CHAPTER TWO

The Public Sector

INTRODUCTION

In the last three years many sectors of the economy have been forced out of the shelter of protection and regulation. They have demonstrated both capacity and willingness to contribute to a better standard of living for New Zealanders as a whole, in the face of increased competition both within markets in New Zealand, and from international sources.

If the Government wishes its public administration to demonstrate a similar capacity to face the realities of the 1980s, it will need to confront some major policy issues. In particular, it needs to decide what type of public service it wants to meet its objectives. It needs to decide whether it wants a public administration capable of high managerial skill and policy analysis over a wide area. We believe that such capability is essential if the public sector is not to affect adversely the adjustment process taking place in the remainder of the economy. The public sector consumes a significant proportion of New Zealand's resources, diverting them through tax revenues from other uses. We must be satisfied that those resources are being put to their best possible use. In its role as a regulator the Government impacts upon all aspects of economic and social activity; the extent to which we can achieve higher standards of living depends, among other things, on the quality of that regulation.

If the Government wishes to have a public sector capable of producing high quality advice, and managing its own affairs on a basis comparable with private sector efficiency, major changes in the nature of administration are essential. Some fundamental changes to the systems of financial management, performance assessment and pay fixing are imperative. The problems faced by the public sector are now evident. The public sector has not been able to recruit and retain the skilled policy advisers that it requires. This is evident in the problems being faced currently by this department, Audit, and Inland Revenue. More generally, most departments are finding they are losing their skilled staff to the private sector. In essence the state is now subsidising heavily the training of private sector specialists.

Many of the problems that occur today arise from previous public sector growth. Efficient management becomes much more complicated when it is carried out in a larger organisation where a greater diversity of skills are needed and outputs undertaken. Systems of accountability and incentives have not adapted over time to encourage the most efficient and most effective public service. We believe that the Government requires a public service that provides high quality advice, delivers effective implementation of government policies and provides a rewarding and stimulating environment in which people can work. To achieve this some basic principles should guide reform of the public sector. The strengthening of accountability mechanisms is crucial. As long as departments are constrained by input controls the monitoring of performance will be difficult. It is important to have structures in place that encourage public sector managers to act in the best interests of their clients. These clients may be Ministers, or they may be the general public. From the Government's perspective it is important that the advice that it receives is not unduly influenced by the narrower interests of particular sectional groups. This is one of the disadvantages of institutional arrangements that reflect the interests of particular sector groups.

The Government quite clearly is required to resolve conflicts of interest. In resolving these conflicts it is important that it has advice from different perspectives that will enable the most informed trade-off to be made. Therefore it is important that incentives exist for information to be made available to the Government and not withheld or manipulated in some form.

To move away from systems that control the public sector through constraints on the way in which resources are managed, it will be necessary to develop systems of improved accountability. This will have implications in areas such as methods of appointment, security of tenure and performance assessment. No one single solution is likely to provide an all encompassing answer to this problem. Rather the need will be to look at different parts of the public sector and the way they operate and determine what the most appropriate institutional arrangements are for conducting those activities. In some cases this may be putting functions on to a state owned enterprise basis. In other cases it may be a move towards greater user pays or it may be appropriate to separate the provision of government support from the production of services.

This chapter is structured in two parts. Part B discusses the state production of commercial goods and services. Part A is concerned principally with government activity which is, at least at present, predominantly 'non-commercial' in character.

It opens with a discussion of the aims of the government management process. Following an analysis of the principles that should guide reform of that process, it discusses current arrangements, assesses their adequacy, and suggests reform in a number of key areas: accountability and responsibility, the state sector labour market, the structure of government, the funding process, performance assessment, and the role of control agencies. Finally, it concludes with a summary of recommendations and a discussion of their inter-relationship.

PART A-REFORM OF PUBLIC SECTOR MANAGEMENT

Aims of the Government Management Process

The public sector—those agencies which are established by the Executive to carry out the day-to-day administration of government-may be viewed as the culmination of a series of relationships in which various groups concede power to others. The administration acts on behalf of the Executive, or Government. The Government receives its power through a majority position in Parliament, which in turn consists of those people in whom the electorate has reposed its confidence to act on its behalf to tax, legislate, spend and borrow.

The starting point in considering the way in which the conduct of government may be most efficiently administered is thus our unwritten constitution. This governs the relationship between the electorate on the one hand, and Parliament and the Government on the other. The extent to which that constitution enables the preferences of the electorate to be transformed into action, and the strength of accountability of the Government and Parliament for that action will be a determining factor shaping the nature of administration.

This section deduces the fundamental aims of the government management process by analysing the reasons for the existence of government, tracing its development in the Westminster parliamentary tradition, and examining the relationship between Parliament and the Government in the current New Zealand context.

The Role of Government

An earlier chapter discussed extensively the role and limits of government. A role for government as a monopolist of coercive powers was viewed as a fundamental outcome of a condition of scarcity and the resulting competition between individuals, or groups of individuals, for scarce resources. In order to enable collective gains the Government provides the framework within which interactions occur by prescribing the rights of individuals—property rights with respect to their power or control over resources, human rights with respect to their power vis-a-vis each other, and civil rights with respect to their relationship with the state.

While the Government's powers can enable it to achieve or promote collective goals, individuals can be expected continually to interact with the state in attempts to persuade it to alter any given definition or distribution of rights in their favour. Elections provide one opportunity for those who are enfranchised to select a group of people to act in their interests. Elections are, however, infrequent discrete events and the process of seeking to influence the Government does not take place once every three years alone. Between elections Governments are faced with continual requests to act in particular ways. Individuals form themselves into groups with common interests to lobby the Government on particular issues.

However, the expression of preferences by interest groups cannot be regarded as a sufficient revelation of the wishes of the electorate at large. In any policy issue it is likely that information concerning the distribution of costs and benefits of a proposed change will be asymmetric. The costs are often dispersed across many people and therefore less evident, while the benefits may be concentrated on a small group. This creates different incentives for various groups of voters to lobby government and express preferences.

Given scarcity and interdependency a key characteristic facing government is the tendency for groups in society to lobby the Government to secure policies to their benefit, frequently at the expense of other groups in society. This could lead to the adoption of policies which are not in the collective interests of society. The sanction of removal from power through election provides some discipline on any Government excessively pursuing narrow group interests, but by itself this may be an insufficient expression of the broad interests of the electorate. Rather, the need is to have institutional arrangements which allow conflicts of interest to be settled in line with legitimate collective goals rather than in ways which favour legislators or public servants or some sub-group of voters.

In attempting to ensure that its policies are in the overall interests of the electorate, the Government's objectives may be broadly encapsulated by the terms effectiveness and efficiency: effectiveness in the translation of the preferences of voters into outcomes, and efficiency in the conduct of government administration.

Proposals for constitutional reform that might result in a better realisation of voter preferences are beyond the scope of this document. This part of the chapter has been prepared on the basis that besides the constitution, the institutional structures through which an elected Government manages its affairs determine how well it will be able to realise broad voter preferences. It identifies a number of problems with current practices and suggests directions of reform that should lead to more effective and efficient government administration.

The Origins and Nature of New Zealand Government

The particular form which government in New Zealand takes today has been shaped by its origins in the Westminster parliamentary tradition. Parliament came into existence in England during the second half of the thirteenth century as a reflection of the principle 'no taxation without consent'. It was not, however, until after Parliament had established control over the Monarch's power to spend that it made a more concerted effort to develop effective expenditure and management control systems. As the importance of central administration increased together with the complexity of civil government, Parliament increasingly sought to control the activities of that administration through control of the resources at its disposal. By the middle of the nineteenth century most of the features of our current appropriation process—the means by which Parliament grants supply to the Executive to conduct the day-to-day administration of government—were in place, along with a system of public accounts, the Treasury and the office of Controller and Auditor-General. By the time Parliament was formed in New Zealand, then, two constraints that are central to the Westminster tradition had emerged: control of the tax burden, and parliamentary scrutiny of the activities of the Executive.

We turn now to the relationship between Parliament and the Executive to examine the way in which Parliament's objectives are translated into action by the Executive of the day.

During the nineteenth century, when governments rose and fell according to the shifting allegiances of Members of Parliament, the Government could be seen as the agent of Parliament with Parliament in turn the agent of the electors. Since our constitution continues to follow nineteenth century forms, there are several practices which appear to indicate that this is still the case. Electors vote for individuals not parties, and Governments must face the test of confidence votes. Since the rise of the modern party system, however, government in New Zealand has been characterised by great stability. There has not been a minority Government since 1931, and leaving aside the equivocal events of 1984, no Government since 1911 has had to resign or seek an early election because it was unable to maintain its position in the House. This suggests that the Government is the agent not of Parliament but of the electorate, responsible to the electorate, which alone determines its fate. When voters go to the polls they are conscious of choosing a constituency representative, but the most important question before them is which party shall be the next Government.

If the Government is no longer responsible co Parliament, what is Parliament's function? While the liability of the Government before the judgment of the electorate *at elections* is clear enough, the electorate is too diffuse by itself to exact ongoing accountability from the Government. The electorate therefore requires institutions to monitor the Government on its behalf. The press plays an important part in calling the Government to account, but Parliament is still more important. Only in Parliament is the Government subject to continual scrutiny of a form which it cannot escape. General debate, parliamentary questions and select committee investigations are all part of the process by which Parliament holds the Government accountable. Regulations and all government Bills other than those of a financial or budgetary nature or to which the house has accorded urgency are subject to select committee investigation, and all government spending must be authorised through the appropriation process.

Earlier, we suggested that the Government's objectives could be described as effectiveness in the translation of the preferences of voters into outcomes, and efficiency in the conduct of Government administration. While the process by which Parliament calls the Government to account is an important assurance to voters that the Government will attempt to meet these objectives, that will be substantially reinforced by the existence of management systems that provide appropriate incentives to managers, and generate the information necessary for the Government to assess and formulate policy.

PRINCIPLES FOR ASSESSING THE MANAGEMENT PROCESS

The previous section suggested that a key objective of the Government was the resolution of conflicts of interest- n o t only between different groups of voters, but also between voters and legislators and public servants. This implied the need for an institutional arrangement which would enable such conflicts of interest to be settled in a way which voters, in aggregate, prefer. A second objective-which is in fact a corollary of the first-concerns the efficient administration of government activity. Effective management systems are crucial if the electorate is to have confidence that its interests are being pursued by the Government.

A management system may be described as the means by which objectives are achieved. Typically there is separation between those setting the objectives and those acting to fulfil them. A crucial element in assessing the effectiveness of any management system is thus an analysis of the way in which the actions of those responsible for decisions are conditioned to meet the aims of those in whose interests they act. Such an analysis of a private sector firm might, for example, examine the means by which shareholders' objective of the maximisation of their wealth is transmitted into day-to-day actions by the employees of a firm. In examining public sector management, we are concerned with the means by which the administration acts to meet the objectives of the Government. Although these latter objectives may be more complex than the simple private sector analogy, the features of the management process which align the interests of those responsible for decisions with the interests of those setting objectives are common to both.

Key Elements of the Management Process

The following criteria are likely to be found in any effective management system. In a sense, they may be regarded as both necessary and sufficient, since the absence of any one is likely to allow decision-making inconsistent with a given set of objectives, and if all criteria are met, efficient management will be achieved. When considering reform of the public sector it is essential to recognise the mutually reinforcing nature of these elements and to avoid piecemeal change that could weaken or distort the incentives of those given responsibility for management decisions to act in a way consistent with the objectives they have been given. These being: clarity of objectives; freedom to manage; accountability; effective assessment of performance; and adequate information flows.

Clarity of Objectives

The initial element of a management process must be as clear a specification as possible of the objectives which managers are responsible for achieving. This implies both a clear identification of individual objectives-objective performance targets in areas where that is possible, for example-and the avoidance of multiple, conflicting objectives.

Freedom to Manage

Once objectives are clearly stated, managers must be given the power to make their achievement possible. Managers should, for example, have freedom to make resource allocation decisions on a basis which enables the most efficient attainment of objectives. Controls over inputs are in general likely to prevent such a process.

Accountability

Freedom to manage is not by itself a sufficient precondition for good management. Incentives and sanctions must be in place to modify the behaviour of managers to ensure that they *do* act to meet established objectives rather than pursuing independent goals of their own. For this to be achieved, managers must be accountable for the decisions they make, and those on whose behalf they act must have the means to make that accountability 'stick'.

Effective Assessment of Performance

If managers are to be accountable for their performance, those to whom they are accountable must have the means to establish the quality of that performance. How well have managers met stated objectives? Are any deficiencies the result of poor management or of external factors over which the managers concerned had no control?

Adequate Information Flows

If emphasis is to be placed on performance assessment, a sufficient quantity and quality of information concerning performance will be required. If managers are to be given a goal of efficient resource use, for example, accounting systems must provide the information to enable an adequate assessment of the quality of resource decisions.

The preceding principles are intimately related. Any one measure will not in itself guarantee 'good' management. A clear assessment of a manager's performance, for example, would not lead to adequate outcomes if no use could be made of that information because no power to reward or penalise existed, or even if it did, detailed input controls prevented the manager concerned from acting in any other way. These very close interrelationships imply the need for flexibility in designing a management system. For example, the extent to which, and way in which, performance can be assessed varies across different operations in the public sector. Consequently the extent and means of achieving accountability of managers, and the extent to which those managers might be freed from input restrictions, is also likely to vary. The constitution of the Government's trading activities as state owned enterprises (SOEs) on a basis entirely different from that of departmental structure illustrates one set of accountability and performance monitoring arrangements. The objectives of the managers of these agencies can be clearly specified in terms of relatively objective commercial criteria, and conflicting objectives 'removed' for separate resolution. Therefore it will be possible to hold these managers fully accountable for the conduct of their enterprises, and they have been freed from the normal public service staffing controls and the constraints of the annual appropriation process.

In reforming the management of the 'core' public sector we therefore suggest that the key element is the reconstitution of activities or relationships in ways which more nearly meet the above criteria. Such reform should acknowledge that the appropriate organisational structure and process will vary depending on the nature of activity. (For example, purely commercial activities can be measured in different ways from policy advisory activities.) This is reinforced by the fact that the nature of activity conducted by the various agencies in the public sector is likely to change over time as circumstances change. This implies the need for adaptation in organisational structure and process to allow for continuing evolution.

The remainder of this part of the chapter examines key features of government management—both process and structure—in the light of these criteria and identifies possible reforms.

ACCOUNTABILITY AND RESPONSIBILITY

The Current System

The Executive in New Zealand consists of the Government at its head with the public service and some other agencies of the State Services carrying out the administration. The way in which the Government confers responsibilities on its administration and exacts accountability for the exercise of those responsibilities, and the way in which the Government itself is held accountable in Parliament, play a major role in shaping the conduct of the administration. The starting point in identifying these key relationships of accountability and responsibility is an analysis of what is meant by 'the Government'.

It is tempting to identify the Government either with the ruling party caucus or with Cabinet. Caucus elects the Prime Minister, and its concurrence is required for major policy decisions. However, it does not have the day-to-day involvement in the administration that is implied by the word 'Government'. The Cabinet, on the other hand, is the source of all significant policy decisions, taking them either as a whole or through Cabinet Committees or individual Ministers. By convention it accepts responsibility collectively for its decisions. However collective responsibility does not extend to decisions made by Ministers individually, who can therefore be seen to have independent authority apart from Cabinet; the decisions of Cabinet may be vetoed by caucus; and to think of Cabinet collectively obscures the fact that some of its members may be more able or influential than others. No one part of the governing process can be identified as the single source of authority. In fact, it is suggested, when people think of the Government they do not make any such precise identification. If instead we think of the Government as 'the political executive in action' then we can see the Government as being represented for different purposes by an undersecretary, a Minister, an ad hoc group of Ministers, a Cabinet Committee, the full Cabinet, or caucus.

The Government acts on the administration through Ministers. They may be implementing collective decisions, or making decisions themselves. In either case the Minister is the administration's point of contact with the Government. Ministers are in charge of departments, and by convention responsible for their administration, What this actually means is somewhat blurred, despite having been the subject of a good deal of debate. It does not mean, and never has meant, that Ministers must resign because of errors in administration. The liability for such errors is borne by the Government as a whole, and to that extent ministerial responsibility merges with collective responsibility. Ministers are, however, personally accountable for their departments, and must answer for their departments' actions in Parliament. They are expected either to defend the actions of their departments or to undertake to correct any mistakes that may have been made. In addition, Ministers are personally liable for errors they have committed themselves. In practice the Government, in particular the Prime Minister, decides on the nature of the liability, if any, and there is no recent instance of a penalty being publicly exacted. However, a Prime Minister in a National Government, and the caucus in a Labour Government, may choose to change the membership of Cabinet. Ministers can thus be seen as responsible to the Government for their performance. Therefore we can speak of Ministers' individual and collective accountability to Parliament, individual responsibility to the Government and collective responsibility to the electorate.

We have identified Ministers as being in charge of departments and by convention responsible for their administration. We turn now to the nature of that administration in terms of the way in which responsibility is conferred on its officials by the Government.

