Reflections on Privatisation

Roderick Deane

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CIS Occasional Papers 32

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THE CENTRE FOR
INDEPENDENT
STUDIES
1991

Published March 1991 by

The Centre for Independent Studies Limited

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National Library of Australia

Cataloguing-in-PublicationData

Deane, R. S. (Roderick Sheldon), 1941- ,
Reflections on privatisation.

Bibliography
ISBN 0 949769 63 0

1. Privatisation — New Zealand. 2. Corporations, Government — New Zealand. 3. Government business enterprises — New Zealand. I. Centre for Independent Studies (Australia). II. Title. (Series : CIS occasional papers; no. 32).

354.93092

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Foreword

Dr Roderick Deane's *Reflections on Privatisation* is a report from the economic front line. New Zealand is undergoing unprecedented economic change and Dr Deane has been a key agent of that change.

As a young man at the Reserve Bank of New Zealand, Dr Deane introduced modern methods of analysis. His research reports gave the Bank a high profile and impacted increasingly on the policy debate. As the Bank's chief economist he led the drive towards a more market-oriented financial system. As Deputy Governor he struggled against re-regulation in the dying days of the Muldoon Government and then was pilloried in parliament through the efforts of an economic committee organised by Mr Muldoon, then the newly-installed Leader of the Opposition.

Many men would have retired quietly at that point. Instead, Dr Deane took on the task of reorganising New Zealand's public service, and, in particular, separating out its many commercial functions into a corporate format suitable for privatisation. With irreversible change under way in the public service, he moved on to reorganise one of the country's largest and least efficient statutory authorities, the New Zealand Electricity Corporation, within a now deregulated generation market.

This CIS Occasional Paper is entirely characteristic of the author. It combines high standards of intellectual rigour with telling use of statistics. Only brief mention is made of the stunning turnaround in the performance of the Electricity Corporation; Dr Deane's own managerial achievements are presented as only one brick in an imposing edifice, but anyone acquainted with the recent economic history of New Zealand would praise his consistent example and influence in the pursuit of accountability and efficiency in public service and business enterprise alike.

Dr Deane's paper begins by noting the influence of fashions and fads in life as in economic doctrine. At a recent conference (organised jointly by James Capel Australia and Price Waterhouse) where the paper was presented, Professor Geoffrey Blainey gave a powerful presentation on the historical swings in views about the range and scope of government activities in Australia. Professor Blainey identified five swings of the pendulum. For example: it was an Australian Labor government that lost power over the issue of

bank nationalisation in 1949; it is another Labor government that has begun the task of denationalising the Commonwealth Bank in 1990.

In Australia as in New Zealand, economic necessity has played an important role in the latest swing to privatisation. Of course, neither Australia nor New Zealand has been at the forefront in the latest swing of the policy pendulum. Dr Deane cites a 1988 study that lists 1343 cases of privatisation in 86 countries. While both antipodean countries are showing signs of wanting to catch up quickly, they have so far made more progress with corporatisation than with privatisation. Much of Dr Deane's paper is about the great benefits that corporatisation has brought to government enterprise in New Zealand, and it is fair to say that similar progress has been made in Australia. Why then take the further and politically more painful step of privatisation? Dr Deane's answer is that, in order to lock in the gains of corporatisation, it is necessary to remove, or at least to make much more difficult, political interference in matters that appropriate private sector structures can handle better. At the aforementioned conference, Mr Roger Douglas put it more colourfully when he said: 'The threat of a takeover will beat the best bureaucratic monitoring system'.

The basic case for privatising most government business enterprises is that economic efficiency is likely to be enhanced. We all know examples of inefficient private enterprise, and most of us will acknowledge that there are some efficient government enterprises. But we also know that there are, relatively speaking, more private enterprises that are efficient than government enterprises.

Professor Blainey's pendulum, however, may have a different message. There is a body of opinion associated with the names of Joseph Schumpeter and Mancur Olson that in one way or another associates progress with change. Schumpeter spoke of 'the process of creative destruction'; Olson focused on the necessity for change that destroys the entrenched monopolies that inhibit and ultimately strangle economic progress. Both of these famous scholars have useful insights to contribute to the current debate. Moreover, any economic doctrine pushed to its limits sows the seed of its own destruction: 'Those whom the gods wish to destroy they first make mad'. I suspect that we are in an era of privatisation because the era of socialistic regulation, particularly after World War II, went well beyond its original aim of curing manifest social and economic ills. The socialist movement created its own increasingly outmoded structures and vested interests. Now we are witnessing the breaking down of those

structures and we are again entering an era of (relative) *laissez faire.* Some excesses of competition have already appeared, such as the recent credit binge in Australia, but the new era has a long way yet to run. Recent debate about the possibility of handing some of the administration of social welfare to the voluntary charities is a nice example.

No doubt the pendulum will swing back at some time in the future. But if the analysis of Schumpeter and Olson is applicable, as I believe it is, we should embrace privatisation for the sake of the economic energies it will unleash. Dr Deane's paper is a telling, as well as timely, contribution to the debate.

