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CORPORATISATION AND PRIVATISATION OF WATER SUPPLY

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1. Introduction

The question posed for this panel session on the organisation of the water industry is: 'Which is the more effective option – privatisation or corporatisation?' While I am happy for the purposes of this discussion to argue the case for considering a wide range of privatisation options, the question frames the debate too narrowly.

I have pointed out elsewhere that only five pages of the 1995 New Zealand Business Roundtable (NZBR) report *Reform of the Water Industry* – which ran to 150 pages – were devoted to a discussion of arguments for privatisation.¹ We believe that ownership matters, but it is not the only thing that matters. The main chapters of the report dealt with water allocation, efficient pricing, regulation of market power, regulation of quality, structural issues, ownership arrangements (mainly a discussion of corporatisation), and international experience. If I had to pin a label on this approach, I would describe it as a market-oriented approach to water industry reform, as opposed to the politicised approach which has characterised the industry to date. Privatisation has not been the main focus of the NZBR's push for reforms.

It follows that a recent outburst by Local Government New Zealand (LGNZ) president Kerry Marshall that "The Roundtable is touting privatisation as the solution to all ills" is dishonest rhetoric. Why do Mr Marshall and other local body politicians behave in this way? Anthony Wilson, in an article which canvassed a similar range of water problems to those identified in the NZBR study and lamented the slow response to them, noted that much of the debate in the media has degenerated into arguments about privatisation.² My interpretation is that this behaviour serves as a convenient smokescreen for those in local government who have done nothing or very little to address the problems.

1 See Kerr, R L, 'Reform of New Zealand's Water Utilities: The Snail's Pace of Progress', AIC 1997 New Zealand Water Management Conference, Auckland, 24 March 1997.

2 Wilson, Anthony, 'Water Supply and Sewerage Services – The Need for Change', New Zealand Water and Wastes Association Journal, November 1997.

Because my brief is to consider the issue of corporatisation and privatisation, I shall not rehearse here the arguments which the NZBR has made elsewhere on the other water industry reform issues.³ Nor do I propose to discuss at length the arguments for corporatisation. For one thing they are now well understood; for another, a number of councils have set up Local Authority Trading Enterprises (LATEs) to run their water operations or are considering doing so. Rather I want to focus in the balance of this paper on two specific areas. In section 2 I consider the main objections to privatisation, which turn out to be issues that arise in considering corporatisation. In section 3 I briefly list the main arguments for going beyond corporatisation and promoting various forms of private sector involvement in the water industry. I also discuss other objections to privatisation. Section 4 makes some observations about political obstacles to change in the industry and is followed by a conclusion.

2. Corporatisation issues

Anthony Wilson has pointed out that water and sewerage services are utilities:

... in the same way as electricity, gas and telecommunications services are, and should be treated the same. They are essentially private goods, although they do have an element of public good (particularly sewerage) and this must be recognised.⁴

This view is undoubtedly correct, contrary to the argument of Laila Harre that water is a public good.⁵ Piped water clearly satisfies the traditional definition of a private good – rivalry in consumption and the ability to exclude non-payers. If one individual consumes a quantity of water – whether for drinking, car washing or watering the garden – another person cannot use the same water. While there are public health benefits from a clean water supply, the private benefits are so high that people are prepared to pay for them, just as they are prepared to pay for milk and food. Water is also cheap compared with these other everyday items. And clearly water can be metered, priced and sold privately in a variety of circumstances, like other utility services.

³ For a comprehensive discussion, see CS First Boston New Zealand Limited (1995), *Reform of the Water Industry*, New Zealand Business Roundtable.

⁴ *Op. cit.*

⁵ Harre, Laila, *The Independent*, 2 October 1997.

Few people would argue today that electricity, gas and telecommunications should not be run commercially. Around the world they are predominantly operated in corporate structures, the majority of which are privately owned. In general, private goods are best produced by the private sector, as the disasters of state provision illustrate. It follows that water and sewerage services can and should be operated as businesses, like their electricity, gas and telecommunications counterparts. Business structures provide stronger incentives for efficiency in pricing, investment and operations, freedom from artificial capital constraints, and a clearer focus on consumer interests rather than the interests of incumbent politicians.

