THE PUBLIC BENEFIT OF PRIVATE OWNERSHIP

THE CASE FOR PRIVATISATION

NEW ZEALAND BUSINESS ROUNDTABLE

JUNE 1992

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SUMMARY

The New Zealand experience with requiring state-owned enterprises (SOEs) to be run as successful businesses demonstrates that high quality reforms can generate enormous gains in productivity, product quality and profitability - along with lower (real) prices for consumers.

Nevertheless, the gains were always likely to be limited by the difficulties involved in:

* applying full commercial disciplines when state industries do not *have* to succeed to survive;

* providing risk capital to SOEs when fiscal constraints and/or political considerations may conflict with commercial goals;

* making the competitive environment genuinely neutral, when continuing government ownership brings with it the possibility of future state bail-outs; and

* maintaining the early gains in the face of the political pressures to weaken the commercial disciplines which were put in place when the SOEs were first formed.

The New Zealand experience (post-1986) with the SOE process does indeed confirm the reality of such difficulties, in that continuing public ownership has clearly been associated with:

* a degree of instability and disruption, reflecting the inability of political processes to resolve key strategic questions definitively given the ongoing conflict between commercial and political goals;

* periodic friction between some SOEs and the government about commercial decisions;

* a tendency for some appointments to the boards of SOEs to owe more to their political connections than to their commercial expertise;

* an apparently growing tendency for direct political intervention in commercial pricing decisions for reasons unrelated to commercial considerations; and

* a political focus on remuneration levels in SOEs, without regard to either performance considerations or the effects of this focus on the ability of the SOEs to recruit and retain high quality, commercially oriented staff.

All these developments suggest that the SOE model is unstable in that over time political and bureaucratic processes will tend to reassert themselves. Ultimately state-owned trading enterprises could revert to their previous departmental status ñ which is so inimical to the employment of commercial expertise and to the efficient management of the Crownís assets. This expectation is consistent with worldwide experience with nationalised industries.

These difficulties with the SOE model extend to partial privatisations. Partial asset sales introduce the additional risk that non-government shareholders might gain benefits at the expense of the government.

Far from being unique to New Zealand, such weaknesses have been recognised internationally by such organisations as the World Bank (arguably the most experienced agency in the world in these matters) and the International Monetary Fund. As the World Bank has noted, ìthe performance of state-owned enterprises can be improved without changing ownership, but evidence from both developed and developing countries shows that, on average, good performance has been difficult to implement - and even harder to sustain".

The problems cannot be readily fixed under continuing government ownership; they are inherent in the interplay between government ownership, political democratic processes and the government's conflicting roles. Politicians do not have the knowledge, the incentives or the training to make commercial operating and strategic decisions, and neither can they readily monitor the effectiveness with which public sector managers make delegated decisions.

The developing recognition of these difficulties with public ownership, in an increasingly competitive world, has seen the sale of almost 7,000 SOEs in more than 70 countries since the early 1980s. The problems of running public enterprises are one part of the wider problems associated with state-controlled economies, and privatisation is now spreading rapidly in Eastern Europe and the former Soviet Union.

Nevertheless, business sales are no panacea. For society to obtain the full benefits from such sales it is essential that the activities that governments sell are exposed to full commercial competitive pressures. Where monopoly issues arise, the regulatory environment should maximise the incentives on firms to find ever-better ways of meeting customer needs.

Best practice international advice for governments contemplating sales of state-owned businesses stresses the following key features:

* address regulatory issues prior to sale;

* impose little if any regulation on SOEs functioning in competitive markets;

* make efficiency the primary goal of asset sales - do not seek to improve sale revenues by sheltering the SOE from competition, and do not weaken managerial incentives by seeking to avoid concentrated shareholdings;

* avoid, wherever possible, prohibitions on who can buy shares - e.g. use golden shares to protect any residual national interests;

* ideally, let the market set the price of the asset and sell for cash, and make the transaction clear, final and transparent;

* where the sale is large relative to the size of the local capital market, recognise that open bids in a competitive tender can be superior to sale through the sharemarket; and

* facilitate the sale process where necessary by easing transitional costs for the SOE labour force through severance pay, unemployment benefits, retraining and job search assistance.

Against these criteria, the New Zealand privatisation process clearly scores very highly - which explains the favourable attention which it has attracted internationally. In particular, a recent International Monetary Fund publication used the sale of Telecom as an example of a successful business sale.

Even so, the New Zealand privatisation process has inevitably fallen short of the ideal:

* problems arose from partial sales - notably the part sale of Petrocorp to Brierley Investments and the part sale of the BNZ;

* controversy and continuing government involvement has arisen from the put and call options associated with Fletcher Challenge's purchase of the Crown's shareholding in Petrocorp;

* problems have arisen during the sale process. Opposition to the sale has come from some of the boards and/or managements of the SOEs, from political lobbying by potential bidders, and from the political difficulties associated with determining the precise terms and conditions of sale. Not the least of these difficulties were Maori land claims.

Nevertheless, despite the almost inevitable problems associated with the privatisation process, a survey of entities which have been sold supports the view that the benefits are substantial and stem from their improved ability to:

* focus on commercial objectives;

* resolve strategic issues;

* obtain international expertise and other benefits through shareholder ownership structures;

* make major capital expenditure decisions;

* change the organisational culture; and

* remunerate key staff appropriately for a commercial operation.

Fears of increased prices following privatisation have not been borne out. Typically reductions in costs and prices have continued and service standards have improved further. It is now apparent that it was the former publicly-owned entities (such as harbour boards) that were responsible for inflated charges (even though they were not required to make commercial profits). The benefits of competition and private ownership have been highly visible in cases such as the airline industry (Air New Zealand and Ansett) and telecommunications (Telecom and Clear).

The benefit the nation derives from Crown asset sales is not limited to the gains from securing and locking in an improved commercial performance. Freeing the government from the need to ensure that these enterprises are using resources wisely should allow it to better focus on core public policy issues. Where the provision of social services requires the use of commercial vehicles for their delivery, this can be achieved by competitive contracting. The dominance of private ownership amongst the most successful economies, and the greater ability of the prosperous market economies to provide affordable social assistance, illustrates the point that selling assets can complement the pursuit of other goals.

Improved environmental outcomes are another illustration of this point. Severe environmental damage has occurred, particularly in Eastern Europe, as a result of the distorted incentives facing managers of state enterprises. As the World Bank has noted, ″[t]he environment can benefit as the managers of state enterprises are made more accountable and exposed to the same competition as the private sector″. It has further argued that assigning private property rights to resources is a more effective environmental strategy than nationalising them in the name of conservation.

Since the former public sector organisations are frequently grossly overstaffed from a commercial perspective, substantial job losses can be associated with the process of converting them into successful businesses. Such costs of change must be balanced against the less visible costs associated with maintaining the status quo. Keeping individuals working in unproductive jobs is to prolong the wastage of their talents and to continue to impose excessive costs on other, more productive enterprises and reduce their capacity to create jobs. Given the need to change, it is better to facilitate change through labour market and income support policies.

Finally, privatisation should be seen as one part of a broader agenda for improving social and economic outcomes in New Zealand. As the World Bank has noted, ì[t]here is no magic bullet, and if there were, privatisation would not be it. But it does make an important and significant contributionî. The decision as to whether or not continuing government ownership of an asset is desirable must be made on a case-by-case basis.

Such a decision needs to be informed, however, by a due recognition of the general advantages which attach to private ownership.

1. INTRODUCTION

This paper reviews the New Zealand experience with the corporatisation and privatisation of state-owned trading enterprises (SOEs) in order to assess the case for further privatisations. The corporatisation process centred on requiring these enterprises to operate as successful businesses while remaining under government ownership. Privatisation refers to the sale of these enterprises (or their assets) to private owners.

A notable feature of the New Zealand economic environment for many decades up to 1984 was the dominant position of state trading enterprises in many sectors. In the financial sector the government owned outright the largest commercial bank (the Bank of New Zealand); the largest savings bank (the Post Office Savings Bank); the largest insurer of motor vehicles (State Insurance); the largest lender of farm mortgages (the Rural Banking and Finance Corporation); the largest residential landlord and lender on residential mortgages (the Housing Corporation of New Zealand); and one of the largest merchant banks (the Development Finance Corporation). It ran one of the largest businesses in the insurance/superannuation industry (the Government Superannuation Fund) and controlled the boards of four more (the Government Life Office, the National Provident Fund, the Accident Compensation Corporation and the Earthquake and War Damage Commission).

In the utilities sector, it owned the entire telephone industry, the wholesale electricity distribution sector and virtually all generating capacity. In addition, locally-elected boards controlled the ports, the retail distribution of electricity, and (very commonly) gas.

In the energy sector, the Crown owned the dominant wholesale gas supplier (the Natural Gas Corporation); it also had major interests in oil and natural gas products through Petroleum Corporation (Petrocorp), and it owned the major producer of coal (State Coal).