Peter Jonson

Author's Note

This paper is based on background material for an address to the United Kingdom/New Zealand 1990 Committee Conference on Economic and Social Reform, Windsor, United Kingdom, 15 - 17 September 1989.

Although its content is solely the author's responsibility, a number of useful comments were kindly provided by Roger Kerr and Susan Begg, and the paper more generally has benefited greatly from discussions on the issues it covers with John Fernyhough, Chairman of the Electricity Corporation, and Roger Douglas, former Minister of Finance. Other colleagues in the State Services Commission and the New Zealand Treasury, as well as the Electricity Corporation, have contributed to my thinking on the issues. The author is also grateful for the most helpful comments provided by independent referees.

About the Author

Roderick **Deane** is Chief Executive of the Electricity Corporation of New Zealand Ltd. He is also National President of the New Zealand Society for the Intellectually Handicapped (IHC). He was previously Chairman of the State Services Commission and, prior to that, was successively Alternate Executive Director of the International Monetary Fund and Deputy Governor of the Reserve Bank of New Zealand.

Dr Deane has Ph.D. and B.Com. (Hons) degrees in economics and is a Fellow of both the New Zealand Society of Accountants (FCA) and the Chartered Institute of Secretaries and Administrators (FCIS). He is a member of the New Zealand Board of the AMP Society.

Reflections on Privatisation

Roderick Deane

I. INTRODUCTION

Life is full of intellectual fashions and passing fads. Many of these resurrect in different guises ideas of the past. Moreover, international emulation of fashionable ideas is not uncommon. It is, therefore, not surprising to find that privatisation of state-owned enterprises (SOEs), one of the public sector's most popular trends of recent years, not only harks back to the past but has also achieved considerable international appeal. The governments of both the United Kingdom and New Zealand have endorsed this taste for privatisation, although they are hardly alone in this. A recent World Bank technical paper (Vuylsteke, 1988) documented 1343 privatisation cases in 86 countries, confirming that privatisation now encompasses the full spectrum of political systems in countries as diverse as Australia and Zaire.

The need to explore with considerable care the analytical and empirical foundations of the case for privatisation is emphasised in various ways. First, Britons and New Zealanders are familiar with the historical policy vacillations between nationalisation and privatisation, and indeed the political altercations that have arisen from this long-running debate. Second, as one of New Zealand's most prominent educationalists, Dr C. E. Beeby (1986), has reminded us in another context, every utopia is a myth and, moreover, myths tend to change with the generations.

Bearing in mind the changing nature of the debate on privatisation over the years in both our countries, this paper aims to sketch briefly the rationale for state-owned trading activities and some of the challenges to these; to elaborate some of the conceptual issues involved in the debate; to explore the gains from the process of corporatisation and the nature of the incentives underpinning SOE performance; to touch on some of the myths associated with the privatisation discussion; and to explore the nature of the further potential efficiency gains that can arise from the process of privatisation. The paper concentrates upon the

analytical underpinnings of the debate but refers also to some of the empirical evidence, particularly within the New Zealand context.

II. THE ROLE OF STATE TRADING ACTIVITIES

The rationale for state involvement in commercial activities has varied over time and between different activities. The reasons have ranged from the perceived need to protect society from being exploited by the market power inherent in monopolies to the arguable case for governments promoting particular industries as part of a grand plan to provide employment and investment growth. Other rationales range from the need to provide economic infrastructure which it is believed would be under-provided by the private sector to rescuing a failing firm by loans or subsidies because the firm was seen to be a critical player in the economy; from preventing foreign ownership of particular activities to promoting 'cultural sovereignty' in areas such as publishing and broadcasting; and from providing public goods and services based on concepts of equality or equity to the promotion of international image and prestige as typified by the airline industry.

Given that these rationales frequently have as much a political as an economic basis, it is not surprising that they rarely stand up well to rigorous or objective analysis in terms of the particular need for government ownership rather than private sector ownership. For example, it is now widely agreed that many of the industries that were viewed as 'natural monopolies' in the past, such as electricity and telecommunications, can and should be subject to competition across a relatively broad spectrum of their activities. In New Zealand, it has been estimated that over 70 per cent of the electricity market is contestable by other fuels. Within the electricity industry itself, a recent UK study (Sykes & Robinson, 1987) found that no more than 30 per cent of the industry's activities fell into the naturally monopolistic class. In any event, even where monopoly elements are present, it has not been demonstrated that government ownership is preferable to private sector ownership given an appropriate regulatory framework.

Other rationales for state sector involvement in commercial activities have come under question as it has been realised that direct government involvement in business enterprises can too readily lead to the imposition of non-commercial objectives and thus generate loss-making activities. There is also plenty of evidence to suggest that governments are not typically successful in rescuing failing firms, which should usually be allowed to respond in a commercial way to

their changing marketplace situations, In terms of promoting economic development or employment or infrastructure, the argument that governments need to be involved directly in enterprises to promote these activities carries little weight, since successful large private firms have demonstrated that not only can they contribute to these types of objectives, including the development of large scale projects, but can also do so within the constraints of the need to perform profitably. In addition, the ability of governments to pick winners in the industrial arena has come increasingly under scrutiny.

