECD Corporate Governance of State-Owned Enterprises (2005)

- In the centralised model, there is one government body, a ministry or a holding company, responsible for the government's stake in all SOEs[32]. In most cases, this is the Ministry of Finance (e.g. Denmark, the Netherlands, and Spain) or the Ministry of Industry (e.g. Norway and Sweden). In Belgium, there is a specific ministry, the Ministry of State-Owned Enterprises and Participations. The main advantage of the centralised model lies in the clear line of accountability from the SOE to the government, the ability of the government to exert close financial supervision and to develop a coherent policy/ strategy for its SOEs. A criticism of the centralised approach is that the central Government body as a shareholder may exert too much influence on other arms of Government in its role as a regulator. There is also a risk that over-centralisation could inhibit opportunities for innovation and agility in individual SOEs.

32 A well known example of a centralized agency is Temasek of Singapore. Temasek is one of two investment arms of the Singaporean government. The other is the Government Investment Corporation which administers Singapore's foreign reserves. Temasek was established in 1974 to take over the government's stakes in companies held by the Ministry of Finance. It holds stakes in a wide range of areas including telecommunications (e.g. SingTel, Starhub, Global Crossing), financial services, energy and natural resources (e.g. Singapore Power, Power Seraya), transport and industries such as semiconductors, biopharma (Temaske Life Sciences Laboratories) and healthcare.

- In the decentralised or sector model, SOEs are the responsibility of different ministries. The main advantage of a decentralised model lies in the much greater availability of sectoral expertise if the SOE deals with sectoral ministries. It is also likely to take a developmental role in setting objectives for the individual SOE. The main disadvantage is the difficulty of separating the ownership function of the State from the regulatory function and the greater risk of interference in the day-to-day operations of individual SOEs.
- In the dual form, responsibility is shared between a sector ministry and one single central ministry, such as the Ministry of Finance. A potential advantage of the dual model is that it can alleviate the conflict of interest inherent in State ownership in terms of ownership of the SOE and the representative of the SOE's customers. If the roles are divided between two different ministries, the competing constituencies may be more likely to subject corporate policy to more rigorous checks and balances than would a single government ministry. The dual model also facilitates both developmental/technical oversight (from officials of the sectoral ministry) and fiscal/financial oversight (from Ministry for Finance). The main disadvantages of the dual form is that the sharing of responsibility and accountability may not always be clear and that it may not solve conflicts of interests between the state, SOEs, and customers of the SOEs.

The OECD favours a centralised approach to the State's ownership function. The OECD suggests that there is a clear international trend in favour of the centralized model, possibly because centralisation permits greater consistency and transparency in SOE governance[33]. There are several examples internationally which Ireland might be able to learn from. For example:

1) Coordinating agencies which are owned by other parts of central government

- The UK Shareholder Executive, which has direct responsibility for some SOEs such as British Nuclear Fuels, British Energy, Royal Mail and Channel 4, allows for a pooling of resources and expertise required to monitor key SOEs effectively and to provide corporate finance advice to Government departments;
- Similarly, Australia (Government Business Advice Branch) and New Zealand (Crown Companies Monitoring Advisory Unit) also have units which provide specialised advice on, for example, corporate finance, governance and board appointments to the Ministry which exercises ownership;

2) Centralised ownership agencies

- The Finnish government harmonised the State's ownership policy to make it more predictable and transparent in 2004. It centralized the ownership function for 39 out of 53 SOEs into a new unit known as the 'ownership steering department' within the Ministry of the Prime Minister[34]; and

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33 The OECD goes even further in recommending the centralized ownership to be exercised by an independent agency (e.g. a holding company), even though this model is relatively untested in practice both in developed and developing countries.

34 Mac Carthaigh, 2009, *The Corporate Governance of Commercial State-Owned Enterprises in Ireland*, Institute of Public Administration.

- In Sweden, the Ministry of Industry and Energy is responsible for the administration of 55 state-owned companies and the Government makes an annual report to the parliament on the performance of SOEs.