In the transport sector, the Crown owned the rail system, a major bus network, the inter-island ferry service (all through the Railways Corporation), the sole national airline (Air New Zealand) and a national shipping line (the New Zealand Shipping Corporation). The government also had significant shareholdings (along with local government) in New Zealandís three international airports.

In broadcasting, the Crown owned the only two television channels and all the nationwide radio networks.

The Crown also owned a major tourist hotel network (the Tourist Hotel Corporation), the postal system and more than half New Zealand's commercial forests (now the Forestry Corporation). It was a major investor in farmland (now through the Land Corporation) and urban non-residential property (now Government Property Services). It also controlled much of the nationís likely mineral resources through an extensive system of national parks.

By the early 1980s, state trading enterprises accounted for more than 12% of GDP and about 20% of gross investment in New Zealand. Moreover, public debt servicing, which accounted for approximately 18% of government spending, was arguably restricting the investment the government was able to make in other more desirable areas. Jennings and Cameron noted that "over the twenty years to 1985/86 the government invested $5,000 million (in 1986 dollars) of taxpayers' money in the departmental trading activities of the Airways System, the Lands and Survey Department and Forest Service, the Post Office, the State Coal Mines and the Electricity Division of the Ministry of Energy. In 1985/86 these organisations managed assets valued at over $20 billion but returned no net after tax cash to taxpayers.î Such statistics, in conjunction with diffused accountability for results, raise serious doubts about the value the nation was deriving from these activities.

This situation, which had evolved over many decades in response to underlying political and bureaucratic pressures, reflected the ambiguous and conflicting roles and objectives which arise from political processes.

Governments are elected to govern in the national interest, but they also bring with them narrower, party-political and interest group motivations. Vested interests may self-servingly offer to support the governing party if it diverts national resources to their advantage. Policies which lack transparency (i.e. allow resources to be transferred in ways which are very hard to quantify) facilitate this process. Ownership of trading activities is one example of such policies.

The managers of state-owned assets can be given multiple and conflicting goals. For example, product prices can be held artificially low to favour politically important constituencies, either selectively ñ as in the cases of residential electricity supply and rural postal deliveries ñ or on an across-the-board basis as can occur when inflation and/or interest rates are rising to a politically embarrassing degree. In addition, capital expenditure programmes can be targeted at stimulating activity in politically-sensitive regions or at meeting a political need to be seen to be "doing something" to boost the national economy. Finally, self-interested bureaucrats can exercise influence on departmental employment and expenditure policies.

In the event, what had evolved in New Zealand was a highly centralised system of political and bureaucratic involvement in the detailed operations of trading departments. All significant strategic, pricing and capital expenditure decisions were taken at a political level. Trading departments had little delegated authority. Consequently, managers could not be held accountable for the consequences of many of their decisions.

Information systems were geared to the government's system of financial appropriations rather than to the requirements of a commercial operation. Remuneration and employment systems similarly reflected the dominant cultural requirements of security of tenure, sensitivity to political and bureaucratic considerations and the absence of private sector performance-related incentives.

Pricing policies often responded to political pressures, with cross-subsidisation between customer groups (e.g. in electricity) and from one product to another (e.g. between toll calls and local calls) being prevalent.

The key impetus for the post-1984 reforms came from the growing political need to escape from the low growth, high inflation and escalating indebtedness which was New Zealand's lot following the 1973/74 world oil shock. In its efforts to reduce the fiscal deficit and the national debt and improve the nationís economic performance, the government naturally had to look closely at improving the operations of state trading enterprises - first to stop them from being a major drain on the state budget and thereafter to make them a net source of funds to the government and more efficient users of resources.

The process of reform was also motivated by the growing recognition internationally that there are inherent deficiencies with state ownership of trading activities, relative to private ownership. Not only are state-owned trading activities more exposed to politically motivated interference, but also they lack the full range of capital market disciplines faced by privately owned operations. In contrast to the general situation under private ownership, individuals who are ultimately liable for the consequences of poor quality decisions (i.e. the taxpayers) have no ability to either avoid these losses (e.g. by selling their shares) or to recoup them by suing those responsible for such decisions. Instead taxpayers must rely on their elected representatives, whose interests will typically differ from their own, to take steps to safeguard their interests.

Governments fulfil many conflicting roles. They regulate, redistribute income, own assets, run businesses and purchase services from those businesses. Conflicts between these roles are exacerbated by the conflict between a government's political interests and the national interest. The bureaucracies themselves have a conflict of interest when they advise on and administer policies which affect the competitive position of their own activities.

In such situations, confusion about priorities and trade-offs between objectives is probably inevitable. However, it can be reduced by organisational arrangements which assign different roles to different units and hold each unit responsible and accountable for its performance in respect of its clearly defined role. In this context, responsibility for the governmentís performance in using commercial assets efficiently has, logically, to be assigned to the managers of those assets ñ the state-owned trading enterprises.

Given the extent of the confusion of roles in the pre-existing situation, as will be seen below, the corporatisation model offered the promise of great initial savings. While such gains were no doubt seen as sufficient

justification for the changes, they did leave open, or even facilitate, the later option of achieving further gains from full privatisation.

Hence the process of structural reform of the state sector in New Zealand commenced with the corporatisation of a number of major state-owned trading enterprises. The process of corporatisation was particularly facilitated by the recognition amongst key ministers of the desirability of improving accountability for the performance of these enterprises. Within these enterprises, some of the more able employees also recognised the benefits of greater clarity concerning objectives and greater autonomy in the pursuit of these objectives.

At the heart of this reform was the state-owned enterprise model in which responsibility for non-commercial objectives was removed from SOEs, which were then required to operate as successful businesses. The government was expected to formally contract with the SOE to provide any non-commercial services in a transparent manner. A summary of the SOE framework is given in Appendix I. The current SOEs are listed in Appendix II.

The SOE model was designed to force major efficiency gains whilst maintaining Crown ownership of state trading operations. A key feature was the appointment of top quality commercial expertise to the governing boards of these organisations. The boards were responsible to ministers of the Crown who were, in turn, fully alert to the need to keep boards totally accountable for the commercial performance of the SOEs. The fragility of the SOE model arises from the continuing pressure on politicians to compromise this clarity by imposing conflicting political goals on the SOEs.

The evidence, reviewed in section 2, identifies the major efficiency gains which have indeed resulted from this process. However, it also supports the view that the gains which have been achieved may not be sustainable and are likely, even at their best, to fall short of those which can be obtained from full privatisation, subject to a well-designed regulatory framework.

Section 3 examines how privatisation has resulted in gains over and above those achieved by corporatisation in New Zealand, and mitigated a number of the flaws inherent in the corporatisation model.

Section 4 addresses issues related to privatising entities with perceived market power. Clearly there may be costs to the economy if state-owned ìmonopolisticî trading operations are sold, as is, to private owners. There is a strong case for deregulating the markets in which such firms operate well in advance of privatisation, exposing them to competitive pressures. Supplementary controls may sometimes be needed. In designing the regulatory framework, the costs associated with regulating such operations must be weighed against any benefits associated with the intervention. A relatively light-handed form of regulation has been found to be preferable in several instances.

Conclusions are given in section 5. This discussion points to privatisation as a desirable progression in the restructuring of New Zealand's state-owned trading operations. Not only would this cement in place the efficiency gains achieved through corporatisation, but it would also lead to further gains through the imposition of the full range of capital market disciplines, the relaxation of political constraints, and the incentive improvements achieved through private ownership. Furthermore, privatisation reduces the potential for conflict between the government's roles: as owner of state-trading entities, regulator of the industries in which they operate, and provider of social services.

2. RECORD OF THE CORPORATISATION MODEL

2.1 Introduction

Considerable efficiency gains have been realised from the corporatisation of state trading enterprises. The next section illustrates these gains. However, the experience with corporatisation also illustrates the weaknesses

inherent in the SOE model. Section 2.3 elaborates on this point. Section 2.4 draws some conclusions from these findings.

Of course the gains catalogued in this section reflect the influence of many factors. Absolutely fundamental to any successful reform process is political will and the appointment to board and management positions of highly competent people, with the relevant skills, who are motivated to achieve the desired results through their terms of reference and broader incentive structures.

There can be no doubt that the productivity gains listed below would not have been achieved if mediocre people who perceived that they would be well-rewarded for defending the status quo had been appointed to key positions.

In this context, the fact that the relevant boards knew that it was the government's firm intention to expose them to competition was another critical factor underlying the achievements detailed in this section.

Naturally one thing leads to another in any reform process. Excellence attracts excellence. As the proportion of highly motivated, commercially oriented and remunerated personnel in senior positions grew in each organisation, so did that organisation's enthusiasm for the reform process.