Two main objections are commonly raised to the privatisation of water and sewerage (as well as some other utilities). As we shall see, these objections are in fact objections to corporatisation. As long as water and sewerage operations are charged with the primary objective of operating as successful businesses, the concerns apply regardless of whether they are publicly or privately owned. Those councils that have proceeded to set up LATEs have concluded, correctly in my view, that the objections have no substance or are outweighed by the advantages of corporatisation compared with other feasible approaches.

- ***'Water supply is a monopoly industry'***

Critics of corporatisation/privatisation of water supply recite the mantra 'water is a natural monopoly' as though that disposes of the issue.⁶ Of course it does nothing of the sort. It begs two questions: 'Is the proposition true?' and 'If there are monopoly elements in a utility industry, what is the best way of handling them?'

The treatment of natural monopoly issues in modern economics is far more sophisticated than was the case several decades ago.⁷ New technologies and global competition are also weakening the relevance of natural monopoly arguments for many industries. Given the power of actual and potential competition and actual and

6 See, for example, Laila Harre, *op. cit.*

7 For an up-to-date discussion of this issue and others relevant to this paper, see the discussion in Peter Hartley (1997) *Conservation Strategies for New Zealand*, New Zealand Business Roundtable, reproduced in the Annex.

potential regulation to check monopoly behaviour, the case for maintaining political control of utilities is weak. As Gary Becker, a recent Nobel laureate in economics, has put it:

Although claims about natural monopoly continue to influence policies and academic discussions, this concept has become largely irrelevant to modern dynamic economies. ... The sooner we get rid of this dated idea, the better off the average consumer and producer will be.⁸

Clearly parts of the water industry are contestable – in particular bulk water supply – and there are substitutes for different water products. Monopoly issues do arise with the network of pipes. The task here is to consider the best response to them, recognising that there is no attainable ideal solution. It may well be that the possible efficiency costs of an unconstrained monopoly are relatively small, and that the best solution is not to introduce industry-specific regulation.

Certainly government ownership does not stack up in practice as a means of constraining any problem of market power. If a council-owned operation lacks a profit motive, the result is likely to be cost padding, waste and poor service. Monopoly rents may be dissipated in forms such as an easier life for managements or concessionary treatment of favoured groups. Either prices to customers are raised to cover the inflated costs, or the organisation operates at a loss and ratepayers pay the bill.

Corporatisation improves the incentives of a council entity to minimise costs and operate efficiently. However, a corporatised business is given a profit objective. If the business has market power it may be tempted to abuse it. The issue of possible monopoly pricing therefore needs to be addressed when businesses are corporatised. A transfer of shareholding from public to private owners raises no new monopoly issues. New Zealand's light-handed regulatory regime based on the Commerce Act has worked well for other corporatised and privatised network industries. There is nothing about the water industry to suggest that this regime, including its information disclosure provisions, would not handle any market power issues better than the alternatives.

– ***'Profit-oriented businesses will mean higher prices'***

⁸ Becker, Gary S, "There's Nothing Natural about 'Natural' Monopolies" *Business Week*, October 6 1997.

This claim is often accompanied by the statement that local authorities are not out to make a profit but to provide a service.⁹ Three points need to be made here.

First, profit in this context essentially means a normal rate of return on the capital employed in the water industry. Because capital employed by councils could have been invested to earn a return elsewhere, the capital used in supplying water has an opportunity cost whether or not this is explicitly recognised by councils. If a normal return is not achieved, capital is being wasted and the community's income is lower than it would otherwise be. This proposition holds whether the project is regarded as a commercial or a non-commercial service. A council must generate enough revenue to cover the costs of the water services it provides, including a return on the capital employed. It follows that the prices a council charges must cover the costs of its capital (including a normal profit element) or else non-users or small users of water are forced to subsidise others – often big users.

Secondly, as noted earlier, there is abundant evidence that the introduction of normal commercial disciplines, including the requirement to make a profit, has typically pushed costs and prices down, not up, in former council operations such as ports. There is every reason to expect that corporatisation/privatisation of water supply would see similar efficiency gains. The business sector, which uses around a third of all publicly supplied water, would hardly be arguing for commercial approaches to water supply if it believed prices were likely to go up.