Ireland's current position on the OECD's model is somewhat unclear. It is likely to be similar to the model in the UK – somewhere between the decentralised approach and the dual approach. Potential exists to implement clearer governance structures by:

- Establishing a single, competently resourced agency (or unit) dedicated to SOE supervision which could improve the State's ability to exercise ownership efficiently and monitor companies under its ownership (including oversight of strategic activities and investments, financial performance, quality of service provision, etc.). Potential exists to put this agency or unit on a similar footing to the National Treasury Management Agency (NTMA) which manages financial assets and liabilities on behalf of the Irish Government. Consideration needs to be given to pooling existing resources and expertise in order to minimise costs.

- Separating the policy, regulatory and shareholder functions to ensure greater transparency and more conscious decision making where conflicts between these exist. As highlighted by NESC, *'where commercial state-sponsored bodies are required to provide socially desirable though uneconomic services, the extent and cost of such services should be agreed between the board and the minister concerned and an undertaking given that the agreed costs will be met by the exchequer. Thus the danger of confusing social and commercial objectives within state-sponsored bodies will be minimised'*[35]. OECD guidelines recommend that such obligations are "*clearly mandated by laws or regulations*", that they are "*disclosed to the general public*"; and finally, that their "*related costs (are) covered in a transparent manner*[36]."

4.4 Implement Stronger Corporate Governance Frameworks

Corporate governance is a key issue for all large organisations. There is a major challenge to address the practices which led to corporate governance failures in public and private bodies in Ireland in recent years. SOEs should be held to higher standards of accountability than private companies should as they are owned by the taxpayer. State ownership does not automatically guarantee State control over the mission and activities of an SOE. Unlike private firms, whose main goal is wealth maximisation, the goals of SOEs are typically a more complex mixture of social, political, and commercial objectives. There is widespread agreement regarding best practice systems of corporate governance for SOEs. In essence, good corporate governance is characterised by:

- Strong oversight by shareholders, including monitoring by shareholders; this requires the development of specific and transparent mandates to ensure that SOEs have clear objectives and targets (which can be reported on and monitored over time). In many cases, the legislative parameters which oversee SOEs do not give a sufficiently clear mandate to these bodies regarding their broad objectives and goals. In Ireland, Ministers exercise control of state enterprises by appointing boards of directors, by

35 NESC report on Enterprise in the Public Sector, 1980.

36 OECD 2008; Accountability and Transparency, A Guide for State Ownership

obtaining assurances of sound management such as external audits and through formal and informal contact with the management of enterprises. For the majority of Irish SOEs the Oireachtas is viewed as having little influence on their mandate and strategic direction[37]. The survey of 25 SOEs conducted by Mac Carthaigh suggests that the majority of Irish state-owned enterprises claim maximum policy autonomy. Just 20 percent of SOEs reported that they set goals in cooperation with their parent department while 80 percent set goals themselves. Mac Carthaigh also found that only 16 percent of audit committees of SOEs have external (non board) members such as independent auditors on them[38].

- Independent boards: potential exists to ensure that boards of directors comprise of relevant expertise at the necessary level of depth and that they have clear obligations to the State as shareholder[39]. Company boards often require specific qualifications (e.g. corporate finance, legal expertise etc.) or industry experience. The determination of Board skill requirements should precede re-appointments and new appointments. There is potential to make the overall board appointment process more robust, transparent and less subject to risk of appointing lesser qualified candidates. For example, in the UK the Office of the Commissioner for Public Appointments regulates the processes by which appointments are made to the boards of public bodies. Several Nordic countries employ competency databases in making appointments to the boards of SOEs. Given that boards of SOEs are undertaking fiduciary duties on behalf of the public, it is reasonable to develop a mechanism for evaluation of directors and for treating under-performing directors or directors who have been appointed to a board for which their experience is not compatible. Greater use of independent non-executive directors could improve the accountability of management to the Board and ultimately to the State as shareholder. Equally, there should be clear remuneration policies linking pay to performance subject to evaluation based on agreed metrics.
- High levels of transparency and disclosure: A recent survey of 25 SOEs reveals that there is little public reporting on the financial or non-financial work conducted by SOEs[40]. More structured public reporting (potentially to the Oireachtas) could improve transparency and public trust in SOEs.
- Strong external disciplines that include monitoring by capital market participants and the discipline of raising capital on competitive markets. These disciplines include the cost of raising fresh capital as well as corporate governance-related listing requirements of stock exchanges. Many Irish SOEs do raise capital successfully from private investors.