Broadly speaking, there are two ways in which those conferring responsibility on others can seek to have the latter act in their interests: they may place restrictions on possible activity, by for example restricting the availability of resources and prescribing their use to prevent them being used in a way contrary to their wishes; or they may assess performance, including the way in which resources ate managed, with the position of those responsible contingent on the results of that assessment. The first system is one of detailed control over inputs; the second, one of accountability for outputs. The traditional structure of the public service and other parts of the state sector has been that of an input-oriented control system.

In most of the public sector the tendency has been to keep managers' discretion to a minimum. This system is based on two related assumptions: that it is impossible to make a useful assessment of outcomes, so that for practical purposes one can only assume the same input will always produce an equivalent output; and that because outcomes ate indeterminable, input restrictions must be detailed and specific. Any granting of increased discretion, it was assumed, would lead to uncontrolled increases in expenditure. The lack of personal accountability inherent in the control system was covered by ministerial responsibility-the-Minister was held to be vicariously responsible for everything that happened in the department, regardless of the degree of personal responsibility.

This system was designed a century ago, for a small public sector of limited functions, where Ministers took all decisions of any significance. Until 1 April this year, the great increase in the size and scope of the public sector had occurred simply by accretion, without any change to its fundamental structure. There remains after the corporatisation process a large ‘core’ public service of which this is still true. The assumptions underpinning its structure tend to be self-fulfilling. The emphasis on inputs creates incentives for managers to demonstrate a need for more resources rather than to manage those they have more effectively. Yet without such controls spending would indeed tend to go out of control. The essential question is whether alternative institutional arrangements can be devised that provide greater incentives for improved performance, while at the same time ensuring financial control.

Responsibility for the efficiency of departmental administration is divided between Ministers, departmental heads and the State Services Commission (SSC). The Minister is accountable to Parliament for administration, and section 25 of the State Services Act provides that:

> the permanent head of every Department of the Public Service shall be responsible to the Minister for the time being in charge of that Department for the efficient and economical administration thereof.

However, the Act makes the State Services Commission (SSC) responsible for:

> reviewing the efficiency and economy of each Department, including the discharge of the responsibilities placed on him by section 25 of this Act.

There is no provision to establish any relationship between the Minister’s assessment of the departmental head’s performance and the assessment made by the SSC.

How Well Does the System Work?

The current system creates confusion as to managerial responsibility which in turn serves to reduce accountability. The focus on input controls reduces incentives to monitor output and performance and creates incentives for departments to withhold information. (In a sense honesty is not rewarded-the effect is more likely to be reduced inputs.) Control departments have only limited information and their interventions by constraining managerial freedom may inhibit performance. All this can be compounded by departments having a range of objectives, some of which are likely to give rise to conflicting pressures on senior management.

The system can lead to serious management failures for which it is impossible to establish responsibility. The Maniototo Irrigation Scheme affair is instructive. Cost overruns in an irrigation project were publicly criticised by the Minister of the department concerned. The SSC then made a large number of sraff transfers. Despite the serious nature of the mistakes, it seems that no one was responsible. The Minister refused to accept any responsibility, while the SSC insisted that its actions were not disciplinary. The Commissioner of Works defended his department against what he termed 'political pressure', while the District Commissioner of Works, who was one of those transferred, maintained that his office was being made a scapegoat for problems that existed through the department. It seems reasonable to suggest that the administrative failures shown up were actually more widespread still.

The Maniototo affair also points up the consequence of the division of responsibility for administration between Minister and SSC. The Minister resorted to public criticism presumably because he felt he had little control of his own department, while the SSC maintained that it was acting on its own initiative, not in response to ministerial intervention. In a large department with a monopoly over information neither Minister nor SSC is in a position to exercise effective control. Responsibility for administration goes constitutionally to the Minister; legally to Minister and SSC together; practically it tends to disappear.

The division of responsibility for administration creates a vacuum which is not filled. The legal responsibility of the departmental head to the Minister tends to be weakened by the inability of the Minister to hold the departmental head directly liable for outcomes. The SSC has the legal responsibility to review departmental heads' performance, and the power to enforce its judgment, but it has weak incentives to do so and difficulty in acquiring adequate information on which to base such an assessment. Such sanctions as may be invoked for poor performance tend to be opaque and there is genuine confusion as to who is responsible to whom, and for what.

Suggestions for Reform

The Government is the popularly mandated authority, responsible to the electorate for its conduct of the administration. In conducting the administration the Government acts through Ministers. If accountability within the administration is to be enhanced, it follows that this should be done by ensuring that the chain of accountability is undivided, and has the Minister at its head.

The key relationship between the Government and the public service is that between a Minister and his or her departmental head. It is through- this relationship that the policy requirements of the Minister come up against the capacity and needs of the department in meeting those requirements. The relationship needs to be responsive to the needs of both parties. An effective working relationship is likely to lead to high-quality advice and effective policy implementation. A poor relationship is almost certain to lead to less satisfactory outcomes. If Ministers are to be held accountable for the performance of their departments then it seems essential that they should have an input into the appointments of departmental heads.

It is the co-operation of the most senior advisers with government policy that is most important. If this is assured then with the right incentives the rest of the organisation will follow the lead from the top. There are a number of ways in which top-level appointments could be made. The smallest change that would mean anything would be to give the Minister the formal right to be consulted on the appointment. This would be a regularisation of the present practice. Alternatively the Minister could have the right to veto the panel's nomination; or the right to choose among a short list offered by the panel; or the right to overturn the panel's nomination and make a personal appointment. Finally the Minister could have full power of appointment, seeking advice from anywhere he or she chose.

Which of these alternatives is preferred will depend on how important it seems to ensure a clear accountability relationship between Minister and departmental head, and on how serious the danger of 'politicisation' seems. The possibility that Ministers might appoint political lackeys, in a return to the bad old days before 1912, is sometimes offered as an argument against any ministerial involvement. This fear is based on a misreading of history and is not reflected in the practice of other countries. Before 1912 political patronage was exercised at the lower levels of the service, notably in the Post Office and the Railways, but did not tend to happen at senior levels, presumably reflecting the desire of the Government for competent administration. It would be a difficult argument to sustain that New Zealand politicians were less trustworthy than those anywhere else, yet in every comparable country top appointments are made by the Government. The appointment of the Governor of the Reserve Bank provides support for this argument. The appointment is made by the Government, yet clearly the expectation has been that the Governor would act first and foremost in the efficient meeting of the Bank's statutory obligations and implementation of the Government's policies.

We see a number of incentives that would tend to prevent politicisation of the public sector. First, it is essential that advisers have the confidence of those to whom the advice is given. However, this does not require a complete alignment of points of view. Ministers have other sources for politically based advice. It is in Ministers' interest to have in their departments a source of independent, professional advice. The confidence that Ministers require is that advisers will co-operate fully with their own policy decisions, besides providing a high standard of independent advice. In part, this confidence will rest on perceptions based on complex judgments of such qualities as professional standards, objectivity and integrity. Very close identification of advisers with 'the government of the day' and its policies would lead to the danger of lack of confidence on the part of a new Government. The essence of democratic Government is that the identity of those in charge can change regularly; close identification of advisers with a previous administration which generated sufficient lack of confidence as to bring about their wholesale replacement by an incoming Government would pose severe problems for efficient administration and, indeed, the ability of advisers to provide adequate advice. Specialised knowledge and effectiveness are an important part of the process of formulating advice and implementing policy; these require some continuity of administration. This suggests then that Ministers as a whole will have incentives to maintain the integrity of the administration.

In addition, any appointee would need to be both technically and managerially competent. A loss of confidence in senior management would seriously affect a department's performance and would reflect adversely on the Minister in charge. It is therefore important that the appointee be able to generate confidence in the department's staff. In essence, then, we consider that there are likely to be adequate incentives in place to ensure that the best person for the job would be appointed.

In practice any appointment that did not give competence a high weight would attract the attention of the press and the Opposition. If the person proved less than competent this would be to the Government's public discredit, and this is likely to act as a significant constraint on any tendency to make inappropriate appointments.

Earlier we outlined a number of options for involving Ministers in the process of making top-level appointments, ranging from a simple regularisation of current practice to full power of appointment. The strength of incentives on Ministers to appoint the 'best' people to senior positions will be an important factor in determining the extent of involvement it is appropriate for them to have in the appointment process. In addition, however, it would be possible to devise other safeguards against politicisation by, for example, constituting an agency with responsibility for advising Ministers on suitable appointees and requiring Parliamentary notification in cases where the agency's recommendation was not adopted. (In practice Ministers are likely to require the services of some such agency to assist in searching out suitable applicants, screening them, and negotiating contracts of employment.) It is important to bear in mind, though, that any institutional arrangement which allows Ministers to disclaim responsibility for appointments will inevitably also diminish the extent to which they can be held accountable.

We consider that Ministers should not be responsible for appointments in departments below top levels. If, as we suggest later, agency heads are to be made more accountable for the performance of their departments, they must have also the freedom to affect that performance. A crucial element in this process is the departmental head's ability to control the quantity and quality of staff, within the agency's budget constraint. Later we suggest that agency heads should be given greater freedom to negotiate conditions of employment with staff in their organisations in contrast to the centralised employment and pay-fixing provisions which currently exist. We see no case for the formal involvement of the Minister in making appointments in such an environment.

Even more important than appointment procedures in establishing the accountability of departmental heads to their Ministers may be procedures for termination of those appointments. Tenure can also provide strong incentives for performance. Unlimited tenure can reduce the incentives on a permanent head to innovate and adjust operations to meet the changing needs of the department's clients. Limited tenure on the other hand can impose strong incentives to perform and achieve results within a certain period by the increased contestability of the position of departmental head. Balanced against this, tenure that was too insecure might encourage an unduly risk averse approach to be adopted, and create problems recruiting people to the position.

At present departmental heads may remain in office until retirement. Since many appointments are made of people in their forties, this may mean for fifteen years or more. Clearly someone who was suitable at the time of appointment might not remain so for that length of time. We consider that incentives to perform would be enhanced if appointments were made for more limited periods, and the title of 'permanent head' were abolished. One possibility would be employment on renewable five-year contracts. This would provide sufficient time for an appointee to achieve results, but not be so long that motivation could dull. Such a term would also have the advantage of ensuring that contract expirations did not normally coincide with elections, thus reducing the likelihood of wholesale purges by incoming Governments. Fuller safeguards against this could be achieved by having contracts for four to six years when termination dates would otherwise coincide with elections. Such contracts may however need to make provision for early termination in the event of unsatisfactory performance or a breakdown in the working relationship. Appropriate protection for both parties against either exploiting the relationship could be built into the contract through negotiations between the parties involved. Such flexibility would recognise that different provisions may be appropriate for different people and different positions. Generally, though, capricious terminations are likely to be prevented effectively by the ability of Parliament, the media, and the individual concerned to expose such action. In practice, too, it is likely that early retirement oprions may be preferred to formal termination of contracts.

A further avenue of reform is to increase the personal accountability of individual public servants. This will require a change to the way in which ministerial responsibility has traditionally been regarded as functioning. Public servants have been considered always to act as extensions of the Minister, without having any independent existence, and consequently no independent responsibility, except where statute specified otherwise. The Minister was held to be directly responsible for all departmental activities, and consequently public servants could not be held responsible as individuals and were expected to remain anonymous. In practice this convention is already under threat and the principle of anonymity has been eroded in recent years.

An increase in the personal accountability of public servants would recognise an increase in their responsibility; this increase in responsibility has in fact been occurring for a long time with the increasing complexity of administration—Ministers are unable, even if willing, to make all decisions concerning the conduct of their departments. However, this increasing responsibility of public servants for decision-making, coupled with proposed accountability for those decisions, does not imply a weakening of Ministerial accountability. Quite the reverse: since Ministers would have much greater control over the means to ensure that their objectives were met by their departmental managers, they could be held to account much more directly than at present for the performance of their departments.

THE STATE SECTOR LABOUR MARKET

The Current System

In the following discussion, the focus is narrower than the state sector as a whole. This is because, in our view, the more difficult remaining problems in the state sector labour market arise in the core state services and particularly in the public service.

The SSC acts as the Government's employing authority as far as the public service is concerned. The State Services Act 1762 provides that:

> In matters relating to decisions on individual employees (whether matters relating to the appointment, promotion, demotion, transfer, disciplining, or the cessation of

> the employment, of any employee of the Public Service, or other matters) the Commission shall not be responsible to rhe hlinister but shall act independently.

The SSC acts as a government department in questions of personnel policy, but as an independent--authority in decisions concerning individuals. The SSC is the legal employer of public servants; departments are not. The righr to make most appointments, however, has been delegated to departments.

The State Services Act places constraints over the SSC's exercise of its personnel functions. Appointments from outside the service at above basic grade may not be made except where the applicant shows 'clearly more merit' for the position than in-service candidates. In practice this discourages managers from incurring the cost or taking the risk of appointing an outsider. This is especially so given rhe right of public servants to appeal against such appointments to the Public Service Appeal Board. The appeal process can last for months and demonstrating 'merit' in a quasi-judicial setting is difficult, given that the Act stresses work experience and competence in *previous* duties. Although it is not easy to distinguish the practical effect of the 'clearly more merit' entry barrier, together with appeals, from other more general factors which may deter recruits, the effect is probably to raise entry barriers and thereby restrict outside recruitment and reduce private/public sector interchange.

Appeals may also be made by unsuccessful candidates against promotions, against decisions concerning gradings, and against disciplinary measures. The appeal process protects individuals against 'unfair' treatment-for example, the successful candidate for a job must be demonstrably better than the others--and against arbitrary actions of management. Whether these protections are excessive or not is considered below.

Public servants are grouped into service-wide occupational classes. Pay and conditions for these classes are determined centrally, through negotiations between the SSC and state sector unions. Pay is supposed to follow the principle of 'fair relativity' with the private sector. The criteria for determining this 'fair relativity' are complex, but a greater weighting tends to have been put on relativity considerations than on recruitment and retention factors. Recently, a number of the proposals set out in the Minister of State Services' October 1986 'buff report came into effect-'ranges of rates', performance pay, the facility for enterprise unit bargaining, and the assignment of dispute resolution and arbitration to the private sector arbitral institutions. The thrust of these changes is to increase state pay-fixing flexibility within the 'fair relativity' framework, and to eliminate unnecessary differences between the state and private sectors.

Although departments have delegated power to make appointments and promotions, it is the SSC that sets the terms within which these decisions may be made. The SSC might intervene to prevent for instance what it saw as a too-rapid promotion. Appointments to high-level positions are made by an augmented

SSC, in the form of a 'section 29 panel', consisting of two commissioners and three departmental heads. Salaries above a certain level are determined by the Higher Salaries Commission, according to the same criteria as apply in the remainder of the public service.

How Well Does the System Work?

The constraints currently imposed by the centralised and formalised personnel and pay-fixing systems represent serious limitations on the capacity of managers to achieve desired outcomes. Even with the August 1987 reforms in place, managers' ability co adjust pay rates, reward staff for performance, hire and fire and promote, are substantially constrained. Many crucial management decisions are taken centrally by the SSC and Higher Salaries Commission. This requires the collection and processing of large amounts of information and inevitably particular concerns and needs are lost sight of. Further, the incentives on central pay-fixing negotiators to adequately take into account varying conditions faced by different groups are not particularly strong. This leads to inappropriate settlements or delays in responding to developing problems, with consequent effects on performance.

In a rapidly developing labour market, departments find themselves unable to retain staff whose skills are in demand, but whose conditions of employment have not adjusted accordingly. All the pressures in terms of falling performance bear on the departments but not directly on the SSC, which has the formal responsibility to rectify the problem but has traditionally placed heavy weight on service-wide relativity considerations. Hence changes are almost always slow and often inadequate. Furthermore, the Higher Salaries Commission has tended to the same approach and the problems caused at upper levels by delays in adjustments have recently been compounded by the imposition of a ceiling on their adjustments.

At present the public service faces major problems in keeping-let alone acquiring- a n adequate quality and quantity of staff in key professional areas. Economic and financial analysts remain extremely scarce and there are major problems with accountants and lawyers, affecting departments like Audit and Inland Revenue, and other groups such as rural appraisers and computer programmers. This issue is a key one to resolve: unless the public service is adequately staffed with professional and managerial capability the Government will not receive adequate advice, and will continue to face difficulty in implementing key areas of policy. This can have real costs for the wider economy. An example is the effect of an inadequately staffed Department of Inland Revenue causing delays and uncertainty in the business sector. Moreover, the effect of inadequate staffing is to force Ministers to go outside the public service for advice, which can in turn weaken morale within the public service, and also raises issues of conflicts of interest in the advice given by private sector analysts to the Government.

As well as difficulties in acquiring and retaining staff, departmental managers also face difficulty in reducing staff levels in areas where thar is appropriate. Termination of employment-or redeployment-of inadequately competent staff, or staff who are simply excess to requirements, is governed by centralised administrative rules which are often complex and time-consuming. While these rules have evolved with the admirable purpose of protecting the rights of individuals against capricious and arbitrary acts, we believe it should be possible to provide adequate safeguards while enabling managers to respond more quickly and flexibly to changing resource requirements and external conditions such as comparability with private sector pay rates where that is a relevant consideration. Managers also have weak incentives to make staff economies when savings cannot necessarily be reallocated to chosen priorities; this reinforces the impediments to staff reductions.