2.2 Summary of Corporatisation Gains

PostBank

Established as an SOE in April 1987, PostBank had its origins in the New Zealand Post Office Savings Bank. The commercial performance of its predecessor suffered from conflicting objectives leading to a proliferation of uneconomic outlets, inadequate computer and management information systems, and heavy political control over its deposit interest rates and range of eligible investments. In its first year as an SOE, 1987/88, it returned an after-tax profit of $30.8 million, and commenced a major programme of restructuring to place the organisation on a more commercial footing. This contrasts with an expected loss of $50 million in 1987/88 should restructuring not have occurred. Postbank had reduced staff numbers by about 30% by the time of its privatisation in December 1988, and the number of retail outlets by nearly 40% to 556.

Electricity Corporation of New Zealand

Since its establishment as an SOE in 1987, the Electricity Corporation has:

reduced real unit costs (c/kWh) by 28%;

reduced real average wholesale electricity prices by 13%;

increased productivity, as measured by GWh/employee, by 71%; and

achieved a 187% lift in profit after tax to $404 million in 1990/91.

ECNZ increased station availability, a measure of efficiency, across all 40 power stations to above international standards. It also brought in on time and within budget several large capital expenditure projects, such as the new inter-island DC link.

It reduced staff numbers from 6,076 in 1986 to 3,366 by September 1991. The number of days lost due to accident or injury has fallen dramatically. In spite of New Zealand's recent recession, the corporation was able to increase electricity sales and its share in the total energy market (from 43% to 50%).

Forestry Corporation

In its first year as a corporation, the former NZ Forest Service achieved a cash surplus of $53 million and lifted output per employee by 18%. In 1989 it had a further surplus of $94.6 million, followed by a $150 million

return in the year to March 1990. During this period it reduced staff numbers by nearly 65%. A number of former staff set up businesses, with corporation help, and contracted with it for services.

Coal Corporation of New Zealand Limited

The government created CoalCorp in 1987. Previously the state coal mines had made losses in 20 out of the last 22 years of their existence. CoalCorp's Chairman, Bob Henare, noted that prior to corporatisation the mines "... had many confusing objectives, and profit was not one of them.î Some employees had been employed in uneconomic mines at an annual cost in excess of $120,000 per job.

In the first three years since corporatisation, productivity (in terms of volume per employee) rose nearly 60%. Sales turnover per employee grew 30%, whereas real prices fell 20%. In 1986 dollars, the average price of coal was $52.20 per tonne in 1990/91 compared with $73.48 in 1986/87. In its first year of operation CoalCorp returned a small profit, growing to a $10.9 million profit in 1990, and $8.9 million in 1991. A striking example of the gains achieved through corporatisation was the Strongman mine, which quickly achieved a 20% increase in production with only a third of its previous workforce. Despite halving its workforce, CoalCorp's annual production now exceeds that of the former State Coal Mines. The corporation has been successful in a highly competitive environment, and a major share of its revenues is derived from exports.

Telecom Corporation of New Zealand

Telecom became an SOE in 1987, and was sold in September 1990. It is a major example of the transformation of an inefficient government department into a profitable, market-driven commercial enterprise. Formerly operated under the Post Office, it had been characterised by low productivity, poor service, deficient management information and administration systems, and was dominated by a large government department-style head office.

After an unsatisfactory start, which led to the replacement of its first chairman and chief executive, Telecom has radically restructured itself, with operations being conducted through subsidiary companies which have been given clear areas of responsibility, accountability and autonomy to meet their targets. It implemented a major capital expenditure programme, including the computerisation of outdated systems and the installation of new digital technology, and achieved large gains from the contracting out of services that were formerly provided internally.

The magnitude of the efficiency gains achieved is indicated by the following statistics:

a 47% decline in the number of employees from 26,500 in 1987 to 14,000 as at April 1990;

a rise of nearly 85% in productivity (measured in terms of the number of lines per employee) during the same period while profits increased by around 300%;

a cut of over 20% in the real price of phone services in the year to September 1989 alone;

a reduction in the waiting time for the installation of new telephone lines from around six weeks to less than 3 days for more than 95% of customers, and jackpoint relocations of 1-2 days instead of up to 3 months;

directory assistance enquiries answered within 20-30 seconds instead of up to 20 minutes at peak periods, and directory enquiries processed within 30 seconds instead of several minutes;

electronic payphones now operate 98% of the time instead of the previous 60 - 70%;

a rise, from 30% to 93%, in the number of customers on improved digital technology lines.

New Zealand Post

Like Telecom, New Zealand Post arose from the breakup of the New Zealand Post Office in 1987. In its first year as a corporation, New Zealand Post yielded a net profit of $72.1 million. This was in spite of inheriting an

inappropriate asset structure (more suited to retail banking), no modern mail processing plants, and inefficiencies in transportation and staffing.

In its first four years of operation the price of a standard letter remained at 40 cents (in spite of a rise in GST from 10% to 12.5%); staff levels decreased by 30%; the percentage of next day delivery rose 17% (to 98%); and the return on average shareholdersí funds averaged nearly 30% per annum (it is expected to be 15% in the 1991/92 financial year).

Port Reforms

As required by the Port Companies Act 1988, the major harbour boards each set up a port company which took over the port-related commercial undertakings of those boards from 1 October 1988 - with a 40% reduction in numbers employed. This was followed by the abolition of the Waterfront Industry Commission on 30 September 1989 ñ which reduced the number of waterside workers nationally from 3,300 to 1,800 virtually overnight.

All the harbour boards, which had been for many decades largely unaccountable, non-profit-making entities with the right to levy rates if they could not balance their books, were abolished on 1 November 1989, with ownership of the port companies passing to new regional councils.

The following statistics indicate the scale of the benefits resulting from these reforms:

no reduction in tonnages handled nationally despite a reduction of roughly 50% in the permanent workforce;

substantial early reductions ranging from 20% to 50% in stevedoring charges for conventional shipping; and

very substantial reductions in average turnaround times per ship (e.g. in the Port of Tauranga, a 56% decline between 1989 and 1991).

2.3 Difficulties Experienced with the SOE Model

It is not hard to illustrate the difficulties which have arisen with the SOE model. Understandably, their incidence varies from organisation to organisation, reflecting, for example, political sensitivities and the degree to which social welfare and/or monopoly considerations arise. Some SOEs have not yet experienced major problems, but in other cases public ownership has clearly been associated with:

a degree of instability and disruption caused to managements and boards as a result of the inability of political processes to definitively resolve key strategic questions;

friction between some SOE boards and managements and the government about commercial decisions;

a tendency for some appointments to the boards of SOEs to owe more to their political affiliations than their commercial expertise;

an apparently growing tendency for direct political intervention in commercial pricing decisions for reasons which are unrelated to commercial considerations;

an increasing political focus on remuneration levels in SOEs, apparently without due regard to the performance of key staff in relation to remuneration levels, or to the effect of lower levels of remuneration and/or the publication of remuneration levels on the ability of the SOEs to recruit and retain high quality staff;

the difficulties involved in trying to put SOEs on a fully commercial basis when continuing government ownership carries with it at least an implicit government guarantee; and

the difficulties associated with trying to get the Crown, as the sole shareholder, to put more risk capital into the business when the Crown is not necessarily familiar with the risks involved, is unclear about its strategy with

respect to such requests, and faces fiscal and political constraints which are unrelated to the needs of the business.

All these developments are consistent with a tendency for the original political and bureaucratic influences to reassert themselves, taking SOEs back towards their previous departmental status - which was so inimical to the employment of commercial expertise and to the pursuit of commercial objectives (as discussed in section 1).

We discuss these developments below.

Inability to Resolve Questions of Strategic Direction

As noted in section 1, governments inevitably bring with them conflicting objectives. A desire for a lack of transparency may lead politicians to wish to use SOEs, rather than more visible budgetary processes, as a vehicle for transferring wealth in favour of important constituencies. Consequently, SOEs are always subject to the risk that they may be directed to pursue conflicting commercial and social objectives, with the concomitant probability of a decline in the standard of delivery of each. Whilst one government might consider corporatisation an important structural reform to enhance the country's economic performance, subsequent governments may not share this commitment. Hence the environment in which the trading enterprises operate will be inherently unstable.

For example, political processes have so far been unable to provide any stability in strategic direction to the Housing Corporation. Intended by the 1984-87 Labour government to be an SOE, the aftermath of the political rifts within the government in 1988-89 saw this decision reversed in favour of departmental status.

Following the change of government in 1990, this last decision was reversed in the 1991 budget in respect of the corporation's rental operations. Yet this reversal was itself soon qualified. In April 1992, the government announced that the Housing Corporationís rental operations would be set up as a ìhousing rental enterpriseî rather than as an SOE in order to ìbetter enable the state to fulfil its social responsibilitiesî.