Thirdly, it should be remembered that the goal in any industry should be efficient pricing, ie pricing which reflects the value to society of the resources used. Water has often been underpriced relative to its economic cost because politicians have not been prepared to confront voters with the true cost of supply. It has therefore been wasted, with both economic and environmental costs. The costs in terms of resource misallocation are similar in nature to the costs due to monopoly pricing, yet this inefficiency gets much less attention from commentators. Efficient pricing is more likely to be promoted by corporatisation/privatisation, whether prices rise or fall.

9 See, for example, Westland mayor Durham Havill, 'Privatisation of water denounced', *Greymouth Evening Star*, 15 January 1998.

Thus the two arguments that are most commonly made against privatisation – the natural monopoly issue and the effect of a profit requirement – have nothing to do with whether water supply operations are publicly or privately owned. They arise when a council decides whether water operations should remain a council department under political control or whether they should be operated as normal commercial businesses with a profit objective. That threshold has been crossed by councils which have set up water LATEs. Watercare Services has also argued that it would be able to operate more efficiently as a conventional business. These issues are therefore not relevant to the debate over whether LATEs should be privatised.

3. Privatisation issues

The argument that water and sewerage services are best run as businesses is now widely if not universally accepted, partly because of the very substantial gains achieved in New Zealand and elsewhere from corporatisation of other industries. The issue we now need to address is whether water businesses are likely to be run more efficiently in private ownership with conventional shareholders or in public ownership with politicians exercising control on behalf of ratepayers.

The Business Roundtable report on the water industry noted the following problems with continuing government ownership of businesses:

- experience indicates that politicians may be unwilling to accept some of the basic principles of the corporatisation model. For example, councillors may be appointed to boards even when their commercial expertise is limited, and interference with pricing and investment decisions is commonplace;
- capital market constraints on the performance of businesses that remain in government ownership are relatively weak. For example, management is not exposed to the threat or reality of takeovers, and information generated by the sharemarket reflecting management performance is absent;
- there is an ongoing risk that businesses remaining in government ownership will be used to deliver benefits to organised interest groups, as we saw with the former municipal electricity authorities;

- ratepayers are involuntarily exposed to commercial risk; and
- the development of long-term business strategies, including mergers, diversification and geographic expansion, is often hindered by capital constraints and the need to limit business risk.

These strong theoretical arguments about the problems with continued government ownership have been backed by increasing empirical evidence. Privatisation locks in the gains from corporatisation – which are always at risk with political control – and adds to them. As the World Bank has put it, ownership matters, and private ownership is a significant determinant of economic performance in established market economies.

Despite the acknowledged advantages of private ownership, three further arguments that are sometimes made for retaining political control need to be considered.

- ***'The sale of the businesses would result in higher rates because the local authority would no longer receive a dividend stream'***

This is equivalent to arguing that the council should reduce rates by issuing debt and investing the proceeds in higher yielding, more risky assets. There are several problems with this presumption. First, the impression of value creation is entirely illusory and only occurs because the council is not pricing the higher risk to the ratepayer into its calculations. Secondly, some councillors will put political objectives ahead of choosing sound commercial investments. Thirdly, councils will typically not manage council-owned businesses wisely for the same reason. Fourthly, the gamble could backfire. Councils should not gamble ratepayers' money on risky investments which are not independently justified as a core council activity. A water business would produce more value for the community under private ownership, and on this argument it should be sold and the proceeds used to reduce debt and/or rates.

- ***'Water assets are strategic'***

By itself this label has no content. What is strategic and why should any given strategic asset be publicly owned? We do not rely on public enterprises to produce such essentials as food, shelter or clothing. If 'strategic' means the assets are important to the local economy or to the company's customers, this merely strengthens the case for privatisation. The more important the organisation, the more important it is that it operates with maximum efficiency. The efficient production of private goods is most likely to be achieved by private owners.