In evaluating other regulation of personnel matters, particularly the entry barriers and seniority structures described above, it is important to emphasise that there are likely to be some efficiency benefits, for both workers and employers, from such 'internal labour market' arrangements. As a later section on the labour market in Chapter 4 notes, such structures can mitigate concerns which could deter employees from investing in skills specific to the public service. The central question is, however, whether these arrangements need to be specified in regulation, which necessarily ossifies them and typically raises significant cost barriers for managers (for example the costs of fighting appeals) who would prefer greater staffing flexibility. What might in some circumstances be efficient negotiated arrangements seem to have become too rigid and complex as a result of being enshrined in legislation. Rather than acting to 'bond' workers and employers, the arrangements have become bureaucratic impediments to change, resulting largely in increased costs to the taxpayer. The question is then one of considering an alternative regulatory regime in which a better balance is reached between concerns over 'political' influence in personnel decisions, and the efficiency costs of ossified and rigid arrangements.

As far as pay fixing goes, while a number of the 'buff report proposals for reform of the 1777 Act are now in effect, the most important remain to be enacted, and it is unlikely that the nature of claims and settlements will change markedly until the remaining reforms are put in place.

Suggestions for Reform

In considering the nature of possible reforms to state sector labour market it is useful to begin by examining in detail the close parallels between the private and state sectors, but also any significant differences.

There has always been much in common between labour market regulation.in the state and private sectors. For example the procedures of the 1777 Stare Services Conditions of Employment Act are generally analogous to private sector provisions in the 1973 Industrial Relations Act.

The parallels derive from the necessity to maintain strong incentives for performance, and the necessity co let pay fixing and personnel arrangements emerge which 'allow managers to manage', with commensurate accountability. A useful *starting* presumption is that state sector labour market regulation should therefore be no more prescriptive than private sector regulation. Thus, state sector employers should be no more constrained by legislation in reaching mutually beneficial voluntary contracts with their employees, than are their private sector counterparts. Without the ability to freely reach wage and staffing agreements with their workers, they cannot be held to account for their performance, and thus incentives for performance are weakened.

The current system is, however, in practice structured around the presumprion that accountability in the public sector cannot be as clearly established as in the private sector, and that therefore a system of centralised controls on a department's use of labour is needed. While departmental heads have been allowed a degree of discretion in staffing matters, the SSC and the Higher Salaries Commission nevertheless retain effective authority over most significant matters of pay-fixing, hiring and firing, and promotion.

A corollary of this starting presumption is that industrial relations regulation should be consistent across the private and public sectors. In particular, privare sector rules governing union organisation and registration (including contestability and bargaining coverage), union membership, and dispute resolutions, should be presumed to be applicable to the state sector.

In our view a number of the features of personnel and pay-fixing arrangements which can be described as 'internal labour market' arrangements would be found by state sector managers to be still efficient in a more permissive environment. It is notable that arrangements such as seniority structures, formalised appeal processes, collective bargaining for uniform pay increases across large groups of employees, and limitations on the use of contracting and oursider entry inro certain jobs are features of employment relationships found in the private sector, especially in firms where there is a high degree of specialised knowledge and output is difficult to measure. For this reason, it could be expected that if state sector personnel and pay-fixing regulation was more closely aligned with that pertaining to the private sector, many of these features would be. retained, by negotiation, in the state sector.

The differences in the nature of problems in the state and privare sectors, and the need for different solutions, centre on the fact that there is a distinction which occurs uniquely in the state sector between the Government as regulator and the Government as employer. This requires that the Government wear two hats. In general, the Government has an incentive to maintain a distinct separation between the two roles. In carrying out its regulator role, the Government will generally be concerned to establish a regime that is both fair and efficient-fair in the sense that it limits the capacity of the state as employer to behave opportunistically, and efficient in the sense that it has regard to the long-term effectiveness of the state's workforce and its ability to perform well and in a manner consistent with the objectives set by the Government of the day. Given the nature of the Government's incentives, it can be expected to be concerned to signal to the electorate that the regulatory regime it is establishing is indeed fair and efficient and is not designed on the basis of short-term political advantage.

Once the Government has established a regulatory framework which either specifically establishes, or lets emerge, various institutions for pay fixing, the Government of the day then has the very different role of administering the state labour market. This process however is, at least in principle, one of the Government appointing and delegating authority to public sector managers and then applying rewards and sanctions to modify performance, that is, mainraining a high-level interest in the process but being disengaged from rhe day-to-day operation of the system. The tendency, in recent years, for Governments to become involved from time to time in this role of 'employer', through such interventions as the recent 10 percent higher salaries adjustment, suggests that there have been significant deficiencies in accountability and pay-fixing arrangements.

Until Ministers' roles and incentives within the pay fixing and management process can be made clearer, there will be a continuing tendency for Ministers to intervene in a way inconsistent with their 'employer' role of ensuring good public sector management performance.

In Treasury's view, the distinction between the role of the Government as regulator and its role as employer does not imply that state sector pay fixing and personnel rules necessarily need to be enshrined in legislation, or indeed that they must necessarily take the form they have under the 1777 State Services Conditions of Employment Act and 1962 State Services Act. For example, it has been argued that certain rules such as a 'rate for the position' rather than a 'rate for the person' is a necessary means of distancing remuneration and staffing positions from 'political' pressures. However, it can also be argued that such rules are excessively costly in terms of performance and in terms of matching the pay rate to the conditions prevailing at a given time and place. Further, with a good structure of accountability, and disengagement of Ministers from intra-departmental management, there will be strong incentives for staffing and pay decisions to be made on an efficient and equitable basis. In short, the right overall regulatory structure should allow appropriate internal institutional arrangements to emerge, without the necessity for rigid specification of those structures in legislation.

Turning to specific suggestions for reform, we consider first control over personnel matters. Among the most important decisions in management are those concerning personnel. Aside from the capital intensive trading activities, human capital is, by and large, the public sector's largest resource. The ability of managers to recruit, retain, train and motivate suitable staff is thus a key element in their ability to manage well and thus achieve their organisation's objectives. Unless this is assured, holding them accountable for performance against the objectives the Government wishes them to achieve will be a much less meaningful exercise, since they will genuinely have limited control over outcomes.

An earlier discussion focused on the relationship between Ministers and departmental heads, suggesting that a clearer relationship of accountability is essential for improved management. But this only holds if the departmental head is in a position to be held fully accountable-that is, if he or she has sufficient authority, including authority over personnel matters to take the decisions needed for effective management.

We therefore suggest that the head of each department should be designated *employing authority* for that department. This would convey the formal as well as the effective right to make subordinate appointments, and with appropriate associated legislative changes, it would enable the department to negotiate personnel arrangements, and pay and other conditions of employment which suited it.

This proposal has to face two objections: that it would impair the unity of the service, and that it would jeopardise the rights of public servants. However, the current public service is already segmented, and private-public links in professional and technical areas are already often as strong as inter-departmental connections. For technical jobs common to both private and public sectors it is already normal for staff to move freely between sectors. Where jobs have aspects peculiar to the public service, for example requiring institutional knowledge, then they are likely to continue to be filled by people with public service experience, thus maintaining the informal links that would tend to unify the service. It is suggested that it is these informal features rather than artificial constraints that would give value to the unified service. In the absence of inherent tendencies towards unity it is suggested that artificial constraints are likely simply to lock in inferior standards, and make the public service less innovative and flexible.

This is especially so in the management and professional ranks where the lack of flexibility is the most debilitating to departments' performance, and where reliance on the personal commitments to public service of talented individuals has been stretched to breaking point. Moreover, to the extent that gaining a diversity of experience within the public service—for example, skills in policy implementation in a variety of contexts—is valued by employing departments, those departments would have clear incentives to retain 'career service' arrangements such as staff interchanges. The possibility of certain functions being operated centrally is examined later.

Similarly, departments would have incentives not to use staff on contract for more than a limited range of tasks, in view of the costs of arranging and monitoring such contracts, together with the difficulties they can create with permanent staff. Again, these are features of the state sector labour market that would be voluntarily retained, under a permissive regulatory regime, but do not need to be formally institutionalised in law as at present.

The current appeal system is also unnecessarily cumbersome and constraining. To have an independent body with the final say over promotions is not compatible with managerial authority and accountability. The same can be said for the present system of discipline. Quite clearly, employees need safeguards. The issue is whether more flexible arrangements would meet those needs while assisting in encouraging better outcomes. If the disciplinary system was located within departments with departmental heads making the decisions, then a simplified appeal system could remain. Appeals could perhaps be limited to cases in which the employing authority was not meeting its obligation to be a 'good employer', defined in a similar way to that for state owned enterprises, or, alternatively, the employing authority could negotiate with its employees' representatives any disciplinary and appeal procedures. Managers would have both the incentives and the means to make more use of disciplinary provisions than they do now.

The state pay-fixing system, even with the improvements that came into effect on 1 August 1787, needs further reform. It remains cumbersome and is likely to continue to be ineffective in delivering results. One key reason is the present complicated and constraining set of pay-fixing criteria. These criteria should be replaced by a simple statement of pay-fixing objectives which would allow pay-setting to respond more readily to market conditions. Another factor is the high level of union bargaining coverage in the public service, compared with the private sector, a characteristic which can rigidify wage bargaining. Again, greater consistency with the private sector is desirable here.

There may be some occupational groups, where the Government is a monopsonist employer and employees are limited in their ability to take industrial action, where some independent 'compulsory' arbitration authority is needed. The police are an example. In general, however, voluntary arbitration on disputes of interest, as in the private sector, would give parties an incentive to take more responsibility for their own dispute procedures and actions.

For most groups, there is no reason, given improved incentives on managers. why departments should not negotiate pay levels consistent with meeting their objectives. They might find it useful for some categories to combine to negotiare service-wide conditions, but this should be left to departments' discretion. Comparisons with private sector rates may or may not be the basis of sertlemenr. Where jobs are the same between sectors a market pay level would emerge as a matter of course. Where they are not, then there is no reason why the public sector rate should not diverge from the private. A relativity-bound 'annual general adjustment' (AGA) type of adjustment process is made more unreal by the increasing dispersion of private sector increases, and the provision for an automatic AGA would need to be revoked if pay setting is to be effectively decentralised.

Decentralisation of personnel and pay fixing decisions to departments requires that appropriate accountability mechanisms be introduced. This again points up a critical feature of an effective public sector management system-that it be an integrated whole. With respect to pay fixing, a manager charged with negotiating industrial agreements should be fully cognisant of the sanctions on top management if a settlement puts pressure on the department's budget constraint and, conversely, the rewards if a settlement is reached that is consistent with the department's budget while remaining within industrial relations constraints. In addition, the performance evaluation system that is put in place needs to be sensitive to any trade-offs that may exist between constraining expenditure and improving departmental performance. The fundamental objective of the pay fixing process should not be to constrain wages but rather to increase productivity and reward good performance, and in our view this is more likely to be achieved within a decentralised system in which management is motivated by clear incentives.

THE STRUCTURE OF GOVERNMENT

The Current System

The administration of government in New Zealand is characterised by a wide variety of organisational forms, ranging from limited liability companies established under the Companies Act which receive no taxpayer funding, to government departments which rely exclusively on such funding, allocated through the Parliamentary appropriation process. In recent months a number of government activities have been transformed from government departments to state owned enterprises. It is with those organisations which are established as government departments, however, thar this part of the chapter is principally concerned.

The dominant characteristic of the current organisational structure is its *sectoral* orientation. Thus, we have Ministries of Agriculture and Fisheries, Forestry, Trade and Industry, Health, Education, Social Welfare-and so on. These departments are responsible for a wide range of functions within rheir various sectoral responsibilities, such as the initiation of policy advice, review of regulation and drafting of legislation, and the implementation of policy decisions. In addition, the permanent heads of these organisations are responsible for their efficient administration.

As well as these sectorally oriented departments there are a number of others—Treasury and the SSC, commonly designated as 'control agencies', and the Audit Office, which occupies a constitutionally distinct role reporting to Parliament on, inter alia, the proper disbursement of public funds vis-a-vis the purpose for which they were appropriated. The role of the control agencies is discussed in a later section.

How Well Does the System Work?

To assess how well it is served by the present structure the Governmenr must clarify what it expects from its administration. At the most basic level, the Government seeks advice as a basis for formulating policy; and it requires the efficient administration of policy implementation (including the efficient administration of agencies producing goods and services, whether 'sold or not). An earlier section suggested that a fundamental premise for reviewing government administration was that the state should have a means of resolving conflicts of interest in a way that maximises the achievement of voter preferences. In order to do so, the Government must receive advice in a way which first makes clear what those conflicts of interest are, and second, which facilitates the resolution of those conflicts impartially according to broad criteria applicable to everyone (for example, considerations of justice or efficiency). The quality of that advice is also important: it should be technically competent, based on relevant information, elaborate trade-offs clearly, and be unbiased.

It is worth noting that the nature of activity conducted by the administration has changed since the present broad structure was established (and will no doubt continue to do so). Polaschek, for example, writing in 1958, noted that:

> Traditionally, the public service carried out Cabinet and ministerial policy: it did not concern itself much with research, planning, or suggesting to ministers major courses of action. In a small service engaged mainly on routine work, Ministers could take all important decisions, and many minor ones as well. They could do

> their own thinking and planning. And the service was recruited and staffed on that basis. (Government Administration in New Zealand)

It seems reasonable to postulate it was also structured on that basis.

There have recently been major changes to the organisation of a large part of state trading activity. The reconstruction of former departmental trading operations into nine limited liability companies-the new state owned enterprises (SOEs)-represents a radical departure from traditional structures. It was aimed at improving the performance and accountability of the operations given a situation in which it was estimated in the 1786 Statement on Government Expenditure Reform that the net after tax cash return to the taxpayer that year on assets estimated to be worth over $20 billion would be zero. In making such a change, the Government recognised that poor performance was not a result of inherently poor management; rather, it resulted from the fact that managers had previously unclear roles, conflicting objectives, burdensome controls, lack of commercial freedom, and inadequate incentive structures-in short poor management systems.

The distinction between 'commercial' and 'non-commercial' activity is not a precise one. At present many government departments produce some goods and services which are sold-either to private consumers or to other government agencies. The reform process which has culminated to date in the creation of nine new state owned corporations has concentrated on trading activity where commercial objectives can be established relatively readily; the second part of this chapter discusses the principles underlying this approach and their application to further areas of activity. This discussion is concerned, however, with activity which is-at least at present—predominantly 'non-commercial' in character.

Similar problems to those discovered in respect of the organisation of state trading activities are likely to exist in non-commercial areas. Although the conflict between differing objectives may not be as obvious in the 'non-commercial' public sector as that between, for example, running an efficient forestry production operation and providing subsidised employment, a similar kind of analysis could nevertheless be applied. Similarly the fact that a return on taxpayers' assets cannot be readily measured in the 'non-commercial' areas of government does not imply that it is impossible to judge whether resources in that sector are being used efficiently. If similar conditions apply to management in both the non-commercial area and the organisations which became SOEs it is reasonable to presume that outcomes, in terms of performance, may not be so very different.

In fact, there are a number of reasons for believing that the current structure of government activity may yield inadequate outcomes. Managers face conflicting objectives. They tend to be responsible for policy advice concerning their sectoral responsibilities, for the implementation of policy decisions and for ongoing operations within that framework. This can lead to the often expressed confusion about 'clients'-the Minister to whom advice is being given, on the one hand, and the particular group receiving goods and services from the department's production operations, on the other.

Managers seem frequently to be unclear about the perspective of their advice—is it advice reflecting the interests of the electorate at large, or is it advice which reflects the narrower interests of their sectoral clients (and which may conflict markedly with that based on a broader perspective)?

When different objectives are in conflict within a department's broad area of responsibility managers are faced with the dilemma of making-explicitly or implicitly-trade-offs between those objectives. Invariably, however, they lack a coherent framework which would establish the nature of that trade-off and the weight to be assigned to various objectives in given circumstances, and furthermore lack the incentives to develop one. More fundamentally, such a situation undermines the performance of the function which we have suggested is fundamental to government—the resolution of conflicts of interest. At the very least, we would suggest that this process of conflict resolution should be sufficiently explicit and articulated for the electorate to judge the decisions being made on its behalf. Given the importance and difficulty of establishing a clear framework for resolving conflicts of interest there is a need to provide resources that can impartially achieve this objective. The political nature of trade-offs between the interests of particular groups suggests that it is Ministers who should ultimately make these decisions.

The conflicting objectives that arise in the combination of policy advice provision and policy implementation within the one organisation rend also to produce a phenomenon known as 'producer capture'. In any given issue, the implementation of policy through departmental provision is likely to be one of a variety of ways in which a given objective may be met. The Government requires advice which enables it to assess what the most appropriate intervention might be-is it by provision, for example, or by changes to existing regulatory structures to generate different private outcomes; and if it is by provision, is public provision the most efficient means or would public funding to private providers be preferable? It is hard to escape the conclusion that advice on such issues from an agency which is involved in public provision is likely to be biased in favour of that existing provision. More generally it would appear that an agency whose existence is inextricably linked to the continuation of existing policy is likely to be biased in favour of existing policy.