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37 Ibid

38 Ibid

39 For example, see ‘A Guide for Members of Queensland Government Boards, Committees and Statutory Authorities’, http://www.premiers.qld.gov.au/publications/categories/policies-and-codes/handbooks/welcome-aboard.aspx

40 Mac Carthaigh, 2009, The Corporate Governance of Commercial State-Owned Enterprises in Ireland, Institute of Public Administration

The authority and autonomy which is assigned by the Government to state-owned enterprises is essential if these enterprises are to operate effectively. However to ensure that the distinctive nature of state-owned bodies is not eroded through operational interferences, it is critical that SOEs have clear strategic goals and that these goals are monitored. IPA research indicates that the parent Departments and/or regulators are increasingly monitoring SOEs more closely[41]. However, these indicators are primarily focused on financial matters (e.g. financial results including profitability, and use of resources).

Conventional measures of profits risk being unfair to the SOE as they fail to take account of additional objectives that SOEs are often expected to fulfil. There is scope to develop some simple but effective guidelines, quantifying costs and benefits of meeting equality and other developmental objectives which the Government sets for SOEs and entering them explicitly in the accounting system. The performance of SOEs should be evaluated transparently with a strong focus on trends as well as on levels. Additional non-financial indicators are also required that measure quality and costs of services, effects on society and effects on the economy which provided the rationale for the establishment of many of these firms under State ownership[42].

Box 1: Queensland Government's Transparent Reporting System

As part of the Queensland Government's decision to implement biannual reporting for Government Owned Corporations (GOC), interim reports will be published to provide a short and easy to understand one page summary of the performance of each GOC over the first six months of the financial year. The interim reports will include key financial performance information, including earnings before interest and tax (EBIT), net profit after tax (NPAT), return on assets and return on equity; key non-financial performance information, which for each GOC will represent key measures of safety, internal operation and customer satisfaction; and capital programme achievements[43].

The OECD recommends the publication of annual performance reviews which assess developments during the year and evaluate how well the company and the board have performed against the specific corporate objectives set by the State. The central piece of the annual performance review is the assessment of financial and non-financial performance against annual targets. But it is also useful to include an assessment of operating results, corporate value and risks, board performance and corporate governance practices[44]. A more centralised approach to the State's function as a shareholder would facilitate aggregate reporting on the performance of SOEs. In particular, the OECD highlights the importance of reporting to Parliament as Parliaments represent the ultimate owners of SOEs, i.e. the public.

More generally, monitoring processes that are not backed by a specific regulatory institution, and so are undertaken within government, tend not to be as transparent as regulatory

41 For more information, see table 7.9, Mac Carthaigh, 2009.

42 Ibid.

43 http://www.ogoc.qld.gov.au/current_gocs/index.shtml

44 OECD 2008; Accountability and Transparency, a guide for state ownership

processes. As a first step, potential may exist to develop a system modelled on the Department of Environment, Heritage and Local Government's benchmarking of local authorities[45].

4.5 Develop Clear Criteria to Guide the Potential Sale of State-Owned Assets

Privatisation/deregulation/liberalisation has become a part of most countries' pro-competition programmes in recent decades. The underlying motivation for privatisation has been perceived disillusion with the capacity of nationalised industries to deliver efficient services and to achieve the socio-economic objectives they were set up to attain. Privatisation typically aimed to provide clearer objectives and incentives for the management of companies to perform well and to introduce competition into sectors hitherto dominated by State utilities in an effort to improve overall economic efficiency.

Raising funds is also an important reason underlying many privatisations. Since the 1990s privatisation activity has been correlated with equity valuations as many governments have sought to time their public offerings to coincide with favourable market conditions. France, Italy and Germany have been most active in privatising SOEs between 2000 and 2007 – revenue of $233 billion from these three countries accounts for almost half of total OECD proceeds. Finland has also undertaken a piecemeal sell-off of shares in a large number of commercial SOEs with a value of $18 billion or 8.7 percent of 2006 GDP. The sectoral distribution of proceeds from divestment across the OECD has been dominated by network industries since 2000:

- 31 percent of total proceeds from telecoms sector;
- 19 percent from transport and logistics;
- 17 percent from utilities (mostly energy);
- 15 percent from financial sector; and
- 10 percent from manufacturing.