The public goods argument has fallen into question as a result of the demonstrated private sector capacity to provide services as diverse as those in garbage disposal, schooling, services for the intellectually handicapped, hospitals, prison management, and so on. The nature of contractual or regulatory arrangements can be as important as the ownership issue in determining the influence of government policies in matters such as cultural sovereignty, foreign ownership, or industrial development generally.

Against the background of this questioning of the role of the state in the commercial sphere, it may be useful to review the principles that have underpinned the New Zealand policy initiatives of recent years, involving, first, the segregation of government's commercial activities from the social, regulatory, and policy functions and, second, the privatisation of an increasing number of its business enterprises.

III. SOME CONCEPTUAL ISSUES

In assessing this process, one should perhaps reflect briefly on the conceptual framework that underpins change of this kind, in order not only to assist in the examination of the potential success of the SOE corporatisation model, but also to help draw any lessons for ways in which this might be enhanced particularly by privatisation.

Recent economic analysis has placed considerable emphasis upon a number of interrelated concepts that warrant an attempt to simplify and summarise. These relate especially to the importance of transactions and agency costs, and the role of property rights.

The first strand of thought is that economic activity is primarily about transactions between different parties: sellers and buyers; firms and customers; lenders and borrowers; individuals and organisations; and owners and managers. At the heart of the interrelationships between these groups is the need for information, and the costs of obtaining that information, to facilitate decisions about the transac-

tions undertaken by different parties within the economy. The role of the market system is typically to help aggregate and synthesise information and to provide a means of determining these information and transactions costs. Within the marketplace, competition provides a set of incentives to promote good performance and a number of sanctions to penalise inadequate performance by individuals, as well as to assist in the process of discovering what consumers want and what competitors are doing.

The second strand of this analytical framework is the issue of the agency costs incurred by firms which face the problem that the interests of their owners may diverge from those of their managers and other employees. In essence, the company manager acts as an agent for the shareholder, and the owner has to induce the manager to act in the owner's interest. In doing so, certain agency costs are incurred.

The third strand of thinking relates to property rights, which serve the purpose of ensuring that the people who are most affected by economic decisions are also the most efficient at seeking out the information they need. Property rights also help establish a set of constraints upon individual actions. Well-defined property rights typically set out the nature of the right of the owner to decide how to use the resource itself and the income from that resource, as well as defining the right of the owner to transfer the resource. The usefulness of private property rights in promoting efficient resource use is of course influenced by transactions costs.

Within private sector corporations, there are a number of important influences over agency costs, which help the owner control the management of a firm. These include the existence of the share market; the role of skilled investment analysts; the takeover mechanism; the market for managerial services; the role of the Board of Directors, who act under delegated authority for shareholders; the monitoring of company performance by major lenders; competition within the markets for the company's products and services; and ultimately the threat of insolvency. These mechanisms are of a mutually reinforcing nature and information tends to be exchanged by the various participants within this process.

In relating these concepts to state enterprises, the problem with public ownership is that it leaves a substantial area of economic activity free from the system of private property rights and may thus impair the mechanisms described above. For example, when firms are owned by the state, ownership rights are not transferable within the market place, and the nature of the owners who are entitled to the

income from the assets is more dispersed and less clearly defined because of the generality of the nature of government. The problem with this is that it may reduce the incentives of the owners (the government) to monitor management performance and to ensure that the resources are being used effectively. The absence of the share market mechanism and of the threat of takeover, and probably also the moderation of the threat of insolvency, may make it more difficult to obtain information about the firm's activities and inhibit the ability to resolve problems quickly and efficiently. In other words, because both the owners and the managers of an SOE may face less rewarding or less specific incentives and less demanding sanctions than their private sector counterparts, economic performance of SOEs may be impaired by comparison with private sector corporations. In addition, because of the nature of the political process, the possibility of using state ownership to confer benefits on particular interest groups is probably enhanced in the case of the SOE model.

In summary, the lack of ability to transfer property rights under state ownership, and the absence of direct or exclusive rights by individuals to any income accruing from the improved use of public assets, reduces the incentive to control agency contracts and agency costs, may well reduce the incentives for satisfactory economic performance by SOEs, and increases the prospect of political interference in the process.

IV. COMPETITIVE NEUTRALITY

To some extent, these agency and monitoring problems can be moderated for SOEs by ensuring that they are not given any regulatory protection and that they are not subject to any other particular preferential or subsidy arrangements. Equally, they should not be burdened with any disadvantages that are not shared by their private sector counterparts.