A further issue arises concerning the quality and quantity of advice provided to the Government. Once again, the combination of a policy advisory function with other, different, objectives may have perverse consequences. As mentioned above, advice may favour the kinds of intervention already administered by a department, impacting on its quality; in addition, an insufficient *quantity* of advice may be generated for similar reasons. The Government requires access to high quality advice on ail aspects of its policy; that advice should be *contestable* both internally and exrernally-that is, the Government should have access to rhe views of professional experts outside the public sector, and co competing views within it on all areas of government activity. This suggests rhe need to avoid a particular agency having exclusive domain over a particular policy area. Treasury may supply advice from time to time across the entire range of the Government's policy; other departments are responsible for more narrowly-based provision. We believe it is imperative that advice, from whatever source, is of a quality and quantity sufficient to ensure its technical competence and to ensure that conflicts which should properly be addressed by Ministers are exposed. This is facilitated by the actual or potential provision of advice from more than one public or private source.

Just as conflicting objectives may impact adversely on the nature of advice received by the Government, the efficiency with which the Government's production operations are managed may also be impeded. Lack of clarity regarding a manager's client(s) leads to confusion when the objectives of apparent clients are in conflict. Lack of responsibility for clear objectives in running a production operation as efficiently as possible will generate efficient outcomes by chance if at all.

Suggestions for Reform

Greater clarity of objectives is the key principle which must underlie any reform if management is to be improved: structural reforms are an important step in achieving this. One such reform would be the separation, in different agencies, of responsibility for the provision of policy advice, regulatory and funding activities. and operational activity. Such a separation would enable the objectives of managers to be specified a great deal more clearly than occurs ar present and would enable the performance of agencies to be more readily assessed. For example. managers of policy advisory agencies would be responsible for providing the Government with advice in their specific areas of responsibility and would be judged on their ability to produce a satisfactory quality and quantity of such advice; managers of operational agencies, on the other hand, could have as their prime objective running their operations as efficiently as possible given the policy parameters established by the Government. A separation of this kind would have major advantages in reducing tendencies to 'producer capture', giving the Government greater control over the standard of policy advice it received and the quality of regulatory and funding decisions, and providing a clearer means of establishing efficiency in production operations. The latter would also be facilitared by the greater ease of allowing consumer choice to be reflecred.in ouccomes.

Too rigorous a separation would, however, be likely to impose costs at the expense of little gain. An assessment of the costs and benefits of alternative forms of intervention requires a knowledge of the way in which particular government actions impact on the behaviour of individuals in their varying roles as consumers, producers, welfare recipients, and taxpayers for example. The problem of ivory tower or inappropriate policy resulting from the separation of policy and operations should not be overstated. Policy advice divorced from considerations of reality is bad advice, and provided there are mechanisms to ensure the accountability of the managers of policy agencies and incentives to encourage the provision of 'good' advice, these managers might be expected to build a sufficiently strong relationship with the operational agencies to acquire the necessary knowledge. An important mechanism in this respect would be contestability in advice provision. Furthermore, even though operational agencies may have access to specific knowledge relevant to policy formulation, their incentives to use this information to critically review the policy framework may be weak. Thus the gains from giving them an input into policy development may be lost if they further gain control of the policy development process given their possibly perverse incentives to, for instance, maintain a 'quiet life'. This indicates an important distinction between the initiation of policy development and control of its direction.

A compromise solution to total separation of policy and operations that preserves both integrity and informational advantages would be the creation of policy ministries that would control but not monopolise the policy advisory process. In this system, prime responsibility for the broad policy framework would lie with specifically constituted policy advisory agencies. Managers in operational agencies however would not be precluded from initiating advice in their areas of expertise. The control of policy, however, in the sense of prime responsibility for advice on the establishment of a broad framework, and the oversight of the preparation of any legislation that might be required, should lie with policy advisory agencies that are separate from operational activities because of the danger of 'producer capture' identified earlier. This less severe form of separation of the advisory function from the production operations (running schools and hospitals, paying benefits for example) would reduce the tendency for advice to be dominated by existing production structures, enabling the relative merits of alternative forms of intervention to be more readily assessed while also enabling the input of specialist information.

A further question remains to be addressed: how is the policy advisory 'core' to be organised? The basic objective here is to structure the provision of advice in such a way that conflicts of interest are exposed for resolution by Ministers. We have argued that advice generated by sectorally based Ministries may tend to be dominated by the interests of their sectoral 'clients'; in this case we believe that the only client of such agencies should be the Minister to whom the advice is being given. Although different 'interests' are certainly being exposed in such an organisational framework, we believe that the tendency is for insufficiently broad considerations to shape advice—only the interests of one or a few subsets of the electorate are likely to be exposed on any given policy issue. Sectoral interests are, in any event, already represented by the plethora of groups which continually lobby the Government for policy change in their favour.

These considerations indicate that a different and non-sectoral breakdown of advisory responsibilities might be desirable; and we have identified two means by which this might be achieved-functionally-based, and values-based.

A functionally-based reorganisation would draw together the policy advisory roles with respect to a broad area of government policy-commerce, for example, or social policy. Such an organisational split would enable clear responsibilities to be established for the development of major policy frameworks in connected areas: a Social Policy Ministry, for example, would be responsible for advising the Government on a consistent approach in its policy on, and delivery of, social services such as health, education and welfare. A functional split would tend to keep policy ministries close to selected operational agencies. This may enable policy ministries to be close to the information operational agencies possess. On the other hand, policy ministries which are closely identified with particular production departments-(one could envisage a Social Policy Ministry, for example, and Departments of Health, Education and Social Welfare)-may exhibit greater tendency towards producer capture. Past experiences of policy and co-ordination ministries in areas where large state production agencies existed provide some evidence in support of this. An attempt to separate policy and development in the case of the Ministry of Energy, for example, was reversed.

An alternative policy advisory split takes as its starting point an analysis of what is meant by 'conflicts of interest'. What expression of competing 'interests' is likely to enable the Government to make decisions in a way which most closely reflects the preferences of the electorate as a whole? It can be argued that this process requires the elucidation of conflict between broadly-defined *values*—those fundamental goals of any society which must be traded off; that is, the goals to which it is the Government's responsibility to assign weights reflecting the preference of the electorate. Under this schema, for example, one could postulate a policy advisory agency concerned with the goal of maximising the wealth of the economy, analysing policy from the perspective of its impact on growth; another ministry could be given responsibility for looking at policy from the perspective of equity—how is any given level of income to be shared amongst participants in the economy and how will particular policies impact on the distribution of income? Advice provided on such a basis would make explicit, at a very fundamental level, the trade-offs the Government must make. While such an approach has obvious advantages in terms of the basic objectives of the policy advisory function, a number of considerations must be addressed in deciding its overall desirability: for example, the way in which fundamental values are represented; the representation of minority interests; the co-ordination of policy advice into a form readily digestible by the Government; and the ability to staff adequately such a set of ministries. This latter consideration includes such aspects as the current severe shortage of competent analytical skill; the danger of professional critical mass being lost in organisations staffed by a cross-section of disciplines; and the desirability (and possibility) of organisational cultures based around a sole unifying value.

Further issues to be addressed before determining an appropriate policy split include the future role, functions and organisation of the control agencies (addressed in a later section) and the role and function of individual ministers, and of Cabinet, under each option.

In any reorganisation of the structure of the public sector we believe there is a need for flexibility: an approach which is able to recognise differing organisational strengths and weaknesses at a given time and accommodate these flexibly within broad principles is likely to generate better outcomes than the arbitrary application of a rigid framework. This indicates that, in addition to substantially more analysis and discussion, a considered approach which addresses particular agency structures on a case-by-case basis in the light of resource constraints and current priorities will be needed.

THE FUNDING PROCESS

The Current System

The budget process is, inter alia, the means by which the Government, or Executive, determines the cash requirements of conducting its administration for a given year. It is thus a process by which the Government distributes resources among competing spending activities; it is also a process by which, explicitly or implicitly, the Government determines that spending, rather than alternative forms of intervention such as regulation, as the appropriate means to an end. Once budget allocations have been determined, the Government requests that Parliament ratify these allocations through the appropriation process.

The appropriation process in New Zealand owes its origins to the appropriation process which evolved in the British Parliament. It is shaped by the dual and related objectives of control of the tax burden ('no taxation without consent') and control of the activities of the Executive. This gave rise over time to the *gross* appropriation system, the office of rhe Controller and Auditor General (one of whose functions is to check, on behalf of Parliament, whether money has been spent on the purpose for which it was appropriated), the system of parliamentary select committees, and the process of debate and Estimates examination in the House.

The parameters of the appropriation process are laid down in the Public Finance Act 1977, the cornerstone of which is that 'no expenditure of public money shall be made except pursuant to an appropriation by Act of Parliament' and 'the authority to issue and apply money pursuant to an Appropriation Acr shall lapse at the end of the financial year to which the Act relates.' There are some important exceptions to this rule of annual appropriations, where spending takes place under Permanent Legislative Authority as a 'permanent' appropriation. Examples of items which belong in this category are debt servicing (thus providing an assurance to lenders that interest obligations will be met), the salaries of officers such as the Controller and Auditor-General and the judiciary (establishing their independence from the Executive), and money spent out of revolving funds. Parliament has given up annual control of expenditure through revolving funds in exchange for the assurance that certain criteria, relating to performance against established targets, will be met.

The request by the Government for funding of its activities is presented to Parliament in the annual Appropriation Bill and associated Estimates of Expenditure. The Estimates of Expenditure represent the gross *cash* requirements of individual departments and other activities administered by the Government. The Estimates are scrutinised in detail by the Finance and Expenditure Committee (or another Committee nominated by it), with senior departmental officers appearing for questioning. Once select committee examination has been concluded, the Estimates are debated in Parliament. This process provides the opportunity for Parliament to examine in detail the activities of the Government and for the Opposition to expose any perceived weaknesses in administration.

The Effects of the Current System

The funding process described above plays a major role in influencing the behaviour of public sector managers. The way in which individual allocations are established, the way in which the costs of resource decisions are recognised, and the incentives and sanctions incorporated in the system will affect the way in which decisions are made and the ability of managers to plan and manage their activities. The Estimates of Expenditure represent the annual *cash* cost of funding the activities of the Executive. Although cash controls can in theory be fairly effective at constraining cash expenditure, and hence the tax burden for a given year, they have several shortcomings as a control over the activities of the Executive. They can also have a perverse impact on decision making. Some problems of using cash controls are:

- they do not present an accurate picture of rhe amount of activity which is being undertaken, in that cash accounting does not measure resource usage, only the immediate cash costs of that resource usage. The cost of asset acquisition and asset usage are usually quite different, but under the current system assets are expensed on acquisition and annual asset usage is not recorded (thar is, a large capital acquisition will distort expenditure upwards in the first year, and the usage of that asset will not be recognised in following years);
- they do not take account of future commitments. These may range from signed contracts to public assurances from the Government (for example a public pledge to provide funding for the purchase of an expensive item of medical equipment);
- expenditure estimates do not include tax expenditures-tax expenditures may be thought of as government expenditure by way of tax relief, as opposed to direct spending. The Family Tax Rebate is an example of a previous tax expenditure which has since been replaced by Family Support and shown as direct expenditure;
- liabilities, commitments and guarantees are included in the Estimates only in the year that a cash payment is expected. To the extent that liabilities and others result in future expenditure the Estimates understate current activity;
- the cash appropriated represents a control on the inputs that cash buys rather than the purchases of a specified volume of output. To control the activities of the Executive, Parliament requires more indication of the *output* it is purchasing from the Executive;
- concentrating on cash payments alone could result in an unnoticed deterioration in our stock of assets. There is presently no comprehensive record of state owned assets in terms of historic let alone current cost. It is therefore difficult to judge whether the stock of assets is being maintained.

There are some other unsatisfactory features of the present system such as the timing of the Budget—budget allocations are not finalised until some months into the financial year. The emphasis on one-year planning and the lack of flexibiliry to alter resource mixes within allocations forces managers to focus on the short term and prevents them from responding to changing prices and conditions. The lack of rewards for good management-there are no advantages to be gained from underspending - and lack of satisfactory means of dealing with overexpenditure leave managers with little incentive to control expenditure.

Overall, the system does not encourage managers to use their resources to seek the best possible outcome. Instead the system has encouraged departments to compete for increases in their one year cash allocations. It is in a department's interest to:

- underestimate the cost of programmes and overstate the benefits;
- argue for an incremental approach to expenditure allocation rather than evaluate the efficiency and effectiveness of the resources already at their disposal;
- disregard the cost of the funds raised either through taxation or borrowing;
- present expenditure proposals in terms of a macro objective (for example creating employment) rather than analysing the investment itself;
- monitor inputs not outputs;
- advocate other interventions, the costs of which are not included in their budgets (for example tax expenditures and increased regulation);
- encourage the use of non-cash resources, or resources which are underpriced. The attribution of the full costs of activities to departments has been an attempt to counteract this tendency;
- enter into commitments for future years;
- spend their full allocation for the year regardless of whether the expenditure is justified because unspent allocations are typically not carried forward;
- ignore the second and third year of three-year forecasts, and the associated financial monitoring of these limits.

Suggestions for Reform

Our present system of funding government expenditure based on annual cash appropriations does not provide the right incentives for public sector managers to make the best use of the resources available. Nor does it encourage them to provide information on the full cost of activities or the outputs achieved using available resources. An effective financial management system should impose powerful incentives on managers to perform.

Those incentives have already been provided for those trading operations which are now carried out by SOEs. They will be subject to many of the same costing and pricing principles as private sector firms and their managers will be required to produce financial reports on which to assess performance. Where other government agencies sell goods and services to the public, similar principles can be applied. The establishment of revolving funds and net funding targets provides incentives for departments to operate more efficiently as they reap the benefits of good management and face sanctions for poor performance. These developments also encourage departments to seek out more commercially oriented ways of running their businesses. This will possibly result in a greater number of government provided goods and services being subjected to the user pays principle. It could also result in departments reorganising themselves internally so that both inter-and intra-departmental services are charged for (for example EDP equipment could be centrally managed within a department and 'leased' to other areas of the department). Such moves (that is, establishing internal cost centres) should result in a better awareness of the cost of resources and improve asset management, although some changes to the funding process may be necessary as a result.

There will, however, always remain a core of departments which provide public goods, collect revenues or distribute social welfare benefits. The level of funding required for these functions is an important determinant of the present and future size of the tax burden. The question of how to maximise the return on the expenditure in this area of government activity poses the greatest challenge in the public sector reform programme.

Accountability and performance assessment are discussed elsewhere. Increased accountability and better performance assessment should lead to better performance and would allow a lessening of centralised input controls. (The degree to which these controls should be abandoned is a complex issue and is discussed in a later section.) If cash limits were to be adopted, managers would have greater flexibility to alter resource mixes within a given allocation. Incentives and sanctions for operating within the cash limits could be introduced, and budget allocations could be finalised much earlier in the year. However, the benefits of decentralising the appropriation process will only be realised if other reforms (such as the setting of objectives and greater accountability) are already in place.

Better performance assessment also implies a funding allocation system, and accounting for subsequent decisions, based on an assessment of the full resource cost of those decisions. A major area where costs are not measured remains in the consumption by departments of capital resources, which are currently fully expensed in the year of acquisition. It would be preferable to show the costs of using assets as depreciation over the life of the assets and to recognise the opportunity cost of the funds used to purchase them. This would imply the development of an accrual accounting system for purposes of resource management. Cash accounting would still be required for effective cash management.

If we are to move to an accrual accounting system we would also need an accrual budgeting system so that actual results can be measured against plans and budget. The accounting system would need to be on the same basis as the budgeting system to avoid the possibility of conflicting objectives. An accrual budgeting system is one which is expressed in terms of costs to be incurred rarher than in funds to be obligated or spent. Cost in this context is the value of goods and services used or consumed by an agency of the Government within a given period, regardless of when ordered, received or paid for. There are a number of advantages to the use of such budgets:

- they provide management with a more comprehensive financial picture of proposed operations;
- supported by a good cost accounting system they provide managemenr with the cost of activities and identify the use being made of all available resources. Such information is needed to evaluate financial plans;
- they provide a better matching of expenses with the delivery of goods and services over time;
- they should benefit the review process. Decision-making can be aided by information on the full cost of programmes and the uses being made of all available resources.

To allocate truly all costs to programmes it may be necessary to accompany accrual budgets with additional information on costs not traditionally included in the budget (for example, tax expenditures and the costs associated with a particular regulation).

A move towards accrual accounting and budgeting would improve the information available to assess managerial performance. Since the budget process is fundamentally conditioned by the nature of the appropriation process, changes to the former may imply changes to the latter. This leads back to the role of Parliament in controlling the tax burden and the activities of the Executive. Changes which are consistent with improved managerial performance are also likely to improve the achievement of Parliament's objectives. A focus on net consumption of resources and resource commitments backed up by supporting information (stating performance objectives and historical accounting for performance against objectives) would enable Parliament both to measure more clearly the commitment by the Executive of future and current revenues and to establish more clearly the nature of activity being conducted.

PERFORMANCE ASSESSMENT

The Current System

Performance assessment of management in the public sector is currently. conducted by a variety of means, and to different extents. In parr this reflects the variety of organisational forms which have developed to handle a range of activities.

