ASSESSMENT OF ANTI-CORRUPTION AND MONITORING MEASURES IN KUWAIT'S PRIVATIZATION PROGRAM

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ABSTRACT

The State of Kuwait is a small rich oil based economy characterized by dominance of the large public sector and limited participation of the private sector in major economic activities . Such dichotomy has adversely affected real economic growth, in particular, the nonoil GDP. The government of Kuwait, in its efforts to diversify sources of income and energize the role of the private sector in economic activities, opted to reduce the large size of the public sector by embarking on a privatization program. For this purpose, The Supreme Council for Privatization (SCP) was established in 2012 to regulate, implement, and supervise the privatization program. This paper aimed to highlight on the objectives of Kuwait's privatization program and described in details the three phase implementation process. The paper has also addressed the anti-corruption and monitoring measures the SCP intends to adopt to insure the transparency, good governance, and fairness of the privatization program. Finally, recommendations and policy implications that can enhance the privatization process and the performance of SCP were presented.

***Keywords**: Private sector, Public sector, Privatization program, Anti-corruption, transparency, Kuwait.*

Introduction

Kuwait is a small rich economy with abundance in crude oil that is entirely owned by the state. Due to unprecedented high oil exports and revenues, total nominal GDP grew substantially by 51.23% from US$ 125.3 bn in 2010 to a historic high level at US$ 189.5 bn in 2012. in 2012, Kuwait's oil and nonoil GDP accounted for 60.6% and 39.4% of total nominal GDP, respectively. Moreover, oil revenues accounted for around 96% of exports and 94% of government income (CSB, 2013). Consequently, Kuwait's economy can be characterized by the dominance of the public sector and heavy dependence on oil exports both in terms of the generated value added and revenues. The government of Kuwait in its efforts to share the oil wealth with citizens has adopted an extensive welfare-oriented approach toward development. The development of Kuwait has tremendously depended on public policies geared toward heavy government spending. consequently, such public policies have led to the dependence on the government for the provision of employment and most social services. Such dependence has created prolonged structural imbalances that include among others:

- Overwhelming contribution of the public sector to GDP compared to the contribution of the private sector (70% public vs. 30% private).
- Government revenues are dominated by a single source coming from the sale of oil and other hydrocarbon products, which makeup over 94% of total revenues.
- Labor market dichotomy, with over 75% of the national labor force working for the public sector, whereas over 80% of the expatriate labor force work for the private sector.

These structural imbalances have adversely limited the role and the contribution of the private sector in economic activities. This fact has detrimental impact on the sustainability of long-term economic growth. Over the period 2002-2012, the share of the private sector in GDP has averaged around 31.1%. Once more, this fact signifies the limited role of the private sector in Kuwait's economy (CSB, 2013). In terms of the public budget, government spending in FY 2012/2013 reached US$ 68.3 bn, around 12.5% increase from the previous budget of US$ 60.75 bn. The rise in spending was forced by the hikes in salaries, grants, and transfer payments. Total government revenues was estimated at US$ 113.3 bn, with oil income constituting 93.6% of total revenues. More importantly, the primary budget surplus peaked at US$ 44.9 bn in 2012 (Ministry of Finance, 2013). Expenditures on salaries and miscellaneous expenditures (subsidies for electric and water, health, education) constituted around 72% of total public spending. In contrast, spending on capital investment and developmental projects constituted only 9.3% of the total expenditures. This fact emphasize and accentuate the limited opportunities for private sector involvement in developmental activities. Hence, the dependency of state budget on oil income raises the concern on the future strains that these expenditures will have on the public budget in the light of government lack of efforts to diversify its sources of income.

In response to these structural imbalances and increasing pressures on the public budget, and in order to energize the role of the private sector in economic activities, the government of Kuwait opted to reduce the large size of the public sector by embarking on a privatization program. For this purpose, The Supreme Council for Privatization (SCP) was established to regulate, implement, and supervise the privatization program. This paper aims to focus on the aspects of anti-corruption and monitoring measures, the SCP intends to adopt to insure the transparency, good governance, and fairness of the privatization program. The concerns for focusing on anti-corruption and transparency arises for two main reasons:

- According to the Corruption Perception Index published by Transparency International, in 2013 Kuwait had a score of 43/100 points, and it was ranked 69/177 in terms of corruption. It should be noted that scores below 50 points and high ranks indicate that the country is perceived to have serious corruption issues[4].
- Due to the fact that the public sector in Kuwait dominates most of economic activities, privatization will involve the transfer of many large public assets with high associated values to private firms (local/foreign). Emphasising anti-corruption and monitoring measures within the operations of the SCP will assure transparency and consequently safeguarding the interest of the different stakeholders and the public at large.