In New Zealand, considerable progress has been made by the government in deregulating the market environment for most of the SOEs, by requiring them to pay tax and dividends on a normal commercial basis, by ensuring that they have to fund their own balance sheets on regular commercial terms, by making explicit the absence of a government guarantee, and in some cases by moving to the sale of shares or equity bonds in the organisations. It is only by moving as close as possible to such a neutral environment that normal commercial criteria can be used to assess SOE performance in a meaningful fashion. This process also ensures that competition for SOE products or services will

provide both incentives and constraints on their performance.

While this line of reasoning is clear-cut enough for organisations that operate in intensely competitive marketplaces where other well established competitors exist, it has often been argued in the past that the case for state control and ownership is greater in those situations where important monopoly elements are perceived to exist, such as in the case of telecommunications and electricity. However, economists' views on the nature of competition and monopoly have undergone considerable modifications over recent years. Whereas monopolistic behaviour was formerly regarded as a problem in markets where there appeared to be only one or very few producers, and these were seen to have the ability to restrict output and/or increase prices in order to enhance 'monopoly profits', economists now tend to take a rather broader and more dynamic view of what constitutes competition. The forms of competition are today seen to be diverse, numerous and generally pervasive; contestability and competition are judged against a much broader perspective than simply the nature of a particular market or the presence of a particular single firm. Monopoly problems are essentially ones of scale and degree.

In New Zealand, the Electricity Corporation has sometimes been quoted as an example of a natural monopoly. However, there was nothing 'natural' about the legislative protection it had in its earlier guises against competition from other power generators or the legislative monopolies existing as a result of the geographic boundaries constraining competition between electricity supply authorities. These 'monopolies' were essentially artificial in character. Closer analysis of the activities of the Electricity Corporation makes it clear that other parties could readily get into the power station business. Since the recent deregulation some have indeed indicated considerable interest in doing so, and in the same way there should be no constraint on other parties marketing electricity providing they can utilise the national grid.

When the process of deregulation of the electricity industry is complete, both the production and marketing ends should become contestable, and the only natural monopoly to remain should, one hopes, be the line networks. This is why the Electricity Corporation has placed so much attention upon the need for transparency with respect to the national grid's operation, and has provided unequivocal assurances with respect to access rights for other parties on the same basis as internal access. Setting up the grid as a separate subsidiary company with outside directors and full transparency seems to be a more satisfactory option than regulatory or rate-of-

return controls as a means of constraining any potential monopoly power. This is in effect a voluntary form of the common carrier provision that is utilised in a number of overseas countries with respect to similar monopoly networks.

The alternative of price or rate-of-return regulation as a means of controlling a monopoly is a complex one in view of the major problems faced by regulators in obtaining the information they require to exercise appropriate judgements about either price or rate-of- return setting. Historical experience in New Zealand of controls of this type suggest that bureaucrats are not good at making these types of judgements and do not have the appropriate mix of incentives and sanctions to ensure that they make decisions that are necessarily more satisfactory than those made by the relevant company itself. This suggests that the emphasis should be on providing fully contestable market environments and appropriate private sector monitoring arrangements to check the performance of the enterprise, such as through the share market or the mechanism of the potential takeover.

It needs to be remembered that state control of itself does not prevent an organisation from having the ability to exercise monopoly power and indeed may open the way for SOEs to be used to further political ends rather than improve economic efficiency. Actual or perceived monopoly power should thus be constrained not simply by state ownership, which carries with it all the other problems already sketched, but rather by making the operating environment of the SOE organisations as contestable as possible. By taking a broader view of the processes of competition, it can be argued that the problem of 'monopolies' is not nearly as pervasive as has sometimes been thought, providing there is a willingness to pursue deregulation in a vigorous and innovative way. Too many so-called monopolies have in fact been of an artificial character, buttressed by state ownership itself, legislative protection, trade barriers and other artificial impediments to competition. The key issue is the identification and removal of these impediments.

V. THE GAINS FROM CORPORATISATION

Within the New Zealand context, concern about the need to improve the efficiency of state-owned trading activities led to the introduction of the State Owned Enterprises Act 1986 and the conversion in 1987 of a range of major government departments into nine new corporations under the auspices of this legislation. The principles underlying this

process included the need for SOEs to concentrate upon their commercial objectives; to be run as successful businesses; to be as transparent as possible in their operations by providing full and ongoing information about their activities in a normal commercial manner; to function within competitively neutral environments free of both regulatory favours and inhibitions; to be appropriately monitored to ensure adequate accountability; and in some cases to be privatised to ensure that the maximum degree of efficiency was attained. The reform process also provided for more flexible, commercially-based, management procedures within SOEs including the appointment of professional boards of directors, sufficient management autonomy and authority to facilitate key resource use decision-making, improvements in the incentive and sanctions systems for managers, and generally more competitive pressures upon both management and the enterprise itself.

Despite these reforms taking place against the background of an economy undergoing a substantial adjustment process and thus suffering from relatively slow economic growth, most of the new SOEs have substantially reduced their costs and increased their profitability. Shareholding Ministers have been freed from day-to-day decision-making with respect to the enterprises and can now concentrate upon broader policy perspectives. Agreed statements of corporate intent and strict reporting regimes facilitate close monitoring by the government and its advisers. The monitoring process concentrates upon overall commercial performance and, at least where this is satisfactory, the boards and managements of the enterprises have considerable freedom to run the businesses on a day-to-day basis.