At one end of the spectrum are the state corporations. In these rhe specification of clear objectives to manage operations as commercial enterprises should enable the better assessment of performance on the basis of defined financial targets.

Other activities in the public sector which are, in the main, of a predominantly commercial character have been established as revolving funds. In this case, too, managers are responsible for making decisions on the basis of performance objectives related to the efficient conduct of the activity involved.

Some departments which have the ability to tailor a portion of their output to the needs of private sector purchasers have had their budgets established as net funding targets: in this case, the performance of managers can in part be assessed in terms of whether or not the targets have been achieved. Performance assessment in this case falls somewhat short of providing a complete reflection of the quality of managerial decision-making, however, since achievement of a net funding target does not in itself reveal the quality of decision-making within the net spending allocation.

Finally, there are the core administrative and advisory departments. In this case formal performance assessment, to the extent it exists at all, consists of such factors as the ability of managers to remain within gross spending limits appropriated by Parliament, and to spend money on the purpose for which it was appropriated. In fact, explicit performance assessment is in some measure conducted by Parliament, rather than the Government, through the process of select committee examination of Estimates allocations. Naturally enough, the focus of much select committee inquiry is the collection of information for use in political debate. In addition select committees are not responsible for setting departmental objectives. Select committees should therefore probably not be considered as responsible for performance assessment.

Limited formal performance review is conducted by the Government or the SSC (which has formal responsibility for reviewing the efficiency and economy of each Department); specific reviews may be initiated when performance is obviously amiss (the inquiry into the Maniototo Irrigation Scheme affair is an example) and the SSC initiates efficiency and economy reviews from time to time. These latter reviews tend however to be infrequent and episodic. They are probably hampered by the inability of the SSC, in the current environment, to obtain appropriate information to enable regular, balanced, routine assessments to be made.

How Well Does the System Work?

The ability to assess the performance of managers in the public sector has, to dare, been severely constrained by a number of factors. Foremost is the fact that managers have typically faced unclear, and at times, conflicting, objectives. These range from responsibility for the provision of policy advice through to various types of administrative activity including the administration of regulation, decisions on funding allocations (for example, the disbursement of grant monies according to specified criteria), to the production and sale of goods and services of a commercial nature.

The restrictions on managers' ability to control the resources at their disposal to achieve those objectives has been severely constrained by input controls; in such circumstances there must exist genuine confusion as to the extent to which the exercise of judgement influenced the performance being evaluated.

Finally, there has been inadequate information on which to assess the quality of managerial decision making—the level of output achieved and the efficiency of resource use in achieving that output.

In such circumstances performance assessment is fraught with difficulties-in the absence of adequate information how can one assess the level of performance? In the absence of clear objectives how can that performance be assessed as having met, or not met, its target? And in the absence of sufficient authority to affect outcomes, how can managers be held responsible for those outcomes?

The problem is compounded by the current lack of incentives: if managers cannot be held to account for performance, establishing its quality will be an end in itself rather than a means to bring about improvement. In this situation managers have little incentive to co-operate in the process by divulging adequate information to allow a reasonable assessment to be made.

Suggestions for Reform

Adequate performance assessment is a crucial element in achieving improved management outcomes in'the public sector. Giving managers greater freedom to make decisions is unlikely to lead to better decision-making unless it is combined with an increase in managerial accountability, and this depends on our having the means of judging and influencing the quality of decision-making. This in turn depends on the prior specification of the *kind* of decision-making for which managers are responsible--'in other words, a much clearer specification of objectives.

The public sector includes a wide range of functions, and different means of performance assessment will depend upon the nature of the employment 'contract'. Changes to the structure of the machinery of government that distinguish the different functions from each other can enable clearer specification of objectives to be achieved for the different functions. This would reduce the conflicting objectives managers face in running their operations.

These issues have been addressed with respect to a large part of the state's trading operations with the application of the state owned enterprise principles.

The constitution of trading activities as SOEs with commercial objectives will provide a powerful means of assessing their subsequent performance: the ability to price output and exchange it in a market is an extremely efficient source of information. Better information still is conveyed with the existence of tradeable equity. The price at which this is exchanged provides signals of the expected future worth of the firm; and the exchange itself provides a strong discipline on managerial performance by making it contestable-those who have controlling equity are also in a position to control (and replace) management. There is considerable scope for the application of these principles to remaining areas of government activity which are, or could be, constituted as trading activities. These issues are discussed in the second half of this chapter.

Earlier in this chapter we discussed changes to the structure of government activity which would facilitate better management. The key reform which was suggested centred upon a clearer separation of policy advisory functions from those concerned with the implementation of policy regulatory and funding activity, and production operations.

It will be important to clarify the nature of the performance being assessed. This is clearly to do with the objectives that managers are given responsibility for meeting; this will vary depending on the function of the agency-policy advisory, regulatory and funding, or production. If such a structure were adopted, policy advisory agencies could be assessed on the quality (arid quantity) of policy advice they gave their Ministers given resources at their disposal. This would be the overriding focus of performance assessment—the quality of specific resource management decisions, for example, would become a second-order issue. At the other extreme, managers of agencies with responsibility for running efficient production operations would be judged, fundamentally, on the efficiency with which they implement stated government policy. Unless these managers are given formal responsibility for the initiation of policy advice it would not make sense to assess their performance in producing such advice or to hold them to account for that performance. In this context it will be important to distinguish between two possible sources of poor production outcomes-poor policy design, or poor policy implementation.

In agencies dedicated to the provision of goods and services there is considerable scope for changing the way government funds to secure services are disbursed by moving from producer-based funding systems to those based on consumers. This would involve explicitly transferring the delivery of government funds from producers to consumers, or alternatively making the funding of providers explicitly dependent on consumer demand while at the same time relaxing constraints on competing sources of supply. This would be facilitated by the separation of production agencies from departmental funding systems and organisational structures. Success in meeting consumer needs then automatically provides a measure of performance. The ACCESS programme, which provides unemployed people with an entitlement to training but gives them a choice as to what form that training shall take, is an example of this.

Assessment of performance management in the policy advisory area has traditionally been regarded as extremely difficult, often characterised as 'subjective' in contrast to a simple private sector model in which, it is postulated, the existence of profits as the 'bottom-line' provides a totally objective measure of performance. As a section on the labour market in Chapter 4 shows, such a depiction is an over-simplification-both of the ease of performance assessment in the private sector, and of its difficulty in the non-commercial public sector.

In the private sector 'subjective' considerations are likely to affect assessment of managerial performance for a wide variety of reasons. Share prices do not all show the same price/earnings ratios for shares of companies in a similar risk class. Instead, the share prices embody assessments of the quality of management-is it innovative, flexible and competent? The share prices of poorly managed firms trade at discounts, and the firms are liable to become takeover targets.

This suggests that performance assessment of managers in any organisation is likely to involve consideration of a number of factors by a number of different participants before a judgment can be made. There is no reason, however, to suppose that the performance of public sector managers is in any sense 'unmeasureable'. It is clear that Ministers do acquire an appreciation of rhe relative strengths and weaknesses of senior public service managers, through their individual contact with their own officials, consideration of a range of policy advice at Cabinet and Cabinet Commitrees, and experience during the budger review process.

The role of the Minister will be important in the assessment process. Strengthening of the accountability of departmental heads to Ministers, through the formal involvement of Ministers in appointment and tenure decisions, suggesrs that Ministers should also play a formal role in assessing the performance of agency heads. There may also be a role for centralised performance assessment of some sort since an agency wirh responsibility for advising Ministers on this basis mighr generate efficiencies from a common approach where thar is -appropriate. Ministers are likely to require assistance in coming to their judgments, and a separare agency would provide them with a source of advice on performance independent of the agencies being assessed. Different forms of assessment will be appropriate for different agencies, according to the degree to which an objective assessment can be made.

The focus of assessment is also important. We have suggesred rhar Ministers should play a formal role of some sort in the appointment process, and that this implies some degree of formal involvement in assessing the performance of agency heads. Because it is the departmental head who will be negotiating a contract of employment based on the achievement of specified objectives, it is the performance of that person in meeting those objectives that should be rhe focus of assessment. This will of course involve assessments both of the overall performance of the agency and of the personal performance of the head. In such an environment, performance assessment *within* agencies would become the responsibility of the heads of agencies rather than of any external monitoring body.

A key means of achieving better incentives for internal performance monitoring is through contestability-whether of advice provision, or implementation of policy. To the extent that contestability enables the preferences of consumers—whether Ministers or private individuals or firms-to be reflected in demand for an agency's output, and its consequent size, the problem of external monitoring is reduced.

In essence the monitoring of performance in ways that are realistic should be possible. To the extent that those assessments create incentives to provide information and to reward good performance the performance of the public sector as a whole should improve. Nevertheless greater attention to performance review will not in itself be enough. The scope and resolve has to exist for action to be taken when poor performance is exhibited. Sanctions and rewards should exist as must the willingness to use them. Even with administration and policy departments the idea of competition is applicable. To the extent that departments compete to provide advice and to get the analysis to a high standard better quality advice should result.

THE ROLE OF CONTROL AGENCIES

This section discusses the role of the control agencies in the light of the preceding analysis. The agencies discussed are the State Services Commission and Treasury; Audit's role is not discussed. Although Audit exercises a control function and may prevent the issue and payment of public money if it believes it will not be spent in accordance with appropriation, it occupies a constitutionally distinct position in that the Controller and Auditor-General is appointed by the Governor General and reports to Parliament. It should be noted however, that changes to the ways in which public sector agencies are funded and account for their performance has implications for the nature of the Audit function.

The Current System

State Services Commission

As mentioned earlier, the SSC is the central personnel authority for the public service and has statutory independence in all matters relating to decisions on individual employees. It is also responsible for advising the Government on machinery of government issues; for reviewing the efficiency and economy of each department (including the discharge of permanent heads' responsibility to Ministers for the efficient and economical administration of their departments); for approving and reviewing establishments of staff; and for providing training and management consultancy services to other departments. It has the authority to delegate its powers and issues an extensive code regarding these delegations in the Public Service Manual.

Treasury

Treasury is responsible, inter alia, for the administration of the Public Finance Act, and for providing the Government with independent economic and financial advice on all aspects of policy. It administers the budget cycle as a result of its responsibility for the Public Accounts, for assisting the Minister of Finance in preparing the Appropriation Act and for giving advice to that person. Treasury also has the power under the Public Finance Act to issue Treasury Instructions, which are a complex set of rules relating to the spending of, and accounting for, public money. It is not relevant to this discussion that Treasury also administers the National Provident Fund, the Government Superannuation Scheme, the Government Stores Board, the Government Actuaries Office and administers the coinage.

How Well Does the System Work?

It has been stated on several occasions that the current system of detailed input controls impedes the ability of managers to exercise freedom in resource decisions.

These input controls include those on staff, administered by rhe SSC, and those on other inputs, largely administered through the medium of Treasury Instructions. Although in recent years there has been a significant widening in the scope of delegations through both the Public Service Manual and Treasury Instructions, it has been suggested that significantly more responsibility should be conferred on public sector managers (in addition to other reforms> if improved management is to occur. These arguments are not repeated here; they imply a fundamental change in the nature of the ‘control’ function and the degree to which certain functions are centrally operated.

Suggestions for Reform

The degree to which the reforms suggested in the previous sections alter the current roles of the control agencies will depend not only on the extent to which it is appropriate to confer responsibility on departmental managers, but also on the nature of centrally organised functions that are likely to be required in a new environment.

A residual control function will of necessity remain. The extent to which existing controls can be abandoned will depend, inter alia, on the success with which objectives are able to be clearly specified and performance of managers assessed against them. Since this is likely to vary, so too will the degree of responsibility it is appropriate to give managers. The Government and Parliament will continue to require information on departmental activity to enable effective monitoring and reporting, including consolidated information which will enable it to evaluate its fiscal and monetary position, and changes more broadly in the Government’s asset and liability position. The fact that the activities of individual agencies may have implications for others suggest: that the need for central oversight or co-operation will remain. An example of this is the possibility of poor financial management by one government agency affecting the credit ratings of others.

It is in the context of the nature of residual controls and remaining centralised functions that changes to the operation of District Treasury Offices, for example, should be considered. These have traditionally functioned as a cheque-writing service for departments while simultaneously collecting data required for the preparation of the Public Accounts. It would be possible, for example, to devolve responsibility for cash management fully to departments, disbursing allocations at regular intervals throughout the year and allowing managers full freedom to bank with whom they choose. Whether or not this would be desirable depends in part on the degree to which incentives for good cash management could be incorporated into a reformed management framework and the derivation of (and the cost of doing so) alternative information sources (and the cost of doing so) for Treasury monitoring of departmental finances.

Improved financial management within departments would change the focus of Treasury's role from one of central control to one akin to thar of a private sector head office. It would be required to report on the overall activities of government and produce consolidated financial reports accordingly. This would mean the production of sufficient information by departmental mangers to enable Treasury to be satisfied of the quality of departmental financial management. Departments would be operating on approved budgets which include the full resource cost of their activities. The cash flow underlying each budget would be met from the Public Account. The extent to which each department's requirement is met from current taxation or borrowing could depend on the nature of the expenditure, that is, if it is to meet the cost of current operations or to finance capital investment.

Treasury would remain responsible for the overall cash management of the Public Account. The cash flows in and out of the Public Account have not in the past been managed in the sense that a private firm would seek to minimise overdraft charges or maximise returns on surplus funds. This would require more active management of both its short-term cash balances and longer term assets and liabilities. The Government's current banking relationship with the Reserve Bank is discussed further in Chapter 4.

There would also need to be substantial changes to the current roles of the SSC in a new environment, the most major of which would involve changes to its current role as the central pay authority. This need not involve overnight abandonment of that role, as major work in achieving the transition would be required and depending on the final shape of the reform there might be a residual monitoring and consulting role of some kind.

Transitional issues would arise with devolution to departmental heads of the employer role. The employment contracts of public servants are through the SSC. Devolution could take the form of transferring from the SSC to the departmental head all the employer's contractual rights and obligations, with any renegotiation of these rights thereafter a matter between the departmental head and the employee or his or her recognised representative. Devolution could take place ar different times for different employees or groups of employees. Membership of the Government Superannuation Scheme could continue to be portable across the public sector as at present.

An alternative to full devolution of employer responsibilities from the SSC would be to introduce contestability of employment arrangements. This could be achieved by retaining the SSC's current ability to employ public servants, while at the same time allowing departmental heads to negotiate employment contracts with staff independently. Departmental heads would thus have -a choice of contracting through the SSC for all or part of their staff (paying on a full cost recovery basis including the SSC's overheads) or going elsewhere-either to alternative employmenr agencies, or by producing these services within their own organisations. The extent of demand by departments for centralised employment arrangements would depend on the extent to which economies of scale in recruiting, bargaining and monitoring could be achieved. It would also reflect demands from the staff themselves to contract for employment through a centralised agency (such arrangements could for instance offer many people a more attractive career than commitment to a single department). Such an arrangement could make the transition from current employment conditions smoother than outright devolution, generating over time such centralised arrangements as would naturally occur anyway. (Reasons for the existence of such 'internal labour market' arrangements were discussed in an earlier section.)

Another function which might remain centralised concerns top appointments. No matter what degree of ministerial involvement in the appointment process takes place, Ministers are likely to require some agency to assist in that process by, for example, locating and screening potential applicants. Similarly, a possible role for a central agency in assisting Ministers with performance assessment of senior managers was identified in an earlier section. Again such functions can be contestable.

These functions may in fact be related since they both involve the 'operation' of the employment contracts between Ministers and agency heads. In this sense the advisory function would be that of assisting Ministers in establishing and monitoring these contracts. However, although economies of scale may generate efficiencies in providing such advice from a central source, it is important that that source should not be the only avenue available to Ministers. Considerable further analysis is required before the final nature of the control function, and the extent of centralised functions, can be deduced with any confidence. In particular, the nature of many of those functions is likely to depend crucially on the extent to which other reforms identified in this chapter are undertaken. The greater the reform the smaller is the role for central control agencies.

CONCLUSION

This chapter has been concerned with identifying means by which management of the non-corporate government sector might be improved.

Key elements in evaluating any management process were identified as clarity of objectives, freedom to manage, accountability, assessment of performance, and information flows. It was suggested that improvements in any one, or subset, of these would not be sufficient to generate improved management outcomes.

The immediately preceding sections have examined aspects of government management. The ability of current arrangements co facilitate efficient management outcomes were discussed, and the application of the management principles outlined above gave rise to the following suggestions for reform.