In mid-April the new housing enterprise's establishment board chairman resigned, reportedly in protest at the governmentís moves to give the enterprise a social character, on the grounds that ìunacceptableî levels of conflict had emerged. Subsequently the contract of the newly appointed chief executive was terminated.

Of course the difficulties successive governments are having with determining a direction for the corporation may arguably reflect a genuine underlying concern that a corporatised Housing Corporation with a clear profit objective would deprive the government of the most efficient means of delivering a justifiable level of assistance to the corporationís existing customers. However, the corporation cannot hope to realise the efficiency gains from corporatisation if it is given the conflicting goals of profit and social assistance.

Ongoing Friction between SOE Boards and the Government

The instability concerning their future role, particularly in relation to whether or not their particular SOE will revert back towards departmental status or instead be privatised, has lead to some of the energies of SOE boards and managements being diverted into quasi-political activities.

As an example, in 1990 Telecom's former chief executive made a public complaint of "rape" over the size of dividend which the government, as Telecom's shareholder, required it to pay. No such public complaint is being made by Telecom at present (after privatisation), although its current shareholders require a similar dividend payout rate.

The case of the Housing Corporation was noted in the previous section.

SOEs are subject to non-commercial constraints such as the Official Information Act, the Ombudsman Act, and select committee hearings. The impact of these constraints relates to the opportunity cost of board and management time dealing with essentially non-productive issues.

In this context it is noteworthy that the general tendency has been for those responsible for enhancing the commercial performance of SOEs to favour privatisation as the best means of resolving the instability surrounding SOE status. For example the boards and/or managements of New Zealand Post, Electricity Corporation, Television New Zealand, New Zealand Rail, CoalCorp and (prior to privatisation) Telecom all clearly favour, or favoured, the eventual full privatisation of their respective organisations.

Board Appointments

These frictions between commercially oriented boards and managements can arguably motivate politicians to appoint politically sympathetic members to SOE boards rather than those with stronger commercial and business skills.

Examples of events which suggest that political affiliations may have played a role include:

the Labour government's appointment of a former Labour MP to the Railways Corporation board;

the sacking in August 1991 of almost the entire Housing Corporation board. Its members had included a director of PostBank, who was a Labour candidate in 1972, and a political scientist who was a close friend of the then housing minister; and

the appointment under the current National government of previous National party MPs and/or party officials to the boards of New Zealand Post, New Zealand Rail, the Earthquake and War Damage Commission and the Housing Corporation.

In this connection former SOE minister Richard Prebble recently alleged that the current SOE minister, Maurice McTigue, is under pressure from caucus to appoint members to SOE boards as a reward for political service. Whilst Mr McTigue denied this allegation he noted that caucus has a policy of not reappointing members for a third term except in extraordinary circumstances. Such a policy would not appear to be motivated by commercial considerations.

Direct Political Intervention in Commercial Decisions

The Housing Corporation also illustrates the temptation faced by governments to become involved in the day-to-day commercial operations of state trading entities. For example, in 1989, when the Labour government was well behind the opposition in the public opinion polls and the government was under great political pressure to "do something" to reduce interest rates, the then housing minister announced a reduction in the Housing Corporation's mortgage lending rates, reportedly commenting that they were below the market average and expressing the hope that this reduction "should help to reinforce the general decline in interest rates." This implied transfer of wealth from taxpayers to favoured borrowers in order to meet an immediate political objective did not have to be quantified and scrutinised through parliamentary processes as a parliamentary expenditure item. It obviously did not necessarily reflect the ultimate lendersí interests, as revealed by market interest rate levels at the time. Such a politicisation of the corporationís commercial activities has the potential to reduce the accountability of the management of the Housing Corporation for its performance in relation to any previously agreed financial objectives.

We know of no instance in which the Housing Corporation has been instructed to ìlead interest rates up,î either before or since that occasion. To the contrary, the current housing minister recently instructed the Corporation to ìlook atî reducing its mortgage rates in line with cuts made by banks. This intervention appears also to have been motivated by political rather than commercial concerns.

A more direct example of the willingness of governments to succumb to pressures to get involved in the management of state trading enterprises was the recent governmental pressure, culminating in a select committee hearing, that led to a pricing policy backdown by the Electricity Corporation. The prime minister acknowledged that pricing policy was ECNZís responsibility, but he added that he was sure the corporation would not take any step that would defer economic recovery, and that he wanted all decisions to be made consistent with the government's desire to stimulate economic growth. Further to this, ECNZ's two shareholding ministers were publicly reported as telling the corporation that the government would accept a decreased rate of return to accommodate the pricing backdown. The imposition of a clearly non-commercial political objective on

an organisation which, by statute, is required to operate as a successful commercial business demonstrates the fragility of the SOE model.

The select committee intervention pre-empted the commercial negotiations between ECNZ and the electricity supply authorities (ESAs) and almost certainly improved the bargaining position of the individual ESAs. Furthermore, it will have raised the expected returns amongst special interests from lobbying the government for other privileges while creating a precedent for further political interventions in SOE pricing decisions.

The Electricity Corporation has also found itself constrained from entering the retail end of the electricity market at the directive of the government. Whilst it may be argued that this is justified given the current regulatory framework in the electricity industry, it denies consumers the price reductions that can be achieved should the corporation apply similar cost-saving measures to ESAs to those which it has itself implemented. Furthermore, the directive limits the extent to which the corporation can pursue energy efficiency strategies at the retail level.

The political pressure currently being exerted on New Zealand Post to continue to cross-subsidise rural deliveries is a further illustration of this point.

Politicisation of Remuneration Decisions

A key feature of the old departmental model for state-owned enterprises, as for the public sector generally, was that levels of remuneration were related to seniority rather than performance (with relationships to the pay of politicians being an important benchmark). They had minimal discretionary bonus elements and were a matter of public record, at least within the public sector. In contrast, under private sector arrangements, remuneration levels tend to be a private matter between the employer and employee, and there are strong pressures to relate remuneration to performance with significant incentive elements where such elements can be expected to have a significant effect on performance. Pay relativities with politicians, judges and senior public servants are essentially irrelevant.

In this respect the political and journalistic energies directed, in the last eighteen months, at publishing both levels and performance-related aspects of the remuneration packages of chief executives of SOEs, and criticisms of these levels without regard to performance requirements, represents a potentially significant step back to the days in which people with commercial skills could not readily be found within state trading enterprises.

Commercial Neutrality and the Implicit Government Guarantee

Continuing government involvement in an organisation brings with it perceptions that in the event of financial difficulties the government will inject more money on a non-commercial basis. The sale of the Development Finance Corporation (DFC) illustrates the point. The government sold the DFC outright in June 1988 to Salomonís (20%) and the National Provident Fund (80%). However, in part because the government controlled appointments to the board of the latter organisation, it was not successful in dispelling all perceptions that lenders to the DFC had no future recourse to the government. Indeed, following the subsequent collapse of the DFC the government was successfully put under enormous pressure to provide assistance to (overseas) lenders.

The government's continued involvement in the Bank of New Zealand (BNZ) also raises the question of the role of the implicit government guarantee associated with such ownership. In the event, successive governments have injected very large sums into the BNZ to the advantage of existing lenders and minority shareholders. A private sector majority owner may well have chosen a different approach.

An example of the problems that can arise with partial privatisations occurred with Petrocorp where a publication of the International Monetary Fund has suggested that ìminority shareholders were in a good position to ìcaptureî management and thus influence future share sales in a direction contrary to the public sector goals and interests at the timeî.

Finally, the significant cash injections the government has been obliged to make in recent years into the BNZ, New Zealand Rail, Radio New Zealand and Government Property Services all serve to confirm doubts about the degree to which the implicit government guarantee can in fact be removed from SOEs. In the final analysis, governments have not been willing to let normal commercial remedies apply. While the government could in

principle charge the SOE for the value of any implicit guarantee, it would be very difficult in most instances to determine at what level that charge should be set.

An International Perspective

The shortcomings of public ownership (and of partial privatisations) are now widely recognised. In earlier years there was strong debate about the relative performance of public and private enterprise. Many contended that public enterprises could perform as well as their private counterparts. This is now a much more settled issue. The limitations of continuing government ownership have been summarised by the World Bank as follows:

"First, private ownership itself makes a difference. Some state-owned enterprises have been efficient and well-managed for some periods, but government ownership seldom permits sustained good performance over more than a few years. There is a higher probability of efficient performance in private enterprise ...î

The Bank has also reported that in many developing countries state-owned enterprises that were thought to be well on the way to improving performance in the early to mid-1980s have either not improved or suffered serious deterioration.

Nor is this an isolated view. Standard and Poor's Australian Ratings recently (May 1992) made the point in the context of the New Zealand experience as follows:

"That corporatisation can be followed by privatisation is a recognition of the limits to performance improvement which may exist under corporatisation, given the absence under government ownership of performance incentives provided by the threats of takeover and bankruptcy. The necessary final stage in the process of improving public sector efficiency in New Zealand is therefore seen as privatisation. Only in this way might it be possible to realise ultimate efficiency gains and to ensure that benefits achieved by corporatisation are not reversed in time."