In an empirical sense, the success of the SOE reform process is best measured by reference to the annual reports of the various enterprises, which set out in detail the typical cost reductions and profit increases that have been achieved. By way of some anecdotal differentiation, an interesting but random selection of gains from the process might help confirm the points being made:

- Coalcorp, which was formed from the operation of the old state coal mines, made losses in 20 of its last 22 years of operation prior to being corporatised. Some miners were employed in uneconomic mines at an annual cost of around $NZ122 000 per job. In its first full year of operation, the Corporation turned a loss of $NZ23 million into a small profit without increasing its prices. Despite reducing its staff numbers by half, Coalcorp's annual production is now

higher than that achieved by the old state coal mines. Coalcorp expects that with a small increase in its employees, it should be able to double its production again over the next couple of years.

- New Zealand Post was formed from the postal business of the previous New Zealand Post Office. Although the postal business incurred losses of $NZ38 million in 1986/87 and was expected to lose around $NZ50 million in 1987/88, NZ Post actually achieved a substantial profit in that year, its first year of operation. The profitwas achieved without price increases for basic mail and with price reductions of 30-50 per cent for unaddressed mail. Service delivery performance improved by 5-10 per cent despite an increase in the volume of mail delivered.

- The Forestry Corporation in its first year of operation achieved a cash surplus of $NZ53 million compared with the $70 million loss made by the Forest Service in the previous year. Staff numbers were reduced from around 7000 to just over 2500.

- Telecom has decentralised its operations into six major subsidiary companies each of which now has the freedom and flexibility to run cost effectively. Head office staff have been reduced from 2000 to 600 with further reductions to around 200 being planned. The total workforce has reduced from 25 000 to 19 000 and is expected to fall to 14 000 by the end of 1990. More efficient pricing is being achieved by the removal of cross-subsidies between local and long-distance calling, with benefits such as the recently announced 20 per cent reduction in toll rates and business rental reductions being passed on to customers. Telecom has reduced costs in many areas by contracting work out, including to its own former staff now operating as contractors who are, for example, now installing telephones at up to four times the installation rates that were previously achieved. The waiting time for installation of telephone lines has been reduced from around six weeks to less than 72 hours for 96 per cent of customers. In Auckland the PABX waiting list of 800 has been virtually eliminated and installation is now 'on demand'. A new directory service

computer means that calls are answered in Auckland on average within eight seconds, down from a 60 second average.

- The Electricity Corporation (ECNZ) has increased its volume of sales despite the economic recession, producing an increase in electricity's share of the total energy market for the first time in eight years. Over the first two years of operation, ECNZ has reduced real unit costs by around 20 per cent with a further significant decline anticipated in the current year. Output of electricity per employee increased by 12 per cent in 1988/89, with a further increase of 6 per cent anticipated this year. Despite a 50 per cent increase in the asset valuation of the organisation on corporatisation, ECNZ has more than doubled its net profit after tax in the first two years of operations, and is now achieving significant price reductions in real terms. The latter are a response to the threat of potential competition in generation.

VI. THE POTENTIAL FOR FURTHER EFFICIENCY GAINS

The dramatic gains from the SOE reform process have been achieved essentially by changing the constraints, including the mix of incentives and sanctions, facing SOE managers. This raises the issue of whether further changes in the constraints could achieve even greater gains or at least ensure that the gains achieved to date are not reversed in the future.

The constraints imposed on SOE managers are explicitly based on the mechanisms used to promote management performance in private sector 'public' companies. The fact that this form of company has acquired its current dominance in competition with other forms of organisation indicates that it is a successful way of organising many kinds of economic activity. It allows management by specialists and risk-sharing by a diverse group of shareholders who, as owners, are not required to play an active role in the organisation's business affairs. Although the separation of ownership from control gives rise to potential incentive problems between shareholders and management, the problems are typically controlled by a series of market and organisational constraints that arise because of the transferability of ownership in private sector companies.

A similar problem of conflicting interests arises between the

managers and owners of SOEs. The SOE constraints are intended to replicate as far as possible the mechanisms used in the private sector to align the interests of managers and shareholders. However, it is clearly not possible to replicate all of the constraints used in the private sector within the SOE model. The absence or weakness of some of these mechanisms in the case of SOEs may have adverse implications for their performance and there are practical and conceptual problems with some of the surrogate mechanisms that have been devised for SOEs. State ownership itself introduces substantial risks that,the gains achieved by corporatisation may not be sustained.

The major way in which these problems can be reduced further is by privatisation. Private firms can make unsatisfactory investment decisions and perform poorly, but the market checks on sustained poor performance appear to be the clearest and strongest available.

