Government in business needs smart partnerships

BY CHEW SENG KOK AND SHAUN KUA KENG HIAN

In his Budget 2019 speech, Finance Minister Lim Guan Eng declared that "the business of the government is not to be in business ... and the government will focus its expenditure and investments only in strategic sectors and areas where free markets and the private sector are not interested or unable to meet the needs of the people and the economy".

Academician Terence Gomez of Universiti Malaya estimated that, as of 2017, government-linked companies (GLCs) owned by the government-linked investment companies (GLICs) constituted 42% of the total market capitalisation of all public-listed firms in Malaysia. At the Malaysia: A New Dawn forum last October, Lim's political secretary Tony Pua said that divestment of some non-core GLC assets would raise much-needed funds and encourage greater participation of the private sector.

How will the government decide which enterprises should be the target of its investment or divestment, and why? The Pakatan Harapan government has a unique opportunity to conduct a fundamental and strategic rethink of the role of the state in business, beyond immediate fundraising and addressing "crowding-out" concerns. At present, the government is missing a public overarching "ownership policy" that discloses when, why and how the government may impose public policy objectives on GLCs and GLICs.

One common justification in the 1980s and early 1990s was that the private sector would not otherwise invest in these crucial businesses. This "market-failure" rationale is uncontroversial and often relied on by governments to justify control or ownership of assets and businesses. It was a particularly populist rationale when combined with the bumiputera empowerment agenda as a major social justification for investments.

The government implemented this objective through government-linked investment companies such as Khazanah Nasional Bhd and Permodalan Nasional Bhd or by investing in GLCs such as Tenaga Nasional Bhd, Telekom Malaysia Bhd and UEM Group Bhd. As capital markets were then relatively underdeveloped, government assistance to start Perwaja Holdings Bhd, Heavy Industries Corp of Malaysia Bhd (Hicom) and Proton Holdings Bhd was thought necessary. Alternatively, it was said that a "big push" by the state was needed to catalyse coordinated upstream and downstream development of certain industry ecosystems, leading to investment in companies such as Silterra Malaysia Sdn Bhd, a wafer fab and semiconductor manufacturer.

Another rationale was that public goods or natural monopoly cost structures required government investment as shareholders in companies involved in these sectors. Unlike companies, whether public or private, the GLCs have to answer to a wider group of stakeholders, beyond the shareholders and investors. The government, as a major or strategic shareholder in the GLCs, has a broader political or social agenda beyond maximising profits.

The public, as consumers of the products or services of the GLCs, especially those in utilities or infrastructure, do not favour any increases in tariffs, however well justified. The unions and employees may not necessarily be sympathetic to any restructurings to enhance shareholder value if these steps will result in job losses.

The government will have to manage these conflicting objectives and priorities. Nevertheless, as technology disrupts long-standing industry practices, caution should be taken against using this justification to protect an entire industry value chain on this. For example, in Malaysia, electricity transmission may continue to be a natural monopoly but not electricity generation, with the advent of independent power producers with substantial private sector investments.

The concept of "strategic sectors" is more controversial. Practically every government investment has been called "strategic" at least once before! What makes an investment truly so? Most state investments were and continue to be justified on the ground that they are critical to serve as a catalyst for industry development or economic growth. Examples include Boustead Holdings Bhd in defence and Telekom Malaysia in telecommunications — major GLCs whose dominance in the industries are often justified on national security or geopolitical reasons. This rationale should not be too quickly dismissed as outdated or even socialist.

The Washington Consensus prescribing wholesale deregulation and privatisation has collapsed. The rise of the BRICS (Brazil, Russia, India, China and South Africa), particularly China, has provided a tempting, alternative, state-driven developmental model. On the other hand, the UEM Group was acquired as a GLC in the wake of the 1998 Asian financial crisis, the rationale being that its potential collapse posed systemic risks to the banking sector and capital markets. Nevertheless, the fact that the acquisitions were strategic then does not necessarily mean that the government should continue to own a substantial stake in them.

We have two concerns on the dominance of government in business. First, government ownership or control of strategic businesses or assets must avoid any unintended "crowding out" or undermining of our robust and successful private sector. The previous approach of opaquely selecting individuals as "national champions" has been criticised as an example of cronyism and state capture. Indeed, "picking winners" has, ironically, often left us with losers requiring subsequent government bailout such as Perwaja Steel and Malaysian Airline System Bhd.

If the government's approach is to target entire "strategic sectors" as suggested by the finance minister, it can facilitate competition by backing not one, but multiple, competing firms. For all the criticisms of the national car project, it was courageous of the government to pit two competitors, Proton and Perodua, against each other. If this competitive approach can be adopted in the automobile industry with its high-capital intensity and strong economies of scale, why not emulate it in other industry sectors?