2.4 Summary and Conclusions

Strong arguments were mounted in the mid-1980s against the proposals to corporatise state-owned trading entities in New Zealand. It is now clear that the policy shift in the state sector towards corporatisation has resulted in a raft of gains. These include:

clearer objectives, with more effective monitoring and accountability mechanisms to ensure their attainment;

a greater consumer focus, resulting in an increased and/or improved range of products and services;

increased productivity with the same or fewer staff (often accompanied by a shift towards contracting out of services not economically provided internally);

cost reductions, which flow through to lower real prices for consumers;

improved remuneration structures, enhancing the ability of SOEs to attract the skills required for successful operation;

vastly improved profitability; and

the establishment of more effective management information systems.

However, a number of predictable difficulties associated with public ownership of SOEs have also arisen, as summarised in section 2.3. In broad terms these difficulties relate to:

the inability of some SOEs to resolve (with their shareholding ministers) questions of strategic direction;

the ongoing friction between a number of SOE boards and the government (and even direct political intervention) over commercial decisions;

the politicisation of SOE remuneration decisions; and

the issue of commercial neutrality and the implicit government guarantee.

A consequence of these difficulties is the likely erosion of (at least some) of the gains achieved through corporatisation.

Demonstrations of the difficulties arising from continued government ownership of SOEs do not of course establish that privatisation must invariably result in superior outcomes. Under private ownership, organisations can also suffer from the problems associated with an unfavourable or unstable regulatory environment, uncertainty about future government policies, and weak major shareholders.

Therefore, as a practical matter, it is desirable to also investigate the experience with privatised trading enterprises for insights into the circumstances in which privatisation has resolved some of the problems identified with the SOE model.

3. PRIVATISATION EXPERIENCE IN NEW ZEALAND

3.1 Introduction

Relative to the SOE model, gains from privatisation would be expected to stem from:

reduced uncertainty about strategic directions;

the elimination of board appointments based on non-commercial considerations;

reduced political interference in investment, pricing and internal remuneration decisions;

the imposition of the commercial disciplines which are implicit in monitoring by debt and equity holders, company takeovers and the ability of existing owners to replace management teams, and the ultimate sanction of bankruptcy;

the removal of non-commercial constraints on new capital raising and diversification (including into offshore operations); and

the ability to benefit from the managerial, financial and technology resources of new owners.

Against these likely gains must be set the possibility of greater recourse to legal rather than political processes to resolve disputes and the possibility of less-than-ideal outcomes arising from an imperfect regulatory environment.

In section 3.2 we discuss the privatisation process pursued in New Zealand, considering the problems experienced and lessons learned. Section 3.3 outlines the gains that have been achieved due to privatisation. Section 3.4 draws some conclusions from this material.

3.2 The Privatisation Process in New Zealand

The essential features of the privatisation process employed in New Zealand commencing in 1987 involved:

predetermining the post-sale regulatory environment for the entity in question with a view to maximising the gains to the economy from the privatised operation (this involved attempting to remove any monopolistic advantages that the entity might otherwise enjoy); then

maximising, through an open and competitive tender process, the proceeds from the sale. This is a notable difference between the New Zealand privatisation process and that adopted in the United Kingdom - and reflected the New Zealand government's strong commitment to price maximisation as the major financial objective of privatisation; and

addressing the government's (initial) lack of expertise in managing privatisations by using commercial advisers and public servants at arm's length to do all the work involved in preparing the sale documents, screening bidders, monitoring the due diligence process, evaluating the relative merits of contending bids and making final recommendations to the government. Politicians would make all key policy decisions, including the decisions as to the preferred sale technique, the details of the post-sale regulatory environment and whether or not to accept the bid recommended by their advisers. However, they would not become involved in activities which carried the risk of biasing the sale process in favour of politically preferred bidders.

Given the ideological opposition to privatisation amongst a significant segment of the public, and the difficult regulatory, managerial and property right issues involved in the sale process, these procedures were both very necessary and difficult to adhere to. Ministers were under continual pressure to forgo sale proceeds in favour of particular bidders. For example, from time to time there was pressure from local interests to bias sale conditions against foreigners. A farming group lobbied very strongly to buy the Rural Bank. Coded suggestions were made that the government could buy votes by selling shares below market value to the broad class of small retail investors. Similarly, SOE boards and managers in some cases had decided preferences for particular owners.

Such pressures were by and large successfully resisted, in part due to the strong adherence to the goal of realising the best possible price in the interests of taxpayer-owners, but mainly because key ministers recognised that favouring particular bidders ultimately resulted in a wealth transfer from taxpayers to the favoured party.

On at least one occasion a recommended bidder lobbied hard at the last minute to have the sale conditions "clarified" so as to bolster the post-sale competitive position for the entity in question - at an unchanged bid price. (This attempt was rejected and the entity was promptly sold at a comparable price to a competing bidder without the proposed terms and conditions.)

The role of political factors was particularly apparent in the case of the decision to reject a recommended bid for the Bank of New Zealand. Amidst strong ideological opposition to the sale from within its party, the Labour government rejected a bid, of reportedly around $1.45 a share, from Brierley Investments on the publicly-stated grounds that the price was too low. Subsequent events demonstrated that this decision was dramatically wrong and the whole affair provides a graphic demonstration of the difficulties governments face in making such commercial decisions.

More generally, the privatisation *process* was markedly more successful than the popular press would have the uniformed observer believe. Key successful features included an adherence to the price maximisation objective with the adoption of a competitive tender process as the preferred method of sale.

A feature of the sale process has been the widest possible canvassing of potential buyer interest, both overseas and within New Zealand. Bidders have normally been short-listed on the basis of their indicative price bids and a final, binding bid has been sought following an extensive due diligence process. The government has insisted that all bidders at this stage have the same access to information, in spite of any contrary management or board preferences. The selection of the successful bidder has invariably been based primarily on price and, secondly, on the absence of disadvantageous conditions.

A further feature recognised by the government is the desirability of capturing the benefits of any premium for control of the asset being sold. Such a premium reflects the extra value that a potential owner can derive from a controlling interest in the asset. The premium can be dissipated if the asset is sold by a general tender process which is designed to produce a widely-dispersed shareholding with no clear controlling interests. In contrast, a competitive tender process involving the sale of a controlling interest (or more commonly the entire asset) to a single buyer can both overcome the problem of an illiquid market and ensure that the Crown captures the

premium for control. The sale of Telecom illustrates this approach. Efforts to disperse shareholdings are often short-lived as share parcels are aggregated by parties anxious to monitor management performance and influence the strategic direction of the business.

Given the extensive buyer search process, the absence of bias in favour of particular bidders (e.g. New Zealand residents) and the competitive element inherent in the tender process, there is every reason to believe that the prices achieved were the best obtainable at the time. The values realised for PostBank and Telecom surprised many market participants.

Subsequent to sale, some assets rose in value; others did the opposite - just as would be expected from a fair, competitive, sale process. Inevitably, elements of the popular press and some economists have used the wisdom of hindsight to argue that the former group were sold too cheaply. Such critics have, however, failed notably to address the only point which is relevant, namely, identifying what prevented anyone who held this opinion at the time from submitting a higher bid.

Despite the enormous political pressures to subvert the sale process, sufficient integrity was maintained to encourage genuine bidders in subsequent sales to come forward and to invest significant resources in preparing bids in the belief that those bids would be considered on their merits.

The quality of the privatisation process generally followed in New Zealand has been acknowledged internationally. In particular, the World Bank and the International Monetary Fund have independently cited New Zealand as a country which has benefited from properly executed privatisations.

Desirable features of privatisations which have been acknowledged internationally include the following:

the need to put an appropriate regulatory regime in place before privatisation;

making efficiency the primary economic objective of privatisation (as distinct from maximising revenue by selling a sheltered monopoly or reducing revenue by promoting wide share ownership);

allowing open competitive bidding, with the use of golden shares and partial offerings if necessary;

aiming to let the market set the price, and sell for cash;

facilitating labour force adjustments through severance pay, retraining and job search assistance and unemployment benefits; and

ensuring the sale transaction is transparent.

The New Zealand privatisation process has explicitly stressed all these features.

Interestingly, where departures from these features occurred, political problems arose (e.g. the sale of New Zealand Steel to Equiticorp in return for shares in the latter and the put and call options on the sale of Petrocorp to Fletcher Challenge).

A further lesson is that where privatisation is desirable it should generally be done without delay. To delay the sale in the hope that more favourable values will be obtainable at some later date is tantamount to making the unwarranted assumption that the government should be in the business of gambling taxpayersí money on the next rise in the sharemarket. Bidders for assets will build an informed judgment about such probabilities into the price they will pay today for the asset. Collectively their judgment on these issues is likely to be better than the government's, because their incentives to get it right are greater.