In virtually all economies, the share of SOEs decreased in the decade leading up to 2008. Many of these privatisations have been partial sales of large SOEs in utilities/networks[46]. This pattern reflects a departure from theory/ popular understanding of privatisation which is based on governments ceasing to exert influence over a commercial activity. In reality, governments' ability to wield influence has not receded as decisively as the drop in SOEs' share of the economy would seem to indicate as many states continue to hold non-trivial and often controlling stakes in former SOEs. Several OECD governments privatised listed SOEs to the extent that the State holds just over 10 per cent of the company. The delisting rules in

45 Since 2004, the Local Government Management Services Board has produced an annual report on Service Indicators in Local Authorities which details the performance of local authorities across 42 indicators covering the range of services provided by local authorities.

46 For example, the sale of 6.6 percent of Deutsche Telekom, 12.7 percent share of Electricite de France by Initial Public Offering, or sale of 10.9 percent of France Telecom.

various jurisdictions allow a private investor with 90 per cent of the common shares to force the minority shareholder out of the company and to take it private. By retaining just over 10 per cent, governments can deter undesirable takeovers. The primary motivation for privatisation now seems to be about the partial opening of SOEs to private capital to raise efficiency by subjecting the company to capital market discipline and to enhance the financial capability for expansion or new investment by raising fresh private capital.

Privatisation is not an automatic solution to improving the quality of goods and services available to the wider enterprise sector in Ireland or the performance of SOEs. It appears from the empirical evidence both internationally and in Ireland's specific case that a change of ownership from public to private is not necessarily a cure for an under-performing organisation. Palcic and Reeves found a clear pattern of improved performance prior to privatisation as firms prepared by implementing cost-cutting measures including labour shedding. This is consistent with findings in countries such as the UK where studies have found that the prospect of privatisation is associated with improved performance[47]. Similarly, Sweeney came to the same conclusion that 'most job losses occurred in the lead up to privatisation or during the process of commercialisation, while the companies were still in State ownership[48]. These efficiency gains are once-off. Dynamic efficiency gains following privatisation are much more difficult to isolate and depend on a range of factors including improved production processes, management, investment in research and development, etc. The evidence reviewed suggests that if privatisation is to improve company performance over the longer-term, it needs to be complemented by policies that promote competition and effective state regulation of the industries in question rather than viewed in isolation as a matter of ownership. As Ireland is a small market, it is also important to examine the extent to which the theoretical benefits of competition are fully realisable in an Irish context.

Box 2: Lessons from Privatisation of Infrastructure Providers

The drive to privatisation, liberalisation and competition aimed to solve the market failure of monopoly State ownership and has been successful in improving operating performance of many SOEs in the UK. However, there are other market failures and the privatisation drive in the UK has failed to provide a context for efficient investment outcomes for critical infrastructure.

While there have been successes in commercial terms from privatised companies in the UK, there have also been poor performers such as Railtrack which was re-nationalised due to its poor safety and financial performance.

The experience in the UK with regard to railways and more recently energy infrastructure and the lessons from the sale of eircom point to the dangers of privatisation of network infrastructure providers. There is a risk that private utilities companies can manipulate maintenance and capital expenditure to improve short term financial performance and extract value for the new private shareholders at the expense of the long-term viability of companies and ultimately national competitiveness in terms of infrastructure available to businesses.

47 Palcic and Reeves, 2005, Privatisation Policy and Enterprise Performance: The Case of Ireland

48 Sweeney, 2004, Selling Out? Privatisation in Ireland. Page 60-62.

In the UK, this is resulting in an infrastructure expenditure crunch as extensive investment is now required to meet policy objectives in areas such as security of energy supply, electrification of transport and heating and de-carbonisation of electricity generation and adaption to climate change[49]. In Ireland, the privatisation of a critical infrastructure asset has resulted in slow roll-out of essential broadband infrastructure in part due to the debt which eircom carries following its takeover by successive private equity groups.