Based on the aforementioned, this paper will proceed in the following structure: Section two will present a brief background to issues related to privatization with focus on the basic requirement for the privatization transition process. Section three will shed the light on the objectives and the three phase implementation process of Kuwait's privatization program. Section four highlights the main transparency and anti-corruption measures in the privatization process. Finally, recommendations and policy implications are presented in section five.

Background to Privatization

Historically, governments in developed economies have played an important role in achieving high level of economic growth by limiting their role to proper regulation of the economy, implementation of laws, and property rights protection. On the contrary, the international experience shows that economies largely controlled by governments (public sector) have witnessed relatively low level of economic growth. This is due to the fact that most economic decisions are taken by governments with the absence of the private sector interest (Mavrov, 2007). A study conducted by the World Bank (2002) conclude that the private sector plays an important role in promoting economic development and growth. It contributes directly to enhancing the quality and the standards of living, and achieves integration with the public sector by providing the products and services needed by the society. The allocation of many activities to the private sector should reduce the burden of providing such services by the public sector. In turn, the public sector can focus on regulating, supervising, and monitoring these activities through appropriate public policies. Furthermore, the allocation of economic activities to the private sector should foster a competitive business environment that could increase quality and/or reduce cost of the output (products and services). It could also create an enabling environment that might attract foreign investment leading to more competiveness and gradual removal of monopolistic practices (Dabbah, 2010). As a result, reducing the role of public sector in economic activities could minimize inefficient public spending and enhance allocation of resources.

Privatization is one of the most significant tools that countries can implement in order to speed up economic growth. Privatization involves the transfer of public entities or projects owned and operated by the government to private firms. The domain of privatization may extend from complete ownership ceding of publicly owned and operated enterprises to the private sector at one end of the spectrum, to restructuring of publicly owned and operated enterprises based on commercial principles, at the other end. This spectrum includes other privatization arrangements such as public private partnership (PPP). However, there are certain prerequisites that need to be met for effective implementation of privatization process. The most

[4] Source: http://www.transparency.org/

significant of these prerequisites is the provision of an environment that is conducive to promote effective large-scale private sector engagement in economic activities. The enabling environment includes infrastructure, legislation, regulation, and ease of doing business. Countries that are more successful in providing such an environment will be in a better position to reap the benefits of privatization (Bennett et al, 2007).

The recent experience of private sector development process of transitional economies (mainly the former Soviet Union and Communist bloc countries of Europe) verify and confirm speedy and effective private sector growth. Since the early 1990s, the rapid growth of the private sector in these economies coincided with the transfer of assets from the public sector to the private sector. This could be attributed to the aggressive privatization policies adopted by these economies along with removal of constraints that inhibited private sector development. Their achievements verify the positive direct relationship between GDP growth and a more active role of private sector in the economy (EBRD, 1991-2010). Moreover, the early years of the transition period witnessed a notable rise in the number of firms, a fundamental shift in the size distribution toward smaller enterprises, and the creation of a service sector largely comprising of numerous small enterprises (Brixiova and Kiyotaki, 1997). In essence, the transition process can be viewed as the functional restructuring of the role of public entities from being a provider to a regulator and an enabler, with emphasis on the private sector as an engine of growth.

Kuwait's Privatization Program Objectives and Implantation Process

As mentioned earlier, in response to concerns of a large public sector, the government of Kuwait decided to reduce its role in some economic activities by embarking on a privatization program. The most important step in Kuwait's privatization initiative was the declaration of the law 37/2010 for regulating the privatization program and operations. Subsequently, the Supreme Council for Privatization (SCP) was established in May 2012 by the Amiri Decree 106/2012 for the purpose of executing and implementing the law. While the SCP is its initial stage, it faces (as a legislator and regulator) many challenges, including among others, selecting the appropriate method of privatization for each project relative to the operating conditions and requirements of specific sector, formulating a comprehensive legislative and organizational framework to support the privatization process, and protecting the interest and rights of all concerned parties involved in the process (government, investors, consumers, workers, citizens). The main objectives of Kuwait's privatization program, as envisioned by the law 37/2010, can be summarized in the following:

- Increase the role of the private sector in economic activities.
- Enhance the competitiveness of the local economy.
- Attract local and foreign direct investments.
- Assess in developing capital markets.
- Build a friendly business environment.
- Provide a fair distribution of national wealth among citizens.
- Protect and rehabilitate national labor.
- Prepare the private sector to absorb a fair share of the national labor force.
- Enhance the overall state public budget.
- Protect the local environment.