Similarly, as a general rule, it would not be desirable to delay a sale on the grounds that a better price will be obtained following restructuring. Restructuring is often costly, time-consuming and complex. It can be done poorly or it can be done well. The private sector has better incentives to add value during the restructuring process than has the government. It can also be expected to have a better understanding of the commercial

realities which the deregulated enterprise will face. In contrast, the government would not be expected to have a comparative advantage in turning around struggling industries.

An exception to this rule may occur where the government has much better information about a business than do potential buyers. For example, it may be desirable to delay a sale until the government has been able to determine relatively precisely what assets the state-owned enterprise owns, its true liabilities, and matters which will affect cash flows, such as the future regulatory environment. Otherwise, it would be prudent for bidders to to bid relatively low prices in order to protect themselves against unpleasant surprises when these matters are later determined.

An International Monetary Fund publication has commented that: "the case of New Zealand ... is particularly instructive for other countries contemplating ... a privatisation programme". It correctly drew attention to the following two features of the New Zealand experience:

full privatisation was more successful than partial privatisation; and

open bids for purchase were found to be superior to sharemarket sales.

The article commented in detail on the sale of Telecom in respect of its conformity with these lessons, the smoothness of the process and its successful outcome, particularly in relation to the sale price achieved.

Standard and Poor's Australian Ratings have made a similar point about partial privatisations as follows:

"Unlike Australian governments, the New Zealand government does not have a preference for partial privatisation. The normal principle underlying Crown asset sales is to sell all the shares in a business. In situations of partial shareholdings, the Crown tends to bear disproportionate responsibility in the event of a company being in financial distress. While in some cases a selldown may be undertaken over a period of years, the government does not expect to retain part shareholdings in the long term because of the commercial and financial exposure that would result."

3.3 Gains Achieved from Privatisation in New Zealand

The gains achieved by the major privatisations in New Zealand surveyed below illustrate a number of common themes. Privatisation has:

allowed the former government corporations to focus their activities and structures on achieving strictly commercial objectives;

led to further significant productivity gains, improved customer focus and product range; and

improved profitability.

Rural Bank

As a statutory corporation the Rural Banking and Finance Corporation found itself constrained by political/national objectives rather than commercial objectives, and the imposition of public sector employment policies.

In particular, the provision of loans at concessional interest rates did not provide an adequate return relative to the risk.

Since being acquired by Fletcher Challenge in November 1989, the Bank has been able to resolve these problems. Privatisation enabled the Bank to:

introduce effective strategic and operational planning;

establish clear commercial objectives;

increase its employment and remuneration flexibility;

apply new technology to improve operating efficiency and client service;

introduce effective risk management techniques;

change the Bank's culture and motivation through being able to operate in the competitive banking market.

A number of results have flowed from this:

there has been a significant improvement in the Bank's loan portfolio performance (principal associated with arrears over 90 days reduced from 4.1% to 1.5% since privatisation);

staff numbers have fallen 36% to 420;

it is forecast that between March 1988 and June 1992 annual operating expenses will have been reduced by 19%.

Most important has been the establishment of a market related business. For the period March 1989 to March 1992:

loan assets on market rate terms and conditions have increased from $822 million to $1,640 million (100%); and

loans on concessionary terms and conditions have fallen from $1,791 million to $345 million (81%).

A parallel may be drawn here between the Rural Bank situation pre-privatisation and that of the Housing Corporation at present. As state-owned trading enterprises, both exhibited the poor performance associated with the imposition of conflicting objectives by the government - witness the difficulties experienced by the government over the sale of the Housing Corporation's "prime-rate" mortgage portfolio. The recent controversy regarding the future direction of the Housing Corporation's rental operations illustrates the instability of the political commitment to corporatisation, and emphasises the need to place such organisations on a commercial footing, free from political interference, in order to realise and "lock-in" efficiency gains.

PostBank

PostBank, since being acquired by the ANZ Banking Corporation Limited in December 1988, has experienced gains in addition to those realised by corporatisation. Notable developments reported by the company include:

a stronger emphasis on customer focus and service orientation;

improved capital expenditure decision processes which have allowed PostBank to proceed with capital expenditures on outlet remodelling and technology;

the benefits gained from economies of scale in pooling with ANZ administration, funding and technology costs; and

the benefits gained from tapping ANZ's expertise in products, marketing, credit, and management techniques.

Privatisation has also reduced a number of constraints associated with government ownership. PostBank no longer faces a real risk of government intervention, on non-commercial grounds, in the setting of interest rate policies and the restructuring of its retail outlet network. Moreover, the use of its retail outlets is not constrained to include the distribution of welfare payments. As in the Rural Bank case, PostBank has found it advantageous to not have to negotiate awards with a public sector orientation.

Air New Zealand

Whilst the recent downturn in the worldwide aviation market complicates any assessment of Air New Zealandís performance since privatisation in April 1989, significant gains have been achieved. The airline is now able to attract improved management and financial skills and focus on strategic planning and direction, and it has demonstrated an increased urgency to achieve a competitive advantage in its industry. Furthermore, privatisation has enabled the airline to restructure itself so as to enhance managerial accountability. Consequently, Air New Zealand has been better able to respond to the difficult market situation in the aviation industry.

Specific illustrations of these gains include:

a 28% rise in productivity based on a 10% reduction in staff and increases in seat kilometres and passenger kilometres flown; and

a greatly improved management understanding of, and adherence to, commercial disciplines based on financial indicators and targets.

Since privatisation the airline has found itself free from a number of political constraints. As a state-owned corporation it experienced difficulties in shedding loss-making provincial domestic routes, and was potentially exposed to intervention by the government in decision making regarding investment in equipment, on non-commercial grounds. Furthermore a potential conflict existed between the government's status as an airline owner and its roles as an aviation regulator and negotiator of international aviation rights. The company is now in a position to consider expansion offshore, in particular in Australia.

Telecom

Since its privatisation in 1990 Telecom has found itself unconstrained by the governmentís inherent risk-aversion as a shareholder. As an SOE it was restricted in its ability to diversify or to contemplate significant offshore business. It has now realised some possibilities, and is currently examining others. A recent example is its success in winning a multi-million dollar network management contract for the Queensland government.

Information released by Telecom since it was sold is consistent with the World Bank view that privatisation should help lock-in or improve on the gains from corporatisation. Between its last financial year as an SOE (the year to March 1990) and the latest financial year (the year to March 1992), Telecomís net earnings rose 56%; earnings per share increased from 11 cents to 17 cents; and the return on shareholders' funds rose from 10.6% to 15.2%.

Business volume, growth and cost reductions rather than charge increases have driven these results. Vigorous competition in domestic and international toll calls is putting downwards pressure on effective real unit charge-out rates in these areas while unit line rental charges for residential customers cannot be increased faster than the rate of inflation under the conditions imposed by the government at the time of the sale.

Access lines per operating company employee, one measure of labour productivity, rose 41% during the same period. The company believes it can achieve a further 21% lift in this measure of productivity.

A significant amount of Telecom's revenue growth now comes from the companyís New Venture group set up in anticipation of privatisation. This includes, for example, cellular telephone services and directory publishing.

The deregulation of the telecommunications market has led to the entry of a major competitor (Clear Communications) which has reportedly captured around 10% of the toll market in a remarkably short period of time. Bellsouth is about to enter the cellular telephone market in competition with Telecom.

The regulatory issues associated with the telecommunications industry have kept Telecom in the public eye. However, politicians have remained firm in their position that matters between parties in the market should be resolved by commercial negotiation (or if necessary through litigation).

Petrocorp

The Petrocorp privatisation highlights a number of salient points - both in relation to the gains achievable with a change from public to private ownership, and the learning process for the government in managing privatisations.

Partially privatised in August 1987, the governmentís remaining 70% share in Petrocorp was sold to Fletcher Challenge in March 1988. Since privatisation Petrocorpís profits have grown 264%. Between 1990 and 1992 unit production costs for urea and methanol decreased by 10% and 1% respectively, while oil production increased by 135%. Other gains achieved through privatisation include:

a clearer strategic vision, with constant review and performance monitoring;

an increased commitment to quality growth;

the introduction of superior management practices involving:

- access to Fletcher Challenge's management training and culture

- the extensive use of independent management consultants

- a commitment to best industry knowledge and learning;

investments in top class personnel, recruited internationally, made possible by removal of constraints imposed by the Higher Salaries Commission.

Under Crown ownership Petrocorp was unable to make these changes due to the government's:

lack of a clear vision for the company;

unwillingness to invest further capital;

absence of effective risk management techniques; and

inability to comprehend the need for critical mass and global positions in order to be competitive.