The earlier discussion of analytical issues suggests that there are several key problems with the SOE model. Some of the most important are that it is not possible to replicate the private sector constraints that arise from the transferability of ownership and developments in the sharemarket; competitive neutrality cannot be achieved as long as government debt carries an implicit guarantee; and the scope for efficiency-reducing government intervention may be higher while state ownership is retained. These issues are discussed in more detail below by exploring some of the practical implications of the earlier analysis.

VII. THE SHAREMARKET

The ability to transfer ownership in a company by means of the sharemarket acts as a powerful constraint on management performance. The sharemarket aggregates the collective views of investors about the relative performance of different companies and their management teams so that share prices tend to reflect all available information held by market participants on the current and future performance of companies. This in turn reflects the quality of the decisions made by company managements. Market participants can profit from superior information about a firm's future earnings by buying or selling shares, thus providing an incentive for professional analysts, institutional investors and others to study management performance closely.

Because of the non-transferability of SOE shares their commercial performance is not directly monitored by the sharemarket in the same way as for listed companies. The incentives for owners to

monitor management performance may also be weaker in relative terms because the monitors cannot profit from their superior information. The non-tradability of equity has given rise to the acute difficulties of valuing the businesses and the consequent problems of establishing appropriate capital structures for firms. If some of the benefits of the sharemarket are to be realised, then clearly sales of equity in SOEs to the public is a technique for facilitating this.

The gains from replacing unsatisfactory managers and directors may motivate a takeover of a company. When a company's performance is poor, or its managers and directors are overlooking important opportunities to use resources efficiently, the company's expected future cash flows are reduced and its share price is lower than it would otherwise be. An improvement in performance will result in higher share prices (arising from changes in expected future cash flows) and hence capital gains for current shareholders. The capital gains provide the motivation and reward for changing control and replacing management. Because of the vast size of the assets controlled by publicly listed companies, the market for corporate control is one of the most important markets in the economy. As SOEs do not typically have transferable shares; it is not possible for an SOE to be taken over and the management team replaced by this means. Its management team is not therefore threatened by this possibility. The inability to take over the company thus reduces the incentives for investment companies or rival management teams to monitor management performance.

There are a humber of factors that affect the incentives of directors to monitor managers. First, directors' reputations will be directly linked to the performance of the company and will be strongly affected by the information generated by the sharemarket. Poor company performance creates a negative signal about the ability of incumbent directors, thereby affecting their future employment opportunities and expected remuneration. Second, if they hold shares in the company, which is generally the case, their wealth is directly affected by poor managers. Third, if managers, and therefore directors, are under-achieving, shareholders can replace directors by a takeover or proxy battle. The replacement of directors by existing or new shareholders will also adversely impact on the directors' reputations. The threat of a takeover or proxy battle itself places pressure on incumbent directors to maximise the value of the firm.

The important incentives created by the second and third constraints do not apply in the case of SOEs. Because ownership is not tradable, the offer of an equity stake in the business cannot be used to

attract managers or directors to the business or act as an incentive for performance. Directors and managers are not threatened by the takeover market.

The market for managers plays an important role in controlling managerial agency problems. The performance of individual managers and of the management team as a whole provides information to the market that affects the future income and employment opportunities of team members. The market for managers relies heavily on the information provided by the capital market and, in a sense, the market for corporate control can be viewed as a major component of the managerial labour market. It is the arena in which alternative management teams compete for the rights to manage corporate resources. For government-owned businesses, the problem is that the information provided by the sharemarket is not available to those monitoring SOEs' managers.

VIII. IMPLICIT GOVERNMENT GUARANTEE

It is exceedingly difficult to establish a competitively neutral environment while a firm remains in government ownership, if for no other reason than that an implicit government guarantee will tend to remain on SOE debt even in the absence of an explicit government guarantee. The possibility of a major New Zealand SOE defaulting on its debt is often considered remote because of the undesirable political consequences of such an event for the government. The threat of bankruptcy sets the ultimate limit on the amount of value that can be written off by unsatisfactory management performance. The market's view of the bankruptcy risk will be reflected in the cost of its debt capital (its interest costs) and the cost of its equity (the rate of return required by its shareholders). The level of these costs affects the firm's ability to survive and expand.

A proportion of the human capital of managers is specific to their existing enterprise. It may be destroyed by bankruptcy or impaired by inadequate financial performance. Bankruptcy or other financial difficulties also send negative signals to the markets for managerial labour regarding the performance of management teams. These constraints may be absent or insufficiently compelling in the case of SOEs.

Privatisation would remove the distortions resulting from any implicit government guarantees. It should increase the discipline imposed by the threat of bankruptcy and help to ensure that the cost of funds to enterprises reflected their underlying risk characteristics and business performance.

IX. POLITICAL INTERACTION

Many of the efficiency gains achieved to date can be attributed to the government's determination to push ahead with reform despite reservations in some quarters and the political costs involved. The government has been able to attract considerable apolitical talent to serve on the boards of SOEs. The environment has provided the necessary challenge for well-motivated management teams to achieve the substantial improvements in performance recorded to date. However, experience suggests that these conditions may well not persist indefinitely.