Accountability and Responsibility

- Ministerial input into appointment of agency heads
- Limited tenure of agency heads with provision for removal from office for unsatisfactory performance
- Flexibility in appointment procedures

Public Service Labour Market

- Agency heads designated as employing authorities free from detailed central controls over wages and personnel policies
- Simplified appeal system
- Implementation of remaining 'buff report proposals on pay fixing, involving closer alignment of state and private sector regimes

Structure of Government

- Separation of policy advice function from production operations
- Reorganisation of policy advisory agencies away from sector orientation

Funding Process

- Clearer specification of intended outputs
- Substantial relaxation of input controls
- Attribute full cost of activities to departments
- Development of accrual-based budgeting and accounting
- Improve reporting to Government and Parliament by providing additional information
- Incentives and penalties for under and over achievement of budget targets

Performance Assessment

- Explicit performance assessment procedures varying according to nature of activity

— Formal role for Ministers in assessment process
— Possible advisory role for central agency

Role of Control Agencies

— Existence of residual control functions where decentralisation and delegation are inappropriate
— Nature of residual control functions and centralised service provision will depend on extent to which other reform is possible

The nature of the specific recommendations outlined above indicates the complex inter-relationships which must be considered in approaching management reform. No matter what the starting point, achievement of improved management outcomes will only be possible if the system is treated as a whole. To take an example: we have stressed the importance of the Government being able to call upon an adequate resource of competent analytical staff it if is to receive a sufficient quality and quantity of policy advice. We suggested that severe shortages in some professional areas at present were the outcome, at least in part, of the constraints imposed by the current centralised pay-fixing and negotiating arrangements. A solution to that, we suggested, was to constitute departmental heads as employing authorities in their departments, with authority to negotiate conditions of employment to recruit, retain and motivate adequate staff. Would this in itself be sufficient to lead to improvement in management outcomes-in this case, would it be sufficient in itself to generate an adequate quality and quantity of advice? We suggest that it would not: unless those departmental heads are accountable for the outcome of those negotiations and for meeting stated objectives concerning the nature of policy advice provision, greater authority will not necessarily lead to better outcomes for the Government. Holding them accountable is only possible if their performance can be assessed: that too requires clearly stated objectives and information on which an assessment could be based. Finally the structure of organisations-the extent to which similar functions are grouped together, the extent to which policy advice is non-sectoral, and whether. both are adequately resourced—will significantly affect the incentives on and capacities of agencies to deliver better outcomes.

Earlier, we stressed the need for flexibility. Because of the extent of the inter-relationships between the various facets of the management process, the degree to which improvements in one area can be achieved will determine the extent of possible reform in others. This suggests that a case-by-case approach which carefully addresses the nature of activity involved will be important in achieving the goal of improved government management.

PART B-STATE PRODUCTION OF COMMERCIAL GOODS AND SERVICES

Introduction

Very substantial amounts of New Zealand resources are controlled by state and local authority trading activities. The process of recent economic policy reform has exposed the internationally traded goods sector increasingly to international competition. This has, in turn, highlighted the importance of the efficiency and pricing policies of the non-traded sector of the economy in determining the overall competitiveness and productivity of the New Zealand economy.

The Government's state-owned enterprise (SOE) policy has established rhe framework for a much improved performance by its trading activities. This Parr initially reviews the foundations of the SOE policy and emphasises the importance of reconstructed enterprises operating in contestable markets with transferable ownership and control (section 2). Section 3 reports on the issues arising from the implementation of SOE policy. In relation to the product markets in which SOEs and local authority trading activities (LATAs) compete, section 4 discusses the issue of barriers to entry and market dominance. Section 5 addresses the question of transferable ownership and control, by first investigating the ownership-incentives problems arising from monitoring and state ownership, and then examining the case for transferable ownership and control (privatisation). Section 6 extends the analysis to LATAs.

Framework for Analysis

Consideration in this Part is given to the production by state trading activities of goods and services which have characteristics which readily allow their sale. That is, consumers can be easily identified and the amount of good or service consumed accurately assessed and charged for on a full cost recovery basis. Thus trading is not complicated to a significant degree by the high cost of charging for services, or by difficulties in appropriating the benefits or by the cost of excluding non-payers from consumption. With changing technology and preferences, cost-effective pricing mechanisms may develop for products with commercial characteristics. In such cases putting the activity on to an SOE basis would increase performance incentives by improving transparency, clarifying objectives, and increasing accountability.

It should be noted that activities which, by their nature, may need to remain close to the state—for example the management of the state's financial liabilities can benefit from being placed on to a more commercially orientated basis. It is also recognised that while government policy objectives may require the provision of certain products, the state can arrange provision by contracting with outside entities, for example accommodation could be provided by state funding without the state owning houses. For commercially tradeable goods and services, the policy issue that is addressed here is to find the set of institutions and inherent pattern of incentives which deliver services in the most efficient manner.

The general conditions required for the efficient production of goods and services can be stated relatively simply. Allocative efficiency is achieved when the prices paid for a firm's output cover the cost of the resources involved, thereby drawing resources into the production of goods in demand. Productive efficiency is achieved by producing the firm's output at least cost. Finally, production should be expanded up to the point where the increase in revenue obtained from the additional sales just covers the additional costs incurred. In general terms, allocative efficiency is best achieved through competition in product markets, as this allows consumers to choose between alternative suppliers on the basis of price, service, quality and reliability. Productive efficiency is achieved in part through product market competition, and in part through contestability in the ownership and control of assets. Transferability of ownership allows ownership rights to resources to pass to those who can make the most profitable use of them. It also provides incentives for directors and managers to perform in the interests of the resource owners. These two conditions, namely product market competition and ownership contestability, are central to the efficient production of goods and services in the private sector.

Over a long period of time the state has become the owner of a number of enterprises. But closer examination of these enterprises may indicate that alternative organisational forms (either within or outside of state ownership) are superior in terms of economic efficiency. Several general themes have emerged from studies worldwide on the efficiency of trading activities which are under state ownership.

i Production and sale by state trading activities has been used in the past as a means of delivering special assistance to particular groups of consumers. Retention of that assistance has been used as an argument against product market competition. By definition it is a tax on other consumers who pay more for the services in question, or on the taxpayers, who provide the capital, receiving a low return. It is now generally seen as an inefficient and poorly targeted way of delivering assistance. A separation of commercial and non-commercial objectives is therefore a fundamental objective in the reform of state trading activities, with equity objectives being met directly through taxation and transfer payments.

ii State ownership has often been rationalised as a control on enterprises with a dominant position in their product markets. State ownership is frequently seen as a means of preventing that enterprise from exploiting its position. However this policy prescription does not deal directly with the underlying market problem. Exposure of the industry to actual or potential competition in the context of general competition rules is increasingly being viewed as the most effective way of dealing with market dominance.

iii Inappropriate incentives to directors and managers to act in. the owner's commercial interest has emerged as a fundamental problem of state ownership of trading activities.

Product market competition encourages suppliers to meet market requirements. Where consumers are able to choose between alternative products, sellers of over priced or poor quality goods are likely to experience a declining market share. The threat of the entry of new firms into the market will apply considerable disciplines upon the incumbent firms. Such competition occurs not only in the static sense of supplying goods of a given quality at the lowest price, but also through the dynamic process of encouraging technological innovation and responsiveness to changing market requirements. Thus competitive markets facilitate adjustment over time. This is not to say that the competitive process is costless, or that market power cannot arise in certain circumstances, but rather that it is better than the alternatives in that the self monitoring process implicit in rivalry between competing firms has significant advantages over administrative allocation mechanisms and associated regulations.

It is recognised, however, that competitive pressures can be reduced by the interplay of two conditions occurring in the market concerned. These conditions, namely economies of scale and barriers to entry, can occur at either a national or a local level. Firstly, where the average cost of production continues to fall for a significant proportion of that market's requirements, production by a few firms will become the most efficient form of supply. In the extreme case there will be only one firm in the industry, termed a natural monopoly. Economies in the production of one or several related products can arise from plant technology, where larger plants incur lower average costs per unit of output. Another source of economies is that associated with planning and co-ordination. Here production and delivery must be closely integrated, usually in some relatively permanent manner, in order to provide services in a least-cost manner. Organisations need to co-ordinate their activities rather than duplicate certain parts of the existing system and operate independently. Whether co-ordination requires a single corporate ownership, or occurs between several corporate entities is a subsidiary issue.

The second condition which also needs to be met for competition (either actual or potential) to be limited is that there are substantial barriers to firms entering or leaving the industry. Barriers to entry normally take the form of 'sunk' costs which cannot be recovered when the firm leaves the industry. Examples of sunk costs would be training, market surveys, investment in research and development, and the resale of fixed capital investments below their depreciated value. Firms will therefore carefully evaluate the risk of incurring sunk costs before making any decision to enter the market or radically altering their market share. These sunk costs therefore give the incumbent firms considerable market power. With lower sunk costs, and therefore lower barriers to entry and exit by other firms, the market becomes more contestable and the incumbent firms have reduced market power. This highlights the point that it is not the absence of competitors which is important, but rather the barriers to entry, and in particular the sunk costs that cannot be recovered by the firm when leaving the industry. Similar arguments apply to natural monopolies. Where the single firm is the most efficient form of production, duplication will not occur. Statutory prohibition on entry may well have the adverse impact of preventing contestability. The threat of entry can be a potent force in constraining market dominant behaviour, particularly with technological innovation and the emergence of competition as the characteristics of the industry change. If however barriers to entry are substantial, policies to encourage competition will have to be considered in terms of net national benefits.

The consequence of barriers to entry is that companies can exercise market power in the protected area of their operations. This may be expressed through costly or poor quality services or through higher prices. Barriers can arise not only from natural conditions in the market but also from legislation. For some SOEs, in particular Telecom, Airways and New Zealand Post, a statutory monopoly has been continued for certain aspects of their operations. To enhance competition in those situations where market dominance occurs, several policy options are available. In general, economic analysis indicates that statutory prohibitions on entry should be removed. The general provisions of the Commerce Act can then be applied. A further option is to consider the application of 'pro-competitive' policies such as introducing common carrier provisions or franchises. Such policies though risk reducing the efficiency of an industry or a company in attempting to deal with a dominant market position. The application of these policies will have to be established on a case-by-case basis.

The ability to transfer ownership complements product market competition. In the situation where the ownership of an asset or a company is transferable, there are important and powerful influences on managers. Where firms can be taken over, sold or restructured, with the consequential threat to existing managers, there are incentives for the interests of managers to coincide with those of the owner. The existence of a share price for a particular firm also acts as a powerful monitoring mechanism. Movements in the share price relative to other shares gives a clear indication of investor perception of the firm's performance which has direct impacts on managers. A relatively low share price has the effect of raising the firm's cost of capital which in turn reduces its ability to expand and increases

the risk of takeover or divestment. A relatively high share price has the opposite effect. In such circumstances managers have clear incentives to inform investors and analysts about the company's prospect if they consider the marker is under-valuing the shares. Equally investors and analysts have incentives to invest time and resources into monitoring firms. For investors with non-conrrolling interesr holdings their wealth can be increased by selling shares with declining prospects and buying into shares with improving prospects. Such investors can benefit substantially from such activity. For major investors, monitoring of the performance of firms can lead to the identification of firms which offer the prospect of much improved performance resulting from new management or change in business direction. These gains will be appropriated by the new owner. In addition to the equities market, firms are monitored by bankers. Bankruptcy and receivership are other mechanisms by which control of the business changes hands.

With non-transferable state ownership, the absence of the market pressures described above permits managers to give excessive weight to non-commercial objectives. Accountability provisions between the managers and the relevant Ministers, together with the monitoring of state trading organisations in relation to their performance targets, provides a substitute for sharemarket pressures. However it has inherent limitations. The more actively involved Ministers become in monitoring, the greater is the likelihood of non-commercial objectives being injected into the commercial decision making of the business. Ministers may also be less willing to apply sanctions for poor performance. The less monitoring rhat occurs, the greater the likelihood that over time the state trading organisation will themselves adopt non-commercial objectives.

Implementation of State-Owned Enterprise Policy

The first step in the reform of state trading activities has been co reconstruct nine departmental trading activities in accordance with five general principles first announced by the Minister of Finance in December 1985. In brief, these principles were:

- i responsibility for non-commercial functions should be separated from responsibility for commercial functions;
- ii managers of an SOE should be required, as their principal objective, to run the SOE as a successful business enterprise;
- iii SOE managers should have responsibility for decisions on the use of inputs, on pricing, and on the marketing of their output, within the

performance targets agreed with Ministers so char they (that is, managers) can be held accountable for their performance;

iv competitive advantages and disadvantages of SOEs, including unnecessary barriers to competition, should be removed so chat commercial criteria will provide a fair assessment of performance; and

v individual SOEs should 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.

In seeking to improve the efficiency of resource use, the SOE policy framework distinguishes and clarifies three separate functions of Government in relation to its trading activities: the efficient operation of the business including a return on the investment of public funds, the efficient pricing of the goods and services supplied, and separate responsibility for non-commercial objectives. To maximise the returns from its investments in certain enterprises, the Government has appointed private sector directors, making them accountable co shareholding Ministers for the profitable operation of the business. To protect the interests of consumers of goods and services, the Government's policy emphasises the removal of entry barriers, and making SOEs subject to general competition rules. Government will contract directly with the SOEs for the funding of non-commercial objectives. Separation of these functions is important, since the objectives of investors and consumers can be in conflict, particularly where the SOE has some control in setting the level of product prices. Thus the rate of return on investments might be improved, not by improving efficiency and containing costs, but by the expedient of raising prices. Conversely, prices to consumers can be held down by a below-commercial return on assets.

The SOE policy framework is seen as having substantial advantages over the previous arrangements. Substantial advantages are obtained by product market deregulation and the removal of other competitive advantages, thereby encouraging cost containment and responsiveness to consumer demand. Further, isolating those non-commercial objectives which might warrant direct funding forces a fully commercial perspective, and makes the choice among competing claims for budgetary expenditure a matter for Government. This has been assisted by emphasising the interests of investors and subjecting investment and trading decisions to scrutiny from a commercial perspective. Restructuring the business, while rime consuming, has assisted in determining the purpose of the business, improving productivity, reviewing capital projects, and assessing pricing policies.

Negotiation of Business Valuations

The process of establishing the new SOEs involves, inter alia, the existing businesses run by the Crown being transferred at an agreed value to the SOEs. It is crucial that the businesses be transferred to SOEs at a fair market value for a number of reasons.

i Too low a business value will reduce the costs of capital for a business and, potentially, enable it to price below competitors despite having high costs. That is, higher operating costs will be offset by the lower cost of capital. If this occurs, lower cost and more efficient producers could be priced out by a less efficient corporation. On the other hand, too high a value would make an SOE uncompetitive, because of high capital charges, regardless of its efficiency.

ii The business values arrived at will be a central ingredient in assessing the future performance of the SOEs because they affect how well the board of each has to perform to meet performance targets in relation to private sector comparisons. If the business value is out of line with commercial valuation, monitoring the performance against commercial norms will be virtually impossible.

iii If businesses are transferred to the SOEs at prices below their market worth, their effective debt/equity ratio will be too low and accordingly there is a risk of corporations being able to invest excessively and unprofitably.

Included in this process is the establishment of commercial financial structures for each of the businesses. The objective should be to have each SOE operating with a debt:equity ratio in line with commercial norms. Excessive gearing increases the riskiness of the owner's investment while too low a ratio can allow SOEs to invest in unprofitable projects. There are transitional issues involved where SOEs when newly established may not be able to service the optimal debt levels because of cash flow and accounting income constraints.

Originally, at the commencement of the SOE valuation process, the process was seen as a co-operative or joint approach between the Crown and the SOE boards. For various reasons, the Crown and the SOE boards moved away from this approach, and attempted to conclude the transfer of the nine businesses with the Crown as vendor and the SOE boards as purchasers. This process also involved attempting to reach appropriate valuations by boards submitting their 'bids' for the businesses to shareholding Ministers. However it was apparent by early April 1987 in light of experiences with the negotiations up to that time that the vendor/single purchaser approach—which was favoured by the boards-was not without its problems.

i There are no competing purchasers and, thus, there are weak incentives for the SOE boards to take positions in negotiation that are in accordance with the objectives of the SOE policy. From a simplistic point of view it might seem to be to the advantage of the SOE boards to establish the lowest possible business values-so as to show their subsequent performance (expressed in return on assets or equity) in as favourable as light as possible.

ii In many cases, there is an inadequate information base from which to apply standard valuation methodologies and make judgments about non-quantifiable risk. This factor is complicated by the unusual situation of the purchaser having access to all information whereas the vendor has very little. Also, in general, these operations have not been run as businesses before and many have no private sector counterparts. Hence there are some unusual difficulties in assessing what can be achieved in the future and thus the value of the business.

Our conclusions from an analysis of the negotiations in early April 1987 was that it could be more productive to view the business transfer process as part of a reconstruction of an existing business involving both the shareholding Ministers and the SOE boards and management. This approach promotes a focus on the steps involved in the reconstruction of the business, establishing the factual basis and the strategic options available. The range of values for the business can be successively narrowed during reconstruction discussions as issues are dealt with and common methodologies adopted. The potential adversarial nature of the negotiating is reduced, and the parties can work together through issues. The zone in which final haggling takes place is reduced to one in which mutually acceptable outcomes can be found. Nevertheless, the incentives faced by the boards continue to be to negotiate a relatively low value.

Negotiation of SOE Statements of Corporate Intent

In the annual negotiation of dividend payments and performance targets in the Statement of Corporate Intent (SCI), boards will also have incentives to negotiate dividend levels and performance targets lower than average private sector norms. Such an outcome would have the effect of reducing the cost of capital below commercial norms and would ensure that subsequent performance is seen in the most favourable light. To this extent economic efficiency and optimum resource use will be compromised and sub-optimal decisions relating to investment and divestment could be expected.