- ***'Water assets are owned by the public, which would lose control of them'***

The true owners of the water businesses are individual ratepayers. If shares were given directly to ratepayers, they could decide for themselves whether local control was important to them. Any necessary constraints on the business could be written into its constitution. What proponents of this argument are really saying is that they want to maintain political control.

Since these arguments against privatisation do not stand up to scrutiny, the only conclusion to be drawn is that remaining opposition is based not on logic and evidence but on ideology.¹⁰

4. Political obstacles to change in the water industry

In rejecting arguments for privatisation in his recent statement, LGNZ president Kerry Marshall made two rather contradictory comments:

The two things the Roundtable always seems to forget is (a) that councils are democratically elected and (b) that many councils have already decided to contract out many services to private companies.

On the first issue, Mr Marshall's memory is short. I explained at a conference that he chaired in Nelson last year that the argument misses the point:

We all want local governments to be democratic, but we also want their policies to be sound. Sir Robert Muldoon's policies enjoyed democratic legitimacy, but they ran the country into the ground. Economic directions changed democratically in New Zealand because the arguments about the failings of Muldoonism ultimately prevailed. Debate about public policies must be based on sound public policy criteria: the fact that a particular course of action enjoys temporary popular backing does not necessarily make it sound.¹¹

To be sure, politicians should consult and take electorates with them, but they are elected to take decisions in their electorates' interests and they have a duty to lead and inform. Far too many local government politicians are unwilling to accept that duty, and hide behind the claim that privatisation is politically unpopular.

A classic example of such a cop-out was the recent study of water supply options in the Wellington region commissioned from Ernst and Young by local councils. Despite the possibility that privatisation might best meet the prime criterion of the study of achieving "the sustainable provision of high quality water at an optimum cost to end consumers", this option was explicitly excluded from the terms of reference. Without

10 See Kerr, R L, 'The Water Ideologues', paper to the New Zealand Water and Wastes Association annual conference, Rotorua, 29 August 1997.

11 Kerr, R L, 'Promoting Economic Growth: Challenges for Local Government', Commerce Nelson Local Government Forum, Nelson, 20 February 1997.

prejudging the conclusions Ernst and Young might have reached, it is inconceivable that a firm with worldwide experience of privatisation would not have identified some, perhaps compelling, arguments in favour of this option. The exclusion can only be based on ideological considerations, rather than a willingness to examine the costs and benefits of alternatives in an open-minded and pragmatic way. Given such political failures, it is scarcely surprising that privatisation is unpopular in some quarters in New Zealand whereas it is occurring on a vast scale in democracies worldwide.

As it was, the Ernst and Young study identified potential savings of \$55 million in operational costs alone from corporatisation of water supply in the Wellington region over the next 15 years. In Auckland the Waitakere City Council estimated savings of \$133 million from water supply reforms, and the Australian consultants LEK, in a study for the Auckland Regional Services Trust, identified savings of \$177-200 million. These are the kinds of benefits being forgone because of the painfully slow progress on water industry reform in New Zealand. By contrast, in October last year the Kennett government in Victoria announced a \$1.3 billion water reform package which will abolish water and sewerage rates and introduce a user-pays approach to water pricing. The government has pledged not to privatise its \$18 billion worth of water industry assets in its present term, but the reforms are expected to clear the way for privatisation after the next state election, due in 2000.¹²

Acknowledging the efficiency advantages of the private sector, Kerry Marshall rightly pointed out that local government is contracting out many services – although he neglected to mention that in respect of the major item, roading, it has been required to do so by central government. In the face of opposition from some elements in local government, central government is now launching a series of reforms in roading involving the establishment of one or more roading companies to take over the operation of the network. There is a strong case for promoting reforms in the water industry – and indeed the electricity industry – in a similarly comprehensive way.

Consider, for example, Anthony Wilson's point that there are some 80 council-owned water suppliers (as well as around 1400 private suppliers) in New Zealand compared with ten in England and Wales and three in Scotland.¹³ New Zealand's inefficient

12 'User-pays in Kennett's \$1.3bn water reform', *Australian Financial Review*, 10 October 1997.

structure of artificially small units is duplicated in the electricity industry where rationalisation has been painfully slow among the council- and trust-owned power companies. A further advantage of privatisation would be to enable normal market incentives for mergers and takeovers to operate and bring about a more efficient structure. In all industries a lead by central government seems required as long as they remain in council hands, given the entrenched political attitudes.