Upon its establishment, the SCP embarked on the complicated challenge of drafting and approving the Executive Regulations (ER). In the same time steps have been taken to educate all official participants about the privatization process, and once the ER is approved the process will be disclosed to the public at large and posted on SCP's website. It should be noted that some extra obligations could have been removed from the ER to increase flexibility of the implementation procedures. However, it was opted to proceed in favor of transparency rather than operational flexibility, although this direction might carry potential liabilities. In drafting the ER, three phase implementation process was envisioned to facilitate the execution of the privatization law. Although many universal privatization schemes/processes can be adopted, the proposed implementation process by the SCP is a well thought process that takes into account the present governmental procedures in conducting activities within an independent public entity such as the SCP. In essence, the proposed three phase implementation process has been formulated in a unique way, with many specialized experts participated in its development. The three phases process is presented in Figure 1. and can be summarized in the following:

- **Establishment Phase**: The initial phase aims to convert the public project to a company under-establishment (corporatization) and entails taking important steps that includes: appointment of establishment committees. Preparation of Final Assets Identification Report (FAIRs) and Opening Balance Sheet B/S using International Financial Reporting Standards (IFRS). Projection of the company financial budget during the transitional period (i.e. preliminary business plan). The transfer, registration, and legal filings of assets and liabilities to the Joint Stock Company (JSC).
- **Preparation Phase:** This interim phase aims to insure the corporate governance and restructuring of the JSC. The required actions in this phase include: establishment of a temporary executive board. Appointment of Privatization Plan Development Committee to oversee the formulation and implementation of the privatization plan for each JSC. The plan should address the JSC domestic and regional competitiveness, potential strategic investors, human resources, regulatory issues, shareholders structure, timetable and budget. Monitoring the operational and financial performance of the JSC is an integral part of implementation of the privatization plan. Finally, this phase is conclude with proper financial evaluation for the JSC.
- **Execution Phase**: in the final phase all the steps and procedures are taken to sell the JSC and complete its privatization. The major steps include determining the size of government ownership in the new company. Sale to strategic investor (which entails evaluation of qualified investors, due diligence procedures, bid evaluation). Procedures for public share offering.

Transparency and Anti-Corruption Measures in the Privatization Process

In order to facilitate the proper transformation of a public projects or SOE's to JSC's and increase the prospect of attracting prominent strategic investors, the SCP had adopted many measures to insure transparency, good governance, and improve anti-corruption practices. To emphasize the importance of these measures, they were incorporated into the SCP's ER accordingly. The following is a brief description of some transparency and anti-corruption measures:

- **The Use of Independent yet Complementary Committees**: In order to maintain high standards of governance, the process opted to use three cooperatively independent yet complementary committees (see figure 1):

1. The Incorporation Committee
2. The Privatization Plan Development Committee
3. The Strategic Sale Committee (qualifying investors, supervising due diligence processes, and bid evaluations).

The process allows for potential overlap in committee personnel in order to account for intrinsic knowledge accumulation inherent in the process. However, this advantage should not come at the cost of reduced accountability. In other words, governance standards and transparency are not compromised in favor of streamlining the process.

- **Higher Implementation Costs:** For selected public projects to be privatized, in order to prepare both a Final Assets Identification Report (FAIRs) and opening Balance Sheet B/S, two (2) valuations carried by two (2) independent valuation firms, at least one of which is an international firm, are used. A reconciled valuation certificate is used when there are substantial differences between the two independent valuations. Similarly, after completion of the restructuring phase and before the start of the execution phase the company's final valuation (FV) is performed by two (2) independent valuation firms, at least one of which is an international firm. Once again, a reconciliation certificate is used in case there are substantial differences between the two independent valuations. While the detailed financial evaluation will be associated with high financial cost endured by the SCP, it will insure a more transparent process.
- **Disclosure and Supervision:** the following steps and measures will be implemented to assure proper disclosure, monitoring, and supervision:

1. The FAIR and the opening B/S, carried out in the preparation stage, will be submitted for the State Audit Bureau (SAB) for approval. However, to expedite the process any objections by SAB on the standards used in the development of the opening B/S should be submitted in writing (i.e., specifying reasons for objections) within 30 days from the original submission date.
2. The execution of company's restructuring through the implementation of "the Privatization Plan" is closely supervised by the SCP executive committee, which reviews quarterly and semi-annual reports. Any deviations from the original plan or timetable should be justified by the "Temporary Board," which is responsible for both the restructuring as well as the execution phases. The direct supervision will strengthen the monitoring process required in the critical preparation stage.
3. The final valuation (FV) is disclosed and used as the basis for the strategic investors bid submissions and evaluations. All the steps needed to reach the final valuation insures transparent process leading to the appropriate final valuation.

- **Monitoring and Punitive Measures**

The SCP's will establish a "Monitoring Division" with the following main responsibilities:

1. To safeguard the SOEs assets during the restructuring phase (i.e., implementation of the privatization plan).
2. To ensure that the obligations agreed by the strategic investor, especially towards the company's national labor are being met.
3. Chapter 6 of the ER (articles 15-29) intends to reinforce the monitoring of the privatization process by addressing the issue of conflict of interest between the obligations of both the newly privatized companies as well as the Official Participants (OPs). This is done by clearly defining an exhaustive list eligible of OPs in the privatization process, and establishing firm disclosure guidelines for their roles in the JSC's and/or any association with strategic investors.
4. The ER defines the procedures that will be implemented in the event a case of "conflict of interest" of Ops has been found. A list of punitive measures against the OPs makeup a progressive penalty system according to the severity of the violation, ranging from expulsion from boards, fines, confiscation of illegal profits all the way to taking civil or criminal proceedings against the violating party.
5. In order to minimize abuse and misuse of the critical information, the ER defines a "critical information" set and restricts its distribution based on a "need to know" basis.

Conclusions and Recommendations

The review of international experience in private sector development shown that many transitional and developing economies have adopted a combination of privatization, FDI, SMEs, and overall improvement in business environment measures, in order to increase the role of the private sector and achieve high economic growth. Privatization is an important economic/political tool that the State of Kuwait is embarking on in order to rectify some of the economic imbalances induced by the large public sector, and to speed economic growth through a vibrant private sector. The establishment of the Supreme Council for Privatization (SCP) is the first positive step in the privatization process. However, proper privatization policies and effective implementation programs are well needed to ensure that the privatization efforts will support the transformation of Kuwait's economy. policy makers should pay attention to the following issues that might affect the proper implementation of the privatization program and process:

- **Economic Reform**: Privatization works best when it's part of a larger program of economic reforms. The other components of reform include capital market liberalization and development, private sector development, and enabling business environment. Therefore, it is very significant and crucial that Kuwait should be implementing, as rapidly as it reasonably can, the economic reform and business environment improvements that will enable an environment that is conducive to promote effective large scale private sector engagement in economic activities. Such improvements will also create better conditions for higher volumes of investment.
- **Regulation**: Is critical to the successful privatization of monopolies. A well-developed and administrated regulatory framework ensures both the productive efficiency of the company and the protection of all interested parties in the process; namely, consumers, government, national labor, and private investors. The SCP should be able to coordinate with all governmental entities in reaching an effective regulatory framework.
- **Preparation Process**: Successful privatization of large public enterprises entails breaking them into competitive marketable units, hiring of dynamic managers (mainly from the private sector), settling all past liabilities, and getting rid of excess labor. Within this context, SCP should have the political support from both the government and the Kuwaiti parliament to achieve these objectives.
- **Transparency:** Is critical for economic and political success and can be insured by adopting competitive financial evaluations, bidding procedures, developing objective criteria for selecting bids, and monitoring the implementation process effectively with minimal bureaucracy. The main body of this paper has addressed these issue in details and signified their importance within the implementation process of the privatization program.
- **Protection of National Labor**: The government should adopt a generous severance packages to encourage voluntary departures and early retirement options and reduce the need for the outright dismissal of excess national labor. These social measures will validate the importance of the privatization process with the public at large. While these measures require huge financial resources, it will enable the privatized companies to operate efficiently in the long run.

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Figure 1. The SCP Implementation Process of Kuwait's Privatization Program