Government ownership of an organisation increases the likelihood that it will be used to confer benefits on particular interest groups. Because much of the income generated by an SOE is not clearly allocated to any particular individual (unlike a private firm where the rights to income are clearly specified), governments have the scope effectively to divert this income to politically-favoured groups. This could be achieved for example, by requiring SOEs to provide subsidised services to favoured groups at the expense of overall profits.

Interest groups have incentives to lobby for special benefits, and governments may have incentives to grant them as long as the costs of such actions are not readily apparent to those who are disadvantaged. As long as SOEs remain in public ownership there may be the temptation to use SOEs to deliver benefits to such groups at the expense of overall community welfare. Interventions of this type may undermine the incentives provided by corporatisation. Government ownership may also introduce the temptation for the government to sacrifice agreed commercial objectives in the face of fiscal pressures through, for example, requiring the payment of dividends in excess of what directors may deem to be appropriate.

If state ownership of SOEs is retained there is a substantial likelihood that the benefits of corporatisation will lessen or perhaps even be reversed over time. The United Kingdom experience emphasises this risk. A salient feature of experience with SOEs in the United Kingdom has been the difficulty of making the economic and financial guidelines operative and maintaining the integrity of the arm's-length concept (whereby the Government is not involved in the day-to-day running of the organisation). As Jones (1987), a Professor of Government at the London School of Economics, noted '[the SOE process] does not work. The half-way house is not viable. New Zealand, if benefiting from British experience, should regard the

SOD as a stage en route from the departmental form to full privatisation. SOEs offer no enduring model'.

X. THE PRIVATISATION DEBATE

Various reasons have been adduced for privatisation. These include improvements in efficiency, assistance with reducing fiscal deficits, encouraging a spread of share ownership in the economy, and moderating the influence of government generally within the economy. It is difficult to escape the view that the privatisation debate in New Zealand is currently rather poorly focused, partly because some of the arguments are ideologically based and partly because some of them are peripheral to the main issues.

Debt Repayment and Efficiency Gains

One argument centres around whether repayment of national debt is a justification for privatisation. At first sight it may appear that a significant gain from privatisation is the revenue accruing to the government from the sale of the assets of the SOE. However, further reflection demonstrates that this gain is in a sense illusory. If the sale value of the firm to be privatised is equal to the present value of its expected public-ownership profit stream, then the public sector has not altered its net worth through the privatisation process. In other words, the real economic gains are confined to productive efficiency improvements and do not relate to the cash flow generated for the government accounts as a result of selling assets. The gains do not accrue simply from the act of transferring ownership from the public to the private sector, but rather through any improvement in the way in which the assets are used, i.e. through efficiency gains, generated by the change to private ownership improving the set of incentives and constraints as a result of exposing the organisation to the normal disciplines of the market.

The essence of the efficiency gains is that customers should benefit through more favourable prices, as well as wider choices and better service. Privately-owned organisations are likely to be more responsive than their state sector counterparts to changing market conditions and varying customer demands, and be more innovative in introducing new products and generally adapting to change. The problem of agency costs referred to above is likely to be less severe in privately-owned organisations than in SOEs. This is because of the existence of improved incentives and stronger sanctions in the private

sector, Sharemarket listing, private sector monitoring, full exposure to private sector product and capital markets, takeover possibilities, and other similar considerations underpin this line of reasoning.

However, the empirical evidence on the relative efficiency of private and public enterprise is fraught with methodological difficulties and is not fully conclusive. Although the available evidence appears on balance to favour private ownership, efficient performance by individual public enterprises over a period of time, for example as a result of superior management, cannot be ruled out. However, as the experience of the Eastern Bloc has shown on a larger scale, performance over the longer haul is likely to be much inferior. This is the relevant experience in framing policy.

One of the most recent and comprehensive studies (Boardman & Vining, 1989) comparing the performance of private companies, SOEs and mixed enterprises operating in competitive environments utilised the International 500 from *Fortune* Magazine, covering 500 large non-US industrial firms (409 private, 57 SOEs and 23 mixed). The study not only endeavoured to isolate and measure the influence of a range of variables such as firm size, market share, economies of scale, and related issues, but also measured performance using six different variables in an endeavour to overcome some of the problems with earlier studies. Although the results would not be without their challenges from other studies, they did indicate that large industrial mixed enterprises and SOEs performed substantially worse than similar private companies. This suggests that full privatisation is to be preferred to either partial privatisation or SOE status. Other evidence, such as that quoted by the Economic Development Commission (McCabe, 1989) for the United Kingdom, confirms the gains from privatisation in the United Kingdom context across different industries and among companies of different sizes, although the impact of restructuring of some of the former SOEs on the performance figures is not easy to isolate.