The approach to the cost of capital is critical to ensuring correct incentives are in place for investment in infrastructure which makes a return over a long period. There is a need to ensure that balance sheets are not stripped out by unintended financial engineering as has been the case in the UK with Railtrack and in Ireland with eircom.

There is a strong case for developing a clearer rationale that would guide the potential disposal of state assets in future. Key questions to consider include:

- Is the SOE a natural-monopoly (e.g. electricity transmission lines, gas pipelines broadband ducting, airline landing slots, etc.)? Replacing a public monopoly with a private one is unlikely to enhance the quality of products/ services produced or their cost competitiveness. In cases where a SOE is operating in both competitive and monopoly markets, potential may exist to separate the activities and privatise the competitive market elements.
- Would the sale of the SOE enhance or reduce competition in the sector? In part, this may depend on who might buy the SOE. However, as the case of eircom and Aer Lingus shows, once a SOE is privatised, any number of private parties may become interested in the assets of the company in future. As part of any sale process, the State needs to examine whether it is appropriate to hold a stake in strategic companies to ensure that it has some influence over the future direction of the company.
- Will the State retain a key role as a centralised planner of infrastructure networks and be able to ensure adequate investment in critical infrastructure? While there may be potential to privatise the delivery of specific services, it is paramount that the State retains control over assets which are critical to network planning and infrastructure provision[50].
- Does the SOE provide an essential service for which universal access is deemed crucial (e.g. water, electricity, urban transport, postal service)? Will the State need to continue to fund these universal obligations post privatisation?

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49 For further information, see Helm, 2009, Infrastructure Investment, the cost of capital and regulation: an assessment.

50 In electricity, transmission refers to the high voltage nation-wide network of lines which carry power from the generating stations. Distribution involves taking power from the high voltage transmission network, reducing voltage by means of transformers to levels suitable for industrial and domestic usage and then supplying power to individual homes and business premises by means of the lower voltage local line network. Similarly gas is transported over the national high-pressure transmission network, and then through regional distribution pipelines, where pressure is reduced, for supply to individual customers.

- Does the State at the relevant level (national, local, etc.) have adequate regulatory capabilities to deliver on public policy objectives if the SOE is sold? Putting a new regulatory framework in place before privatisation is one of the most important prerequisites for the successful privatisation in infrastructure industries. Is the cost of ongoing regulation being offset against the expected proceeds of the sale?
- Is it feasible to make the necessary organizational reforms in the SOEs without the sale?
- Does the SOE earn a commercial rate of return which justifies the long term retention of assets and underpins the firm's ability to pay commercial dividends?
- Would the privatised SOE still be 'too big to let fail' which means that the "soft budget constraint" is likely to persist, even after privatisation?

From an enterprise development perspective it is essential that privatization policy protects and promotes competition in the market (i.e. by not selling monopoly assets or assets to dominant competitors), ensures that investment and regional development is promoted and that regulatory capabilities are sufficiently advanced to achieve public policy goals in the absence of ownership rights.

The considerable proceeds realised by the Exchequer from previous privatisations indicate that the sale of SOEs (or stakes in SOEs) can make a meaningful contribution to the State's finances. If the State is to privatise any SOEs in future, it is important that direct costs (advisory, investment banking, legal fees etc) and indirect costs (under-pricing of shares or preferential allocation of shares to employees) are minimised to ensure taxpayers benefit from any decision to privatise. Palcic and Reeves note that a distinctive feature of Ireland's privatisation programme has been the granting of sizeable shareholdings to workers at a discount in return for re-structuring. Employee Share Ownership Plans have resulted in significant redistribution of wealth and corporate power in favour of employees in SOEs - ESOPs are estimated to have cost the Exchequer almost €1.1 billion, which represents over 13 per cent of total privatisation proceeds[51].