The SOE Act makes provision for the shareholding Ministers to direct both the level of dividends to be paid and the performance targets to be included in any Statement of Corporate Intent for any new SOE. This is intended to substitute for the incentives operating in the sharemarket which encourage managers to set realistic performance targets and dividend payouts. However, the power of direction is likely to be a poor response. First, it foreshadows political and bureaucratic interference in an SOE's commercial decision-making process. It can serve to reduce the incentives facing the boards to take truly commercial assessments of investments and it could reduce the accountability of the boards for SOE performance. Second, the power of direction is likely to be a second best response. It will be virtually impossible for Ministers to replicate, through the power of direction, the incentives that exist in companies with contestable control to maximise dividend levels and performance targets.

Limitations of the SOE Act 1986

This Act provides the legislative basis for improved SOE performance and accountability. However, there are a number of factors arising out of the SOE Act itself which are likely to inhibit the performance and accountability of all state enterprises under the ambit of the legislation.

i Control is not transferable.

ii The SOE Act requires that the Audit Office be auditor for SOEs. This restricts the scope for the SOEs to select an auditor that best meets its requirements. There is also a potential problem as a result of the dual roles of the Audit Office, as auditor in terms of the Public Finance Act, and as auditor of SOEs in terms of the SOE Act and the Companies Act.

iii SOEs are subject to the Official Information Act and Ombudsman Act and are subject to scrutiny in terms of monitoring (see following) and select committees of Parliament.

The review of the above provisions are important if the maximum commercial incentives are to be placed on SOE managements to act in the interests of shareholders and be fully accountable for their decisions.

Extension of SOE Review Process

The SOE Act does not cover all government owned trading activities. The application of the SOE principles to departmental trading activities is an important first step in applying a full range of commercial incentives on managers. Its coverage could however be usefully extended. Many other departments, in whole or in part, also undertake commercial functions and could be profitably reviewed in terms of the SOE principles.

There will, however, be a need for the timing of extending the SOE principles to further government owned trading activities to be carefully considered.

It is also important to review the businesses of existing statutory corporations, such as the Railways Corporation, Tourist Hotel Corporation, and the Broadcasting Corporation, in terms of the SOE principles. At present such corporations operate under their own statutes and generally have with commercial and non-commercial objectives. They also have accountability and monitoring procedures which are very different to the framework set out in the SOE Act.

Market Dominant SOEs and the Appropriate Regulatory Environment

The self monitoring process implicit in market rivalry between competing firms has significant economic advantages over non-market mechanisms. SOEs operating in competitive markets will have to perform efhciently or they will lose market share, and experience falls in business value. In such situations consumers have a choice between the products of alternative suppliers, and no significant policy issues arise with respect to pricing. However with market power or dominance there is a reduction in rivalry, and companies in the market have scope to set prices above efficient levels. Inefficient behaviour resulting from market dominance can take several forms:

- i excessive pricing on average which might arise from the extraction of monopoly rents, or from inefficient (cost plus) operations;
- ii cross-subsidisation by raising prices in protected markets and lowering of prices in more competitive markets, in order to permanently drive out competitors or to discourage entry;
- iii charging excessively high rates for access to transmission networks; and
- iv low quality goods and services.

In establishing the regulatory environment for individual SOEs, the general principles of competitive neutrality including product market liberalisation has been adopted. In some cases the Government has decided to retain restrictions on entry. In telecommunications, a timetable for the liberalisation of markets for customer premises equipment has been established, but the desirability of competition in the supply of network services is being investigated further. In relation to the administration of the airways system, the Airways Corporation has been granted a statutory monopoly over airways en route control, approach and departure control, and flight information services to aircraft in flight. In postal services, New Zealand Post Limited has a monopoly on the carriage of letters of 500 grams or less for charges of less than $ i .75, pending a review to be completed before 1 April 1989. A consequence of these prohibitions on entry is that the relevant SOE also has considerable market power in the delivery of services. This has the potential to result in costly or inefficient practices, in increased profits through higher prices, poor quality services, or in cross-subsidisation between products or users. Taking a national perspective, such government-imposed economic restrictions on entry to markets reduce national income and, accordingly, should be removed. Analysis suggests public policy concerned with the removal of entry barriers should focus on facilitating the adjustment process rather than slowing the removal of statutory barriers.

Policy Options

There is no neat, simple and general answer to the question of how to control the pricing policies and other practices of market dominant SOEs. Various options are available. There are benefits and costs with each approach, and these have to be assessed in the light of industry characteristics. Consequently, the task is to establish the economic cost, if any, resulting from market dominance, and the costs and benefits of interventions aimed at dealing with the problem. To dare liberalisation of entry conditions combined with the application of the Commerce Act, has been the approach adopted in relation to SOEs. In some situations additional measures may be required. Price and rate of return controls address excessive pricing or profitability directly. 'Pro-competitive' policies seek to identify those parts of an industry where market power exists (such as access to the transmission network) and to change the 'rules of the game' so that more competitive outcomes can arise. Common carrier provisions allow access to the network by independent suppliers and users, while franchising involves a contract to provide the transmission service on specified terms. A dominant organisation can also be broken up into separate businesses.

The approach which traditionally has been used is to deal with the symptoms of market dominance directly through price controls or rate of return regulations. However substantial costs are involved in regulatory intervention. These are incurred directly through the operations of the regulatory authority and interest group lobbying, and indirectly through the distraction of management effort, the blunting of competition between firms and the slowing down of innovation. While regulatory control gives the appearance of dealing with the problem, the burden of proof on regulators and the difficulties they face in obtaining information to prove that lower cost services are possible is an onerous one. Experience suggests that justified prices are likely to rise well above efficient prices. Misallocation of resources can also occur, for example the over-investment in US electric utilities when rate of return regulations restricted profits from the efficient asset base. Consequently, one objective in the selection of policies is to deal with the source of market dominance, and to encourage competition. This reinforces the importance of removing legislative barriers to entry. It also points to the use of competition policy in dealing with restrictive trade practices. There may, however, be limitations in applying such legislation to natural monopolies. Cross-subsidisation and price predation is likely to be difficult to prove, and access rights may be difficult to enforce, which is likely to increase the possibility of sunk costs being incurred thereby inhibiting entry. It may therefore be desirable, to examine the net benefits of adopting a more active pro-competitive policy which gives greater assurance of the terms of access. Such an approach may still require some control over the prices or profits of the network owner in those situations where sunk costs are substantial and the duplication of the network is unlikely. But the scope of regulation is more restricted. It will also involve some loss of efficiency, as access rights and franchise terms limit the network owner's ability to optimally plan. In short, no approach for dealing with market dominance is fully satisfactory, and instances have to be dealt with on a case-by-case basis focusing on net benefit keeping in mind incentives and accountability.

Telecom Corporation

The business of providing telecommunication services covers a wide range of activities including local, long distance and international circuits for voice and data transmission as well as a variety of communications equipment and specialised services. The growth of new technology, offering new products and substantially lower unit-costs, and the increasing overlap of the highly regulated telecommunications industry with the unregulated electronic information processing industry has enhanced the attractiveness of flexible, market-sensitive structures for the supply of telecom products and services. The statutory monopoly supply of telecom services has resulted in a loss of economic efficiency through the cross-subsidisation of services and users, the inhibiting of innovation and reduced incentives on a regulated monopoly to minimise costs. Telecom Corporation appears to be heavily overstaffed, invest substantial amounts in unprofitable projects and still cannot meet the needs of customers.

As is indicated above, while the Government has decided upon removing restrictions on competition for customer premises equipment over the next 18 months, it has decided that removal of restriction on network competition should await a further study. This study will report in December 1987 on:

- i whether it is in the interests of economic efficiency to introduce greater competition into the network services market;
- ii the likely economic and social impact of introducing greater competition into the network services market;
- iii the extent, rate and means by which competition should be phased in.

Electricity Corporation

The Electricity Corporation's (EC) predecessor, the Electricity Division of the Ministry of Energy, operated with a statutory monopoly and thus the current wholesale industry structure reflects this monopoly rather than commercial pressures. The legislative barriers to entry are being removed. This raises the question of whether the EC in the absence of a statutory monopoly is a natural monopoly. In order to answer this, it is useful to examine the Corporation's two functions—electricity generation and high voltage transmission-separately. A market will be served by a natural monopoly if the lowest total cost of supply of one or several products is achieved when it is served by a single seller. With respect to electricity generation, it is clear that electricity generation in a market typically requires more than one generating station. Economies of scale in generarion appear co be exhausted at around half the size of the Huntly power sration. Experience in the US and Sweden for example, indicates that utilities with only base load generation can contract with other utilities to buy-in peak load energy. This suggesrs that the cost of contracting for electriciry sales is not so high as to make the single integrated firm the most efficient means of the providing electriciry. This means that with the removal of regulatory barriers to entry, competition in electricity. generation is possible and the market will impose a discipline on the Corporation's dominant position. This is not to say that new generators can easily or quickly enter the market to provide an actual challenge to EC's position, given the likely excess of generating capacity and the risk of EC acting in a predatory. manner. However, it does lessen the case for economic regulation.

Whether competition in high voltage transmission services is economically7 feasible is more in doubt, with overseas evidence suggesting that high voltage transmission is characterised by substantial economies. Often the owner of a transmission network (either private or state) is obliged to offer transmission access to other electricity producers. At this stage, the Government has agreed that there will not be any legislated 'common carrier' provision on EC. Rather, EC is expected to act commercially. Its SCI indicates that its access policy will be based on offering fair and reasonable terms for access to its network.

There is a concern that total ownership of the transmission network by EC linked to ownership of virtually all the generation will confer on it substanrial market power. Although EC will be subject to the Commerce Act if it appears as though it is abusing its dominant position, it could be difficult for the Commission or the Courts to distinguish between unreasonable and reasonable commercial behaviour. The risk that resource use will be sub-optimal is increased because EC is state owned and as such may not behave in a predominantly commercial manner. For example, the Corporation may be both able and willing to sustain short term losses to deter entry by another electricity producer.

One possible way of handling this problem would be to separate ownership of the transmission network from ownership of generating assets and in turn to split: up ownership of generating assets. Beyond this a further possible option would be to auction off power stations to private sector owners thus allowing the structure of the industry to be influenced by commercial factors in the context of general competition rules. This would increase competition between generators. Competing electricity producers in turn will have an incentive to monitor the owner of the transmission nerwork to guard against abuses of the key position it holds in the market, thus reducing the need for direct regulatory inrervention.

Against such proposals it can be argued that there are offsetting efficiency benefits by having the power stations and the transmission network, under common ownership. As all generating stations do nor run at once, a key aspect of EC's operations involves deciding which combinations of stations should be used at any time to meet demand, bearing in mind an overall objective of cost minimisation. It is argued that if ownership of the transmission network and generating facilities is separated, matching electricity supply with demand would be more costly and hence less efficient.

Reform of the retail electricity industry will also be necessary so rhat there can be an effective interaction between wholesale electricity costs of supply and consumers' willingness to pay. This is discussed next.

Ownership, Incentives, Monitoring and Privatisation

SOEs have been modelled upon private sector companies. This allows a separation between the ownership with shares held by Ministers, and the control of the SOE by a board of directors. The SOE Act requires that SOEs operate as successful businesses, and to earn commercial returns from the resources invested in them. The boards of SOEs are accountable to shareholding Ministers, through the negotiation of the SCIs and regular reporting on their performance in achieving objectives and targets. One of the key elements in allowing shareholding Ministers to effectively perform their functions is a sufficient flow of information, analysis and advice on the performance of SOEs. While this separation of ownership and control substantially reduces the involvement of hfiniscers in the derailed management of the business, it does introduce the problem of ensuring char directors act in the interests of the owners. Such divergences of interest also occur in the private sector, as directors or management of companies will not necessarily have the same interests as the providers of equity and debr capital. However, as indicated earlier transferable control embodies a set of incentives to the various participants in the equity and debt markets which minimise this divergence.

The control of publicly listed companies is contestable through sharemarket transactions. By definition the transfer of ownership is a limited option for state enterprises. This reduces significantly the pressures on directors of SOEs to act in the interests of shareholders. In the development of accountability provisions, the aim has been to develop similar disciplines and incentives to those which arise with private ownership. In general terms, it can be argued that shareholder monitoring in the public sector will be inferior to the incentives for efficiency provided by the sharemarket because of:

i the potential intrusion of non-commercial objectives, despite the opportunity for the direct funding of non-commercial objectives;

ii the absence of a share price indicating the market assessment of the value of the SOE;

iii potential limitations on information flows in the absence of incentives for this to be supplied to owners and other business analysts;

iv inherent constraints on Ministers' ability to apply sanctions when directors' performance is deficient; and vdifficulties in acquiring sufficient monitoring resources.

The extent to which these deficiencies are rectified by the issue of tradeable equity is examined later.

Details of Treasury's proposals for financial monitoring of SOEs by shareholding Ministers were contained in the Treasury report 'Commercial Performance of State Owned Enterprises : Principles for Shareholder Monitoring' which was published on 10 June 1987. In order to obtain sufficient information to assess SOE performance, a relatively extensive monitoring programme was proposed. Further, as required by the SOE Act, and as suggested by private sector practices in monitoring, the programme entailed the negotiation of performance targets and the monitoring of progress towards achieving them, rather than an ex post review of efficiency levels. In addition, procedures were proposed for evaluating alternative courses of action to be taken by Ministers when the performance of an SOE is persistently inadequate.

In responses to the Treasury paper, including a joint submission from SOE chairmen, a number of concerns were raised. First, it was considered that as more information is provided, particularly the detailed information contained in board papers, the scope for intervention increases, either on the part of Ministers or their monitors. Second, there was substantial resistance to the involvement of officials in monitoring, because of potential conflicts of interest. Third, it was considered that the level of monitoring should be individually tailored to the operations and performance of each SOE, for example closer supervision for poor performers, and less or no monitoring as a larger proportion of the equity of the SOE is traded as equity bonds.

By and large the submissions, in our view, under-estimated the difficulties associated with shareholding Ministers tracking SOE performance in the absence of normal sharemarket monitoring. SOE monitoring poses a conundrum for which there is no satisfactory answer. Some argue that the more the Government is involved in monitoring the more.likely it is that interference will occur-exactly what the SOE policy is aimed at restricting. Against that, it can be argued that regular and full information flows will enable Ministers to be assured that they can meet their own accountability responsibilities without intervening in the management of the business. For SOE directors to be held responsible for performance, they must have freedom to make commercial decisions. But there is also evidence from history that the more independence that SOE directors are given, the more likely it will be that over time they will substitute non-commercial objectives because of the lack of commercial incentives that would normally occur with contestable control. The proposed monitoring programme seeks to strike a balance. But the fundamental conflict between avoiding political interference in SOEs and ensuring that SOEs are operated in the owner's commercial interests remains. In essence this arises because monitoring by shareholding Ministers is a poor substitute for contestable control.

Equity Bonds

The SOE Act provides for the issue of equity bonds by the new state enterprises, subject to authorisation by Parliament. In concept the bonds have the characteristics of non-voting ordinary shares. The detailed terms and conditions of the bonds can be specified in the resolution of Parliament and by the shareholding Ministers. It was announced in the 1787 Budget that two of the new enterprises, Government Property Services and the Forestry Corporation, will be authorised to issue equity bonds equal to 25 percent of their capital this financial year. It was also announced that the other new state enterprises will be authorised to issue equity bonds up to the same level with details of the individual issues to be approved by the Government.

In concept, the issue of non-voting ordinary shares in the new state enterprises should improve the incentives on the management of the state enterprises to work in the commercial interests of shareholding Ministers. As is discussed above, the introduction of transferable rights to share in the residual earnings and wealth will allow for the development of a market in at least the partial ownership of the enterprise. Experience both domestically with the Bank of New Zealand issue and also overseas with privatisation issues suggests that such a development makes the management of the organisation clarify its objectives. The results of such clarification are to give a more commercial focus to the business direction. The existence of a price for the equity bonds on the stock market gives a clear and transparent measure of investors' assessment of the SOE's performance and outlook. This allows a judgement to be made about the value of the business and its rate of change in comparison with other comparable SOEs in the market. As with private sector practice SOEs are likely to devote more time and resources to informing analysts and investors about the direction and major decisions that the SOE has taken.

In practice, equity bonds are likely to be subject to limitations so that the gains from the introduction of public participation in the ownership of the state enterprises may be limited. The reason for this relates to the equity bond concept which explicitly precludes the transfer of control, thus protecting directors and managers from the threat of takeover. The issue of non-voting ordinary shares will be perceived by the market as an inferior financial instrument to the issue of ordinary shares, and treated' accordingly. This may reduce rhe interest in rhe market in these instruments with the consequential loss of monitoring pressure and incentive benefits on the state enterprise. Some of the deficiencies in the equity bonds concept could be lessened or offset by the design of the precise terms and conditions of the instruments. One possibility is to permit the equity bond holders to influence the appointment of directors. There may be other options available for improving the marketability of equity bonds thus improving the monitoring and incentive effects of transferable ownership of state enterprises.