Government Printing Office

Since its sale to Rank Group in July 1990, the former Government Printing Office has experienced the following gains:

an infusion of competitive, customer-focused management; leading to

a rapid and significant improvement in customer relations;

an improvement in staff attitude and morale, resulting from a clearer sense of direction, a more commercial emphasis, and a higher level of involvement;

an improved management structure resulting from the external recruitment of management skills and downsizing of non-productive departments, leading to much reduced time taken for decision making; and

productivity gains, flowing through to cost reductions and increased profitability.

There has been a significant improvement in the conduct of wage negotiations (the process now takes a fraction of the time that it required pre-privatisation). The company has also found that industrial relations have become smoother, with negotiations focused more on business issues.

3.4 Summary and Conclusions

There can be no doubt from the reported post-privatisation experiences of these companies that much was achieved simply by freeing them from the uncertainties and constraints associated with political ownership which were identified in section 2.

Naturally privatisation does not eliminate all problems. In competitive markets, all companies face difficult strategic choices. The crucial distinction between state-owned enterprises and privately-owned enterprises in this respect lies in the relative strength of the incentives under private ownership to reach timely, commercially oriented and sustainable decisions.

In general terms, the key gains arising from privatisation highlighted by this survey are:

privatised entities have more flexibility to plan strategically;

conflicts arising over strategic direction between managers and the new owners are resolved by non-controversial means - recourse to the managerial labour market;

the companies are no longer constrained by the government's inherent risk-aversion and fiscal constraints (as shareholder) in their pursuit of strategic opportunities;

privatisation provides the opportunity for the organisation to implement competitive incentive-based remuneration packages, including the possibility of (much sought after) equity-based components, free from undue public (including competitor) scrutiny;

the new owners typically provide the company with access to superior management, marketing and production systems, and the freedom and ability to obtain these externally if required.

Given a competitive market, consumers benefit from such gains in terms of lower prices and/or improved and increased choice.

Clearly the crucial features for improved performance extend far beyond putting competent directors on boards, which is sometimes advocated as a sufficient remedy for inferior public enterprise performance. Most of the important incentives and sanctions which influence performance simply cannot be replicated under public ownership.

4. REGULATORY ISSUES

To the extent that privatisation, in conjunction with an explicit regulatory environment, is the practicable alternative to public ownership with a high degree of political intervention (with or without explicit regulation), any final judgment about the merits of privatisation must be conditional on the quality of that regulatory environment.

It is clear that privatisation does not necessarily improve outcomes if the regulatory environment which the privatised entity encounters is such as to largely inhibit competition at the one extreme, or to artificially deprive the entity of any hope of obtaining above average returns from its investment decisions on the other.

Regulations which inhibit competitive entry or the willingness of existing firms to innovate and take risks could make the industry relatively insensitive to opportunities to better meet customer requirements. A related point is that regulations which compel a firm to pass on some or all of the potential for an extraordinary return to consumers or competitors will obviously inhibit or even smother entrepreneurial investment activities aimed at

identifying and satisfying consumer needs. For example, price control based on rate of return regulation once markedly reduced the incentive of breweries to introduce low alcohol beers into the New Zealand market.

Fortunately, given these double-sided risks associated with regulation, the number of industries in which significant intrinsic competition issues are present is very small. Monopoly issues have arisen, however, in relation to the transmission networks associated with gas, electricity and telecommunications (but not to other parts of these industries which are readily contestable).

In considering what regulations may be appropriate in such cases, a number of guidelines have emerged. As a general rule, a sound competitive environment will avoid mechanisms such as rate of return regulation, restrictions on shareholding, licensing arrangements and protective tariffs which impede voluntary contracting and competitive entry and force relative prices to diverge from relative costs of production. It will also aim to stimulate entrepreneurial behaviour by protecting property rights in investments to the greatest extent possible, within the constraints which are deemed to be warranted by natural monopoly considerations.

As a corollary, it is essential in considering regulatory interventions to avoid taking a static view of the industry. Concerns relating to perceived market dominance by a current SOE, which may result from heavily entrenched monopolistic advantages in the past, are probably of little relevance to the situation of a deregulated and privatised industry.

Furthermore, it is essential in considering market share questions that a very broad view is maintained of the potential for competition. For example, gas and electricity often have to compete with each other and with many other energy forms. Local TV has to compete with actual and potential threats from satellite TV, cable TV, movie theatres, radio programmes and hire-video libraries. Line-based telephone networks have to face competition from land-based and satellite-based networks.

In the case of the telecommunications industry, the competitive inroads made by Clear Communications since privatisation indicate the potential for competition in the context of a regulatory environment that avoids creating undue entry barriers (although whether the existing legislation errs in the opposite direction is another matter).

Another factor, highlighted by the New Zealand experience summarised in sections 2 and 3, is the intensive and ongoing publicity given to complaints about monopolistic behaviour in the electricity and telecommunications industries. Political pressure has been exerted in a variety of ways to such a degree as to raise the question as to who has the greater power, households with votes who lobby politicians, or the so-called monopoly producers of these services.

In the case of electricity, for example, there have been a number of instances in which ESAs have effectively resisted price increases by the Electricity Corporation, relying on the fact that it cannot simply "switch the power off" because of the level of public outcry which would result.

On the whole, the general guidelines for regulation summarised above have been well-observed to date in New Zealand. In every instance, special care has been taken to ensure to the greatest degree possible that privatised entities enjoy no government-mandated competitive advantages, such as government guarantees and subsidies, tax preferences and licensing protection. Moreover, this intention has been made clear to bidders prior to privatisation.

In all cases the privatised entity became subject to the general provisions of New Zealand's key antitrust/competition policy instrument ñ the Commerce Act.

In many cases, including the Bank of New Zealand, New Zealand Steel, the Development Finance Corporation, the Shipping Corporation of New Zealand, the Rural Bank, State Insurance and the Government Printing Office, no natural monopoly considerations arose.

Others, including Telecom, the gas transmission component of Petrocorp, and the gas supply contract from the Maui fields, did give rise to natural monopoly concerns. Such concerns continue to complicate the sale of existing state-owned entities such as the Airways Corporation and the ECNZ high voltage grid.

Air New Zealand and New Zealand Post were special cases in that the monopoly issues arose from government interventions rather than from the intrinsic nature of their markets. Air New Zealand enjoyed valuable landing rights in overseas countries which were of a bilateral, country-to-country nature. The sale process understandably sought to preserve the value of these arrangements, thereby enhancing the value to the country from shares sold to non-residents. New Zealand Post is unusual in that the monopoly issue arises solely from the statutory protections it has been granted. Clearly the basic solution here is to remove the standard letter monopoly.

As already noted, the most difficult regulatory issues arise in respect of utilities such as telecommunications, gas, electricity and water. Privatisation does not alter the underlying nature of the natural monopoly problem, but it may usefully shift the point of focus for the ongoing conflict between consumers, the firm and the firmís competitors from the political process to legal processes. This is because, once an enterprise has been sold, questions of legal property rights arise.

The privatisation of Telecom clearly demonstrates the point. Telecom was sold subject to a particular constraint on its ability to reduce the cross-subsidisation in favour of residential users which was a feature of public ownership. It is not clear why the government preferred this course of action to the payment of an explicit government subsidy to residential users. In addition, major disputes with its largest competitor have arisen over property rights to Telecom's network and its numbering system.

The fact that such disputes were less prevalent under state ownership may reflect in part the much greater risks that any competitor would face in attempting to compete with a state-owned monopoly. Alternatively it might be primarily a matter of timing since privatisation quickly followed deregulation.

In many OECD countries, the greater part of the telecommunications, gas and electricity industries has been in private ownership. Telecommunications companies have been privatised in recent years in a number of countries including the United Kingdom, Japan, Chile and Mexico. Several dozen countries and states are currently engaged in electricity privatisations. The United Kingdom has privatised its water supply companies, and a number of other water privatisations are underway,

5. CONCLUDING COMMENTS

In my view, the argument about state versus private industry in the U.K. is over. Private ownership has won... The reason that the political contest over privatisation came to an end is simply that implementation succeeded. Facts overtook the debate.

The New Zealand experience with the commercialisation of government trading operations demonstrates that high quality reforms can generate enormous gains in productivity, product quality and profitability ñ along with lower (real) prices for consumers.

This experience has, however, also highlighted inherent flaws in the SOE model, with examples of politicians attempting to influence the decisions of particular SOEs on political (and non-commercial) grounds. This is not a criticism of individual politicians or governments, but an inevitable fact of life with publicly-owned businesses which operate in a politicised environment.

The New Zealand experience further indicates that these problems diminish when governments transfer businesses to the private sector. Privatisation greatly reduces the possibility of direct political interference in operating decisions. It ensures that strategic plans will have a commercial focus. Private shareholders will similarly base their capital expenditure decisions on profit expectations and commercial risks, rather than on

political sensitivities and fiscal constraints. Taxpayer-owners will no longer be forced to accept poor rates of return on their investments.