An alternative approach is to ensure that where the government undertakes business activities in competition with the private sector, they do so on a fair and equitable basis. In 2000, the state government of Victoria, in adopting a competitive neutrality policy, defined it as "the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities". In short, government business should not enjoy any net competitive advantage simply as a result of its public sector ownership.

Second, substantial funds are usually required for the government to exercise control or influence over a GLC. The traditional majority ownership stake gives the government both ongoing control and a share in the upside of the business. With respect, we believe it is neither necessary nor important for the government to always own or have majority control of every enterprise that it invests in. It is possible to structure alternative mechanisms for the government to achieve this objective without necessarily having to own a substantial stake. Where both control and share of profits is not needed, the government can provide finance by way of debt through the many state-owned development banks.

This is applicable to small and medium enterprises and projects in conventional, relatively low-risk industries. Where a share of profits is needed but not full control, the government could take a minority stake or legal devices like royalty rights over intellectual property. For high-technology or start-up investments, this "light-touch" portfolio approach to investment is more appropriate. Where control is needed but a share of profits is not, there is always the time-hallowed but heavy-handed golden share. But, its use should be limited to truly strategic enterprises as they bear the risk of abuse without direct financial returns to the state.

Where the government needs to maintain majority shareholdings, there is all the more reason to ensure good governance of GLICs and GLCs. While GLC governance has improved since the completion of the GLC Transformation Programme in 2015, the recent controversies at Lembaga Tabung Haji indicate that there is room for improvement. Beyond the recent specific reforms for TH, broader reforms across all GLCs and GLICs are needed. Transparency and disclosure of specific data on GLIC investment performance as well as on the appointment criteria and remuneration of directors at GLCs and GLICs can be improved. To this end, the government can resuscitate the idea of a State-Owned Enterprise and Government-Linked Companies Act.

Moving forward, we suggest the government should recalibrate its focus from sectors to technologies. Given Malaysia's so-called "middle-income trap", the government should invest with the aim of fostering innovation. As the economist Mariana Mazzucato noted in her book, *The Entrepreneurial State*, innovation is highly uncertain, collective and cumulative, and has long lead times. Hence, the need for "patient" capital by the state, as opposed to private venture-capital funding, which can be excessively focused on short-term exits.

Even radical inventions like the smartphone have been traced back ultimately to research funded by the US government. If the state promotes "general-purpose" technologies such as artificial intelligence and renewable energy, private sector investment can be "crowded-in" by the spawning of entirely new markets for products and services. One would not describe most GLCs as paragons of such innovation.

In Malaysia, we already have state-owned venture capital funds such as Malaysia Technology Development Corp, Malaysia Debt Ventures Bhd and Cradle Fund Sdn Bhd. The streamlining of these funds as well as the RM2 billion matching grants announced in Budget 2019, while laudable, do not go far enough. The sums they have invested so far are miniscule compared to that by the GLICs. This may be understandable given these VC funds' mandates to support early-stage or seed financing. Whereas GLICs like the Employees' Provident Fund, Kumpulan Wang Persaraan Diperbadankan and Lembaga Tabung Angkatan Tentera need reliable cash cows, not uncertain start-up moonshots, to consistently deliver annual dividends.

We believe choosing between profitability and innovation is not a zero-sum game. To raise funds for investments in innovative companies, GLICs can divest stakes in certain asset-rich GLCs that have persistent losses or low profitability, no business synergies with other GLCs and insignificant strategic or social value. These will contribute little to GLICs' cash flows in any case, even in the long term. For example, the Rangkaian Hotel Seri Malaysia Sdn Bhd is owned by no less than Minister of Finance Inc (MoF Inc) and operates 19 hotels throughout Malaysia but has suffered occupancy, branding and management challenges over the past decade.

Neither do we advocate a 360° change in GLIC risk appetites and investment strategy. Some of the funds raised from divestments of unprofitable investments can be channelled into risky early-stage financing via state-owned VC funds, with the balance to be retained by the GLICs for safer late-stage investments in more mature companies.

Khazanah and MoF Inc, the more "strategically-oriented" among the seven GLICs, would be most suited for this mission. Khazanah has already invested in successful tech firms such as Phunware Inc in 2009 and Garena and Blippar in 2016. However, as reported by New Straits Times on Jan 11, 2019, Khazanah's current investment in innovation and technology companies stands at only 4% of its total portfolio. If carefully managed, a gradual shift in GLIC portfolios further towards more mature tech investments need not significantly affect GLICs' risk profile.

Malaysian GLICs and GLCs are currently, at best, maintaining a comfortable existence. But, if well-focused, well-governed and well-regulated, they can have tremendous potential in unlocking creative destruction or disruption in businesses without crowding out the private sector. This smart partnership between the public and private sectors can propel Malaysia to the next stage of economic growth. E

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