It has been suggested that the issue of equity bonds removes the need for shareholding Ministers to monitor SOEs. It is true that capital market monitoring will form a view of the performance of the SOE and their directors. But with stare ownership, assets cannot be transferred to others who will manage the assets more productively. Shareholding Ministers retain ownership responsibilities, and therefore the requirements for monitoring that go with it. In order to provide incentives for SOE directors to perform, and to objectively exercise sanctions against poorly performing directors, information on overall financial performance will need to continue to flow to shareholding Ministers. Private sector monitoring is seen as complementing rather than replacing this activity. However the validity of some of the controls over SOEs specified in the SOE Act need re-examination in this situation. For example, when an SOE has equity bonds on the market, there may no longer be justification for restrictions on an SOE's ability to appoinr commercial auditors, for SOEs to come within the purview of the Official Information Act, and for shareholding Ministers to set dividends, and control diversification and gearing.

The Case for Privatisation

This chapter has argued that for the most efficient production of marketable outputs economic policy should be concerned to facilitate the attainment of both allocative efficiency and productive efficiency. Movements towards these goals are likely to maximise the contribution of these industries to improved living standards for New Zealanders. To achieve the two goals it is necessary to focus on the two instruments-the introduction of potential competition through the removal of Government-imposed economic barriers to entry and the introduction of transferrable and contestable ownership. Comments on the implementation of the SOE policy and on SOE monitoring have indicated difficulties in achieving those goals whilst retaining state ownership. In situations where Government-imposed entry barriers have been removed and where non-commercial public policy objectives are no longer the responsibility of state enterprises, the question arises as to whether continued state (that is, non-transferable non-contestable, with or without equity bonds) ownership and control is consistent with overall wealth maximisation objectives.

As is discussed earlier the consequences of non-transferable ownership of SOEs have efficiency-reducing effects on the performance of the SOEs. With non-transferable state ownership there are less incentives for potenrial investors to invest resources in monitoring the performance of SOEs as the benefit of additional monitoring cannot be appropriated by individuals. The situation is improved by the issue of equity bonds but as discussed earlier their impact is uncertain. More importantly, the absence of transferable control insulates directors and managers of SOEs from the pressures of the market for corporate control reflected in takeover, divestment and bankruptcy actions.

Thus, compared with private ownership, state ownership is likely to give directors and managers of SOEs inappropriate and inadequate incentives to act strictly commercially. This conclusion is generally supported by overseas studies on the efficiency of state enterprises vis-a-vis privately owned firms which suggest that private enterprises are probably more efficient although comparisons are difficult. There is general agreement internationally that when non-commercial functions have been separated from SOEs and the SOEs' regulatory environment reformed, governments should transfer the ownership of the state's commercial businesses and assets to private ownership. As there will be efficiency losses until this policy is fully implemented the policy should be implemented as soon as possible.

In relation to the regulatory reform issue, we discussed earlier the argument that state ownership of enterprises with naturally dominant market positions is a means of dealing with any costs arising from those positions. Our conclusion was rhar concerns about dominant market position should be addressed separately from ownership. In this context we argued that such SOEs should not be protected from competition, they should be subject to general competition rules and that the benefits and costs of pro-competitive policy options should be explored. Given this review process which should achieve the best attainable regulatory environment bearing in mind the efficacy of regulatory interventions, continued state ownership of such SOEs is likely to have the same disadvantages in terms of inadequate incentives and inappropriate objectives as for SOEs in competitive markets.

Implementation Issues

There are a number of subsidiary issues that need to be addressed in implementing the policy. However none of these issues call into question the overall policy thrust. Some of these issues are general, some are specific to particular asset or businesses. Some of the more important issues are:

i should the ownership of the assets or the businesses be transferred;

ii should ownership be transferred free of charge or at market value;

iii if they are transferred free of charge to whom are they transferred? and using what mechanism;

iv if they are sold, what is the Government's objective, how are they sold, and with what conditions if any; and

v partial versus full transfer?

These issues are discussed briefly below. It is worth highlighting that arguments against privatisation of assets based on the loss of future earnings to the Government are invalid. With a properly structured sale process the Government will be able to receive payments for the assets which reflects the present value of future earnings from the asset. To the extent that non-state owners can operate the asset to achieve efficiency gains a proportion of the gains will be captured by the Government in a competitive selling process. Thus privatisation sales, properly structured, should improve the Government's financial position and hence reduce the expected tax burden rather than vice versa.

Transfer of Assets or Business

The issue faced by the Government is whether to sell the assets it owns such as farms or coal mines either individually or collectively in a corporate form. If the assets are already organised into a defined business then it is probably more efficient to sell shares in the business rather than the assets individually. However if the assets are not organised into a business the choice depends on the costs and benefits of transferring the assets to an SOE. Transferring the assets to SOEs could slow the privatisation process as SOEs may have an incentive to delay share sales because of the threat to directors and managers from transferable control and ownership. Examination of this issue should be on a case-by-case basis against the overall policy objective.

Transfer or Sale

The alternative to a conventional sale of state businesses is to transfer the ownership free of charge to private owners. In terms of the overall policy objective, free transfer will substantially (see following) achieve the efficiency goal as control will be transferable and contestable. There are however equity considerations depending on the target group and the market value of the assets.

In considering the issue it is useful to think of the Crown as being agent for its principals, namely, New Zealand citizens. The Crown has developed for its principals, inter alia, a number of businesses. To finance these businesses the Crown has levied taxes and borrowed funds. The Crown's 'balance sheet' thus has as assets the investment in SOEs and the ownership of other assets. These assets are balanced by Crown borrowings and the 'equity' of New Zealand citizens in the Crown.

Viewed in this context free transfer of the SOEs deprives the Crown of the dividend flows from the assets. This suggests that taxes may have to be increased to offset the loss of income. (However as the transfer of ownership results in the privatised SOEs performing better thus generating more income and paying more taxes the increase in tax rates may be less than expected.) Compared with an alternative of selling the assets and retiring debt, free transfer means increased taxes in present value terms with consequential efficiency costs because of .the distortionary aspects of taxation.

In terms of the transfer policy, a number of options are available which are generally in accordance with the overall efficiency objective. One option is to transfer shares in the SOEs free of charge to New Zealand citizens in equal numbers. This can be supported by the above reasoning that the Crown is merely the agent for the citizens as principals and that the citizens are the true owners anyway. This would represent a substantial wealth transfer-the marker value of which will probably be substantially in excess of the present value of the higher taxation burden discussed in the preceding paragraph. In addition it is possible that such a transfer may benefit the beneficiaries more than a conventional sales transaction because of the pressures on the Government to underprice sales issues.

It is beyond the scope of this discussion to fully address the detailed implementation of this concept. Obvious questions to be discussed include the definition of the beneficiary group (for example taxpayers, electors, or all citizens), the Government's distributional preferences, handling the fiscal impact, and the distribution mechanisms. If the concept is considered of value these issues can be addressed.

The Sale Option

If it is decided to sell the assets then the first question to be dealt with is the objective of the sales option. If the objective is to maximise the receipts to the Crown then the classical choices are between an auction (with or without a reserve price) or a fixed price sale (with or without underwriting). It is possible to have a mix of the two which allows smaller investors to purchase at a fixed price determined by an auction for large investors. The revenue maximisation objective will ensure that the businesses are sold to investors who valued them the highest, and therefore is consistent with the efficiency objective.

Objectives Other than Revenue Maximisation

While revenue maximisation is consistent with overall economic efficiency, other goals have been suggested for privatisation programmes including increasing the number of shareholders, increasing worker involvement as well as reducing fiscal deficits. On the first two, objectives of widespread shareholding and employee share ownership appear to have been achieved to a degree in the UK but at a substantial fiscal cost. It is not clear whether there have been commensurate benefits.

On the fiscal issue, it has been argued that UK asset sales were increasingly seen as an ongoing programme of privatisation and the sales were structured to generate interest not only in the issue of the day but also in subsequent issues. If it is decided to sell a number of SOEs it will be important to develop an overall programme to take account of the capital market's absorptive capacity and thus protecting the interests of taxpayers. That being said the argument that early issues should be underpriced needs critical evaluation.

We have discussed the trade-off between business value and protection from competitive pressures concluding that with an objective of economic efficiency the emphasis should be on transferring control when it is clear that the business is not being protected from competition by Government intervention. While Government receipts can be substantially increased by selling statutory monopolies there are likely to be substantial losses of national income as a result. Thus from an overall economic perspective, any fiscal objective of privatisation should be subordinant to the overall efficiency goal of the policy.

Conditions on Sale

Economic analysis would suggest that the share sale should be subject to only general law, for example, Commerce Act and Overseas Investment Regulations and any enterprise-specific conditions necessary to achieve revenue maximisation, for example, protection of Air New Zealand's international landing rights. In the UK the Government is able in the case of some of the privatised firms to block by virtue of a 'golden share' transfer of shares to non-UK ownership controlling interest in the firms. While this is justified by UK Government spokesmen on the grounds of national interest there is a risk that the effect of the golden share will act to protect management from market pressures. This is likely to reduce the value of the business.

Partial or Full Privatisation

In terms of the overall policy objective full privatisation is likely to be the preferred option as it terminates state involvement in ownership of firms and allows control of the firms to be fully 'contestable. Partial privatisation is likely to achieve some efficiency benefits which increase as the level of privatisation increases. For example 25 percent private ownership generally constrains the state's ability to change unilaterally the SOE's Articles of Association, 5 1 percent private ownership generally assumes effective control to the private sector. The absorptive capacity of capital markets may be a constraint on achieving full transfer but even these options such as paying for the shares over a period of time or building consortiums of corporate and institutional investors can be considered.

Local Authority Trading Activities

Like SOEs the trading activities of local authorities (LATAs) are major commercial undertakings and significant users of the economy's resources. Activities such as electricity and gas retailing and appliance sales, urban transport, sea ports, airports, refuse collection and abattoirs are clearly trading activities.

For the year ended March 1786, LATAs invested over $300 million in capital expenditures. This represented about 3 percent of the total capital expenditure in New Zealand for the 1985/86 year and was comparable with the investment made by the construction sector of the economy. At the same time, LATAs contributed 1.2 percent to New Zealand's gross domestic product.

Local authorities are created and permitted to operate by Parliament. The enabling legislation which permits commercial undertakings by local government can confer advantages that in some cases are specific to local authorities, for example, the power to levy ratepayers to cover operating deficits, and can protect LATAs from outside competition (for example through regional franchising systems). The legislation can constrain the operations of LATAs in numerous ways. For example, the Harbours Act constrains the way in which a harbour board can use the proceeds from the sale of its property and LATAs come under Higher Salaries Commission jurisdiction.

From an economy-wide perspective, as with SOEs, the contribution made to the economy by LATAs is likely to be sub-optimal for two reasons. First, in many instances LATAs face little, if any, competition in the markets in which they sell their goods and services. Second, the existing organisational form places insufficient pressures on boards and managers to perform because of inadequate incentives, sanctions and accountability provisions. We conclude therefore that reform of both the regulatory environment and ownership form of LATAs is likely to be required in order to strengthen the incentives and disciplines for efficient resource use. Following the themes developed in earlier chapters, the reform process for LATAs should be guided by the benefits generated by competitive pressures on the LATAs both through the removal of barriers to competition in product markets, and through freely transferable ownership.

Market for Products

Turning to the product market first, as is discussed before, in the absence of competition, the incentives for efficient resource use are reduced. With no threat of competition, any organisation can use resources inefficiently but still remain in business. Survival in a competitive environment is the best rest of whether an organisation is meeting the needs of its clients and using resources as efficiently as possible. Therefore, as with SOEs, there are strong efficiency reasons for removing statutory barriers to competition with LATAs. In addition, it is important that LATAs operate on a competitively neutral basis vis-a-vis private sector counterparts. If a LATA enjoys an advantage not available to private firms, it may be able to remain in business even though it is the less efficient user of resources. Although some steps have already been implemented to establish competitive neutrality for some LATAs (for example the requirement to pay tax) these have been piecemeal and limited in scope. A complete review of LATAs should be undertaken aimed at removing statutory barriers to competition and ensuring that LATAs compete in a fair manner.

Despite the important implications of competition for efficiency, some have argued that markets within which LATAs operate should not be opened up to competition. The argument is made on two grounds. First, it is argued that retaining LATAs as statutory monopolies is important for the attainment of social policy objectives. However, as has been argued for SOEs, mixing non-commercial and commercial objectives substantially reduces accountability, weakens incentives and leads to a waste of resources. There are more efficient ways of dealing with social policy concerns for example though the variety of central government social welfare packages which target assistance to those in real need. Second, it is asserted that some LATAs are a natural monopoly and hence, without statutory controls or regulation, pricing above efficient levels could occur or wasteful duplication of resources could result. As was argued with SOEs, given the failings of government regulation, subjecting LATAs to competition and the discipline of the Commerce Act is seen as the best way of regulating a monopoly. Again, as with SOEs, if problems are encountered it may be necessary to consider implementing pro-competitive policies in specific instances. For example, in the particular case of electricity distribution, there may be benefits from requiring the electricity distributor to offer other electricity suppliers access to its distribution network on fair and reasonable terms. Analysis would have to be on a case by case basis focusing on benefits and costs of different industry structures and regulatory intervention recognising the importance of maintaining commercial incentives and accountability. The LATAs will be subject to general competition rules and policies.

Organisation Structure

The existing diverse range of organisational structures of LATAs are unlikely to be consistent with the objective of maximising the efficiency of resource use. Existing LATAs range from departments or sections within local authorities, to partnerships and stand-alone statutory authorities. In almost all cases this leads to ineffective monitoring of the LATA, absence of sanctions for poor performance and weak accountability.

As with state trading activities the first step towards achieving productive efficiency for such activities would be to reconstruct all as companies under the Companies Act with clearly specified commercial objectives. The exact mechanism for achieving this would require careful consideration and would perhaps best be discussed in a white paper along with the complementary question of who should own the shares in the corporation. As considerable legislation would be required, one possible mechanism would be to set up a LATA trust that would supervise the transfer of the activities to the companies and would hold the shares in the companies in the interim. Local authorities would be required to transfer specified activities to the trust within a specified period.

Corporatisation of LATAs would achieve considerable efficiency gains. It would clearly ring-fence the operation of the activities and in so doing confer numerous advantages. The LATA would be released from the numerous constraints which currently inhibit their behaviour in terms of financing, capital expenditures, staff salaries and so on. This would give management the benefit of the freedom to manage, as well as offering the prospect of achieving more effective accountability and exposing the LATA to banker monitoring. The disciplines that better accountability and monitoring bring will provide the LATA with stronger incentives to maximise efficiency.

Moving to the corporatisation of LATAs would be a significant step forward provided all statutory barriers to competition were removed. However, unless the move is made to full privatisation with transferable ownership it is likely that the maximum benefits possible from improved incentives and discipline on management would not be achieved. It is important to recognise that the SOE model has been developed against the background of restructuring 100 percent government owned trading enterprises as a proxy for the open corporation where ownership is transferable and control is contestable.

As was argued previously, the key advantage that the transferable ownership model has over the SOE model (and in turn the existing organisational form) is that the open corporation has tradeable equity implying that ownership and management are contestable. With private ownership, the managers of the organisation have incentives to act in the owner's interests (that is, generally in terms of wealth maximisation) and usually with a clearly observable indicator of performance-the share price. Transferability of ownership, and hence management, is a mechanism whereby resources can be placed in their highest value use. The retention of any form of public ownership is likely to shelter the organisation against takeovers and the ultimate sanction of bankruptcy and hence lessen the incentives on the board and management to act fully in the owner's interests. In conclusion, Treasury considers that the open corporation form is the organisational structure most consistent with maximising efficiency. ·

Ownership

For the reasons just outlined, it is imporrant that shares in LATA corporations are able to be transferred to those people who are willing to pay the most for those shares. If someone places a higher value on the LATA's shares than the existing owners, it indicates that they think they can manage the LATA's resources more efficiently and so achieve a higher rate of return.

Initially at least, several shareholding options exist. Shares in the LATA corporation could be held by one or more of the following: the territorial local authority; a trust; citizens; ratepayers; or electors. The first two of the above options involve some organisation holding shares on behalf of some grouping of citizens. In each case there are likely to be non-commercial constraints on transferability. In our view, there do not appear to be either efficiency or equity arguments such as to justify a 'middle man' holding shares on behalf of citizens. This suggests that the optimal solution could be to vest shareholding directly in the hands of citizens. Citizens are then free to decide whether or not they want to hold shares in the LATA. We propose that shares in the LATA be transferred free of charge to citizens; that is, for no consideration, accepting the argument that the LATA's assets are owned by the people. Such shares would be transferable. A minority shareholding could be retained for the local authority.

There are issues that need to be addressed concerning the definition of the recipient group for the shares in each corporation taking over the business of each LATA. There are also issues about the actual distribution mechanism. We believe that these issues, together with the legislative framework for the reform, can be developed if the overall principles of competitive pressures in LATA markets, enabling LATAs to compete fairly, and introducing transferable control, are accepted. As with state owned enterprises it is important that these broad principles be agreed at the outset. Experience with joint venture airports illustrates that unless there are clear guiding principles, restructuring can get seriously slowed in detailed problems, often initiated by groups directly affected by restructuring. Therefore it is important to have the advantage of providing a clear overriding objective when it comes to unbundling the numerous issues and problems that naturally arise during the course of restructuring.