Privatisation removes the management problems that arise from the intense, cost-dominated, public scrutiny of SOE remuneration levels. It also allows appointments to be made strictly on merit, and remuneration policies to be tailored more closely to the performance of the business.

Private sector operators also report successes in changing the culture of previously state-owned operations, with a greater emphasis on meeting customer needs. The new owners of such enterprises can also bring with them managerial and technical expertise, and the opportunity for economies of scale and synergies in production, marketing and administration systems.

Furthermore, privatisation reduces the conflicts faced by governments arising from their multiple roles as owner, regulator and producer. It means the government need no longer concern itself intimately with the task of ensuring that those goods and services are being produced economically.

The government can focus instead on the policy issues, such as those associated with taxation, legislation, regulation and social assistance. Governments continue to have very powerful means for pursuing broad societal goals.

Far from being in conflict with non-commercial objectives, business sales should facilitate their pursuit, above all by adding to wealth creation. Any programme that aims to remove uncertainty about exactly who is responsible for ensuring the achievement of each one of a number of conflicting objectives would generally be expected to improve outcomes for all objectives. Privatisation clearly contributes to such a programme by clarifying responsibilities for efficient production. Freeing public sector managers from the need to act as producers should enable them to pursue their remaining goals more effectively.

The primary benefits from privatisation are the improved efficiency with which the nation's scarce economic resources can be used to produce marketable goods and services and hence raise the community′s living standards. A secondary objective in the case of a heavily indebted economy such as New Zealand is to reduce gross public debt. Because the capitalised value of the future earning streams of the entities concerned is likely to be higher under private ownership, the government′s fiscal position will be improved as a result of privatisation. The proceeds of asset sales should be applied to debt reduction and not to recurrent consumption expenditure. Since New Zealand′s foreign currency public debt greatly exceeds its foreign currency assets, the public account is exposed to unnecessary exchange rate risk, so the emphasis should be on the retirement of foreign currency debt.

New Zealand′s experience with privatisation has provided evidence that the economic arguments for the superior performance of private over public ownership, on average and over the long run, are soundly based. These do not claim that private decision making is perfect - plainly it is not - but rather that there are stronger incentives to make right decisions and to correct wrong decisions than is the case with public ownership. This view has been borne out in practice, and earlier fears that privatisation would lead to higher prices or poorer service have proved unfounded. Social objectives have been pursued by more direct and transparent means. Privatisation has contributed to the efficiency gains which have improved New Zealand′s international competitiveness and helped the present economic recovery, and has meant that present debt levels are significantly lower than they would otherwise have been.

While this paper has focused on the case for selling state-owned trading activities, clearly the benefits of privatisation that have been identified are sufficiently general in nature as to have a wider application. For example, it is noteworthy that the private sector is involved in the production of services such as health, education and accident insurance. While the issue of the extent to which the state should be involved in the production and financing of these services is a proper subject for debate, it seems likely that similar benefits could be derived from the corporatisation or privatisation of the Accident Compensation Corporation and the Crown Health Enterprises as have been recorded by the organisations reviewed in this paper.

Of course, structural changes often have transitional costs. Programmes of corporatisation and privatisation are no exception. The costs of job losses in the organisations concerned are frequently highly visible. It needs to be noted, however, that:

overstaffing of state-owned enterprises does not promote overall employment. The excessive costs penalise employment elsewhere in the economy, especially in internationally competing industries;

many of the jobs that have been lost contributed little or nothing of social value - this is the ultimate tragedy for the individuals involved; and

the major job losses have occurred with corporatisation; any job shedding associated with future privatisations is likely to be smaller in scale.

The government can ease transitional costs by severance pay, encouraging a flexible labour market, and providing training opportunities and a welfare safety net.

Increased levels of foreign ownership are also sometimes regarded as a cost of privatisation. However, the amount of foreign ownership in the economy is determined by the cumulative current account surplus or deficit in the balance of payments, not by which assets are for sale. If foreign ownership of some assets is blocked, foreign stakes in other assets will be higher.

New Zealand′s high level of overseas debt means that foreigners already have substantial claims over New Zealand assets. The achievement of current account surpluses, in line with current trends, is the only way of allaying fears about aggregate overseas ownership. Better-performing privately-owned businesses can improve the economyís international competitiveness and its external position. Moreover, foreign investment can bring to privatised businesses the same benefits of new technology, management and financial resources, and market outlets that it offers to other private sector entities.

The dominance of private sector ownership of production in the most successful economies amply demonstrates the power of private incentives and the private enterprise system. Given their greater ability to create wealth, such economies are also better able to protect the environment and provide affordable social assistance. The attachment to public enterprise is often linked to the socialist belief in state ownership of ″the means of production, distribution and exchange″. The East European and former Soviet Union experience with extensive government ownership of major industries demonstrates the difficulties governments face, and the poor multiple outcomes that can result, when they combine extensive ownership of industry with attempts to raise living standards and protect the environment.

The experience and principles reviewed in this paper illustrate the advantages of private ownership, but it does not follow that all activities should be privately owned. Decisions as to whether or not continuing government ownership of an asset is desirable must be made on a case-by-case basis. Such decisions need to be informed, however, by a due recognition of the general advantages which attach to private ownership.

APPENDIX I SUMMARY OF THE SOE FRAMEWORK

Key steps in the state sector reform process were the Labour government announcements of December 1985 and May 1986.

The 12 December 1985 announcement listed the following principles which were to be used to reform the SOEs:

responsibility for non-commercial functions will be separated from major trading state-owned enterprises;

managers of state-owned enterprises will be given a principal objective of running them as successful business enterprises;

managers will be given responsibility for decisions on the use of inputs and on pricing and marketing of their output within the performance objectives agreed with ministers, so that managers can be held accountable to ministers and to Parliament for their results;

the advantages and disadvantages which state-owned enterprises have, including unnecessary barriers to competition, will be removed so that commercial criteria will provide a fair assessment of managerial performance; and

individual state-owned enterprises will be reconstituted on a case-by-case basis in a form appropriate for their commercial purposes under the guidance of Boards comprising, generally, members appointed from the private sector.

The key elements of the major reforms in public sector management which were subsequently announced in May 1986 were:

state-trading enterprises are to be placed on a proper commercial basis, being exposed to competition on equal terms with the private sector and required to earn a market rate of return for the taxpayer;

charges for many services, which are currently provided free or below cost at the taxpayer's expense, should be increased to cover the true cost of supply (including the cost of capital);

non-commercial departments are to be given incentives for better asset management;

some overall reductions in funding are to be imposed to encourage increased efficiency in administration; and

as part of an on-going programme of scrutiny, some quangos are to be abolished and the future of others reviewed.

A major step in the process or reform was to transfer the trading activities of various government departments into corporate structures. The State-Owned Enterprises Act 1986, which provided umbrella legislation for this process, required (SOEs) to be:

as profitable and efficient as comparable businesses that are not owned by the Crown;

a good employer; and

an organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accomodate or encourage these when able to do so.

APPENDIX II SOE LIST, JUNE 1992

Airways Corporation of New Zealand Limited

Coal Corporation of New Zealand Limited

Electricity Corporation of New Zealand Limited

GCS Limited

Government Property Services Limited

Land Corporation Limited

NZ Post Limited

New Zealand Railways Corporation

NZ Rail Limited

Works & Development Services Corporation (NZ) Ltd

Television New Zealand

Radio New Zealand Limited

New Zealand Timberlands Limited

Timberlands West Coast Limited

Forestry Corporation of NZ Limited

The following three Establishment Boards will become SOEs on 1 July 1992:*

NZ Meteorological Service

Management Consultancy Services

Airport Holdings Limited

APPENDIX III PRIVATISATION CHRONOLOGY

The following table summarises the major privatisations undertaken in New Zealand since 1987.

Date		Entity	Government Stake Sold
1987	March	Bank of New Zealand	13%
	August	Petrocorp	30%
	October	New Zealand Steel	100%
1988	March	Petrocorp	70%
	June	Development Finance Corporation*	100%
	December	Post Bank	100%
1989	April	Shipping Corporation	100%
	April	Air New Zealand	100%
	June	Bank of New Zealand	34%
	October	Rural Bank	100%
1990	May	State Insurance	100%
	June	Government's 75% interest in Synfuels	100%

	June	Gas supply contract from Maui gas fields	100%
	July	Government Printing Office	100%
	July-October	Exotic plantation forest cutting rights	40%
	September	Telecom Corporation	100%
1992	April	Exotic plantation forest cutting rights	16%

* 80% sold to the National Provident Fund.

A number of residual assets have also been sold since 1987 (such as surplus property held by SOEs, the Tourist Hotel Corporation, etc).