Social Service Provision

The other major argument that sometimes confuses the privatisation debate relates to the government's role in providing social services. The real issue is whether government provision of social services actually requires government production of such services. In most cases, social objectives can be pursued just as effectively if not more effectively through income transfers than through the direct provision of subsidised services. In situations where the government wishes to

provide subsidised services, it can of course contract for such services from the private sector. The essential point is that the issue of the role of the government in providing social services should ideally be separated from the privatisation debate.

Given the concerns within New Zealand about the issue of 'privatising' social services, including not only the traditional areas such as health and education but also those seen to have been previously supplied by conventional SOEs such as subsidies for rural electricity users and subsidies for remote postal districts, it is surprising how little recognition has been given to the highly successful provision of social services by private sector organisations to groups within society who are normally regarded as highly dependent, Perhaps one of the leading examples is the New Zealand Society for the Intellectually Handicapped (the IHC) which as New Zealand's largest private sector voluntary welfare organisation, with an annual budget of $NZ80 million and staff of over 2000, provides a wide array of services to the intellectually handicapped, ranging from preschool centres to workshop facilities, and from rural training centres to comprehensive residential services, all run on a user-pays basis but with a significant government subsidy.

Two major reviews carried out in recent years of the IHC by the Controller and Auditor-General, the most recent one having been published along with the Auditor-General's report on SOEs generally, not only concluded favourably with respect to the value for money aspects of the IHC services, but also compared them more than favourably with the costing of similar services provided by other organisations such as hospital boards (Audit Office, 1988:43-4). It is interesting to note that just before the last general election, the IHC volunteered to give up its direct government subsidies if the hospital boards and other agencies would also do the same and if the resultant pool of funds was utilised to increase benefits paid to intellectually handicapped people to enable them in turn to contract back to service provision agencies for services. The idea of this was to provide greater freedom of choice and more diversity of services. But the hospital boards were not prepared to support the proposals and in the end neither was the government.

In any event, organisations such as the IHC are interesting illustrations of the way in which social services can be successfully privatised. They also illustrate the validity of conceptually separating issues related to social service provision from those of privatisation.

XI. CONCLUSIONS

Considerable progress has been made in New Zealand over recent years with respect to each of the different stages involved in improving the efficiency of state sector commercial undertakings. Many of the state sector's commercial undertakings that were formerly run as government departments have now been placed on a more commercial corporate footing, and the market environments within which they operate have been made competitively more neutral with respect both to input markets and to competitive pressures in output markets. The SOE reforms have represented a consistent and self-reinforcing package of measures that have facilitated clearly improved performance across a broad spectrum of the public sector.

However, the reforms do not alter the fact of state ownership and the potential problems that this creates in maximising management performance. The essence of the matter is that some of the important constraints on managers that exist in the private sector mechanisms cannot be readily replicated within the public sector, and the absence or weakness of these mechanisms in the case of SOEs may have potential adverse implications for their performance particularly over the longer haul. The necessary third stage in the process of improving public sector efficiency is thus that of privatisation. It is only by this means that it will be possible to realise the ultimate efficiency gains and to ensure that the benefits achieved to date by corporatisation are not reversed.

Substantial progress with privatisation has been made in New Zealand, although much remains to be done not only with respect to conventional SOEs but also in other areas such as the trading activities of local authorities. In economic terms, the process of reform should facilitate a more satisfactory means of determining information and transactions costs, reduce agency costs, and ensure that the private sector system of property rights does its job in promoting the efficient use of the country's resources.

The SOE reforms should be seen as a consistent and integrated package of changes involving commercialisation, corporatisation, deregulation and privatisation. The ultimate effectiveness of the package depends on its completeness, and in this area the major part of the reform yet to come for a number of important SOEs is that of privatisation. The efficiency and profitability gains made by a range of the new SOEs demonstrate the potential contribution of the process to enhancing economic growth for the community generally.

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Reflections on Privatisation

Roderick Deane

Although privatisation of state-owned enterprises made great progress in New Zealand and elsewhere throughout the world during the 1980s, Australia has so far opted mainly for 'corporatisation', which aims to replicate in the public sector some of the constraints and incentives that operate in the private sector.

In this Occasional Paper, Dr Roderick Deane, a close observer of New Zealand's extensive privatisation program, argues that although corporatisation can dramatically improve the performance of state-owned enterprises, it cannot be a complete substitute for privatisation because it cannot replicate three crucial aspects of private ownership:

- ownership cannot be transferred through the sharemarket;
- competitive neutrality cannot be achieved while government debt carries an implicit guarantee; and
- state ownership increases the scope for efficiency-reducing intervention.

Privatisation is the next logical step: 'It is only by this means that it will be possible to realise the ultimate efficiency gains and to ensure that the benefits achieved to date by corporatisation are not reversed'.

Roderick Deane is Chief Executive of the Electricity Corporation of New Zealand Ltd. He is also National President of the New Zealand Society for the Intellectually Handicapped (IHC). He was previously Chairman of the State Services Commission and, prior to that, was successively Alternate Executive Director of the International Monetary Fund and Deputy Governor of the Reserve Bank of New Zealand.

ISBN 0 949769 63 0 ISSN 0155-7386

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