If it is deemed appropriate to privatise a SOE, there is a strong case for opportunistically divesting State assets when conditions in financial markets are favourable. This would require the State to expose SOEs to competition and all other equivalents of private companies insofar as possible and then wait for the right conditions in terms of equity markets for an Initial Public Offering or industry trends for trade sales. In Finland, the government has corporatized the SOEs under the aegis of its ownership agency to the point where it considers them in all essentials as equivalent to private companies. Reflecting this it follows an opportunistic approach to divestment, involving the disposal of asset shares when the conditions are favourable, but rarely discretionary decisions involving the selloff of entire companies[52].

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51 Costly Business: Costly Business: Privatisation and Exchequer finances in Ireland, Dónal Palcic and Eoin Reeves, University of Limerick, 2010.

52 OECD, 2005, Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries

4.6 Develop Contestability within Markets

SOEs should not enjoy any net competitive advantage simply because of their State ownership. When there is effective competition in a market, firms have limited discretion over the price consumers pay for the good or service. Competition forces firms to minimize costs and to search for new and better ways of doing business. Such factors have resulted in many countries seeking to strengthen the forces of competition in recent decades in order to enhance economic efficiency and innovation.

State-owned enterprises in formerly non-traded sectors of the economy – such as telecommunications, transport, power generation and public utilities – have become a focus for competition policy in recent years. Such industries were widely regarded as ‘natural monopolies’ and thus state ownership was desirable to ensure an adequate level of service provision. However, regulatory policies and the presence of independent regulators now exert a significant influence on various sectors in which state enterprises operate.

In other cases where monopoly conditions exist, potential may exist to create competition for the market rather than competition within the market. For example, based on studies of the efficiency of different regulatory approaches to waste collection across OECD countries, the OECD found that competitive tendering – i.e. competition for the market – is the most desirable policy option[53]. Since deregulation of the air transport sector, interventions have been limited to subsidising domestic routes for public service reasons which are allocated on a competitive tendering basis. Once a subsidy is deemed necessary for social/regional reasons, competition is for the subsidised segment of the market.

Potential may also exist to apply this principle in other sectors. For example, the ownership and use of airline landing slots has received much attention. As the landing slots have many of the characteristics of a natural monopoly, potential may exist for the State to create competition for the specified use of these slots to meet economic and social objectives rather than competition between airlines in the market. Likewise, creating contestability in the use of railway lines could encourage the development of additional rail freight services.

Competitive tendering of bus routes is also a possibility to introduce contestability into the urban bus market. A number of avenues are available to improve service levels on urban bus transport. The interests of the travelling public may be best served through imposing regulated performance targets on SOEs, or alternatively through the implementation of Competition Authority recommendations on the liberalisation of the bus market.

Infrastructure services have traditionally received public subsidies as a means of balancing commercial viability and social objectives. Greater transparency on subsidies provided and the costs of meeting public policy goals is necessary. There are often sound reasons for universal service obligations and for the cost of such basic services to be equalised across all consumers through the price they pay. However, the cost of providing services can differ radically across the country – for example the cost of delivering a letter in Dublin is much less than in rural/isolated parts of the country. This results in cross subsidisation as some customers pay more than the cost of providing the service and others pay less than the cost of providing the service. The differences in the cost of delivering services should be more transparent – policymakers and regulators should be aware of the impact that spatial patterns

53 Competition in Local Services: Solid Waste Management, OECD, 2000: http://www.oecd.org/dataoecd/34/51/1920304.pdf

have on the cost of providing critical infrastructure such as postal services, bus services, electricity connections and broadband lines.

In order to ensure a fair market, the SOEs could be compensated (or taxed) in a market-consistent fashion for the costs (or benefits) they incur due to their state ownership. The benefit of this approach is that the conditions in which SOEs operate can be as closely matched to those faced by private sector competitors as possible. One interesting example is the fees that some OECD countries such as Australia levy on their SOEs in compensation for their cheaper access to market financing due to State ownership. In some cases, potential may exist to hold a tender process to assess which firms (state and/ or privately owned) can offer the desired service at least cost to the taxpayer.

4.7 Develop Clearer Policy towards Internationalisation

Internationally, despite trends toward privatisation in recent decades, there are still a significant number of large state-owned firms. For example, China now has over 30 SOEs on the Fortune Global 500 list. In developed countries, companies such as General Motors, Singapore Airlines, Vattenfall, EDF, and Renault are prominent international companies in their industries[54]. The OECD has noted the increasing internationalisation of member states' SOEs. However, despite their perceived ubiquity, SOEs are relatively minor actors in the international economy. UNCTAD data indicates that among the largest 100 multinationals ranked by foreign assets, there are 13 firms with some degree of state ownership. In general, most of the SOEs on the list have minority state ownership.

The rationale to expand overseas varies. Many argue that their domestic operations have provided valuable expertise that can be brought to profitable use in emerging or developing economies that are still in the process of developing similar products or services. Some SOEs have expanded overseas to gain access to more advanced technologies and management practices, to secure access to natural resources and in some cases to diversify from increasingly competitive home markets. Controversy can arise if SOEs are perceived to be moving jobs or investment offshore – to either grow new markets or cut costs.

A range of countries have strategies in place that guide the internationalisation of their SOEs, ranging from non-directive consent to SOEs expanding abroad to strategic use of SOEs to acquire access to key infrastructure, services or natural resources (e.g. Singapore, Finland, France etc.).

Irish experience to date has been mixed:

- In response to the regulatory requirement to develop competition in the Irish electricity generation market, ESB was instructed to divest generation assets in Ireland. ESB planned to offset the consequent loss of revenue by diversifying further into activities abroad. In 2002, ESB proposed to purchase eight power distribution companies in Poland where it already had made significant investments. ESB had been selected as the preferred bidder, but was instructed to withdraw from its planned investment[55]. Subsequently ESB, through a subsidiary, has continued its international

54 The international activities and impacts of state-owned enterprises, Shapiro et al, Simon Fraser university, July 27, 2009

55 Sweeney 2004, Selling Out? Privatisation in Ireland

expansion and invested in Northern Ireland, Britain and Spain and has a small share of a generation plant in Pakistan;

- While Aer Rianta could have been regarded as an early leader internationally in the development of airport shopping, many firms now compete in this market.
- Mac Carthaigh found that major investments require approval from a parent department as well as the Department of Finance when taking out loans and establishing subsidiaries. Furthermore, a third of the 25 enterprises surveyed stated that they cannot shift budgets between years[56].

The home market for Irish SOEs is small. In order to reach the scale required to maximise company potential, it may be necessary for some Irish SOEs to expand abroad. Internationalisation of SOEs can also enhance the performance of firms through access to technical expertise, market knowledge and resources – offering the potential to increase export earnings, profitability and ultimately dividends for the State. However, international activities may entail higher risks and potential losses for the State as shareholder. Given constrained resources (e.g. financial and management focus), management may seek to capture more profitable opportunities abroad rather than develop the domestic market. There is also a danger that SOEs may use monopoly rents in the domestic market to fund overseas ventures where they enjoy no real competitive advantages.

A key issue is the extent to which state enterprises should be free from political and administrative constraints in setting their priorities and strategic direction e.g. should enterprises be allowed to build up or use their reserves with a view to expansion or should they be directed to channel any profits either to government (in the form of dividends) or to customers (in the form of cheaper prices). The issue is whether the public policy objectives that motivate state ownership in the first place are 1) inconsistent with an overseas expansion strategy; 2) whether this brings them into competition on an ‘uneven playing field’ abroad due to their status as an SOE; and 3) whether the overseas expansion could imperil their domestic objectives.

It is important that the board and management enjoy the freedom to pursue commercial opportunities abroad provided that they fulfil their mandate domestically and that the proposed activity is clearly within their mandate. Hence, the importance of having clear missions and goals and strong corporate governance frameworks to ensure they deliver. If SOEs have real competitive advantages in winning business overseas, they should be able to compete successfully against (overseas) competitors in the domestic market without enjoying special supports or privileges. There is potential to clarify Irish policy in terms of the international activities of SOEs.

56 Mac Carthaigh, 2009, The Corporate Governance of Commercial State-Owned Enterprises in Ireland, Institute of Public Administration.

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Forfás
Wilton Park House
Wilton Place
Dublin 2

Tel: +353 1 607 3000
Fax: +353 1 607 3030

www.forfas.ie