Local government in New Zealand operates within a framework laid down by central government, and central government can legitimately alter that framework when it is in the community's interest to do so. It was encouraging that the prime minister's statement in parliament on 17 February signalled that one of the government's key initiatives involved changes to local authority water and wastewater legislation. These should be made the responsibility of the Ministry of Commerce which is responsible for the regulation of other network industries.

As in the case of roads, a government initiative to set up corporatised water businesses structured on more efficient lines could leave the shareholding in the hands of local government. I would argue that a better approach would be to give the shares directly to ratepayers, as the government is apparently considering in the case of the Auckland Regional Services Trust. If it considered some weight should be placed on alleged preferences for community ownership, an obvious solution would be to set up one or more community trusts to which people could assign their gifted shares if they wished. It is hard to see why ratepayers rather than politicians should not be allowed to make their own choices in this matter.

5. Conclusion

There is a raft of opportunities to improve water and sewerage services and New Zealand is making heavy weather of most of them. Christchurch has installed \$16 million worth of water meters but is not using them; greater use of economic instruments in allocating water is hindered by the Resource Management Act; the Department of Internal Affairs is now three years behind its programme for reviewing legislation; charging for sewerage services on the basis of water usage is not possible ... the list goes on. An industry comparable in size to telecommunications and electricity

is not making the contribution it could to the economy, whereas around the world reforms in water and other infrastructural industries are proceeding apace.

All opportunities for reform should be taken, and privatisation is only one of them. Nevertheless, it is an increasingly prominent one in initiatives worldwide. It takes many forms, ranging from management contracts, franchising, and build-operate-transfer schemes to full divestment. The arguments for New Zealand closing its eyes to these possibilities are ideological, emotive and often self-serving. In some cases corporatisation may be a logical move before considering privatisation but this does not necessarily follow: Papakura District Council decided to by-pass this step and go straight to a franchising arrangement. If New Zealand wants to increase its sagging growth rate, combat declining international competitiveness and rising unemployment, and improve its living standards, politicians at both central and local government level need to be pursuing all these opportunities – and pursuing them fast.

Annex
Extract from Peter Hartley
Conservation Strategies for New Zealand

**APPENDIX 2 – NATURAL MONOPOLIES AND
GOVERNMENT OWNERSHIP**

Natural monopoly

There are a number of problems associated with the argument that natural monopolies are best owned by governments. To begin with, it is difficult to know which industries might be natural monopolies when industries are monopolised by government edict. How can we know what the market structure would be when the market is not allowed to operate? Economists have argued that natural monopolies tend to be characterised by technologies that result in declining average costs of production as output expands.

Costs are, however, not a function of technology alone. While some technologies might display increasing returns to scale or scope, they need to be implemented within firms that also depend on other technologies that display decreasing returns to scale or scope. Administrative costs, for example, tend to increase more than proportionately with the number of layers of employees, the geographical dispersion of the firm's operations or the number of markets the firm is trying to serve. Large firms become vulnerable to competitive entry because large size tends to raise average costs.

Furthermore, competition is a spur to efficiency, since it imposes pressure to control costs and keep prices low. Monopolists therefore may tend to lose control of their costs over time as management sees less urgency in being vigilant, and employees unionise to obtain a share of the monopoly rents. The disadvantages of large size and monopoly can even mean that two smaller firms competing for market share can have lower costs than a large monopolist would have. For example, Lubbock, Texas, still has two competing local electricity distributors and, as a result, arguably has a lower price of electricity than comparable cities served by a monopolist. Firms also can face competition from producers of competing products, so it is difficult to determine the extent of a market on a priori grounds. For example, for many uses, natural gas and electricity are substitutes; for others natural gas and coal, diesel fuel or gasoline are. Thus, the ability to exploit natural monopoly in the natural gas market will be limited to some extent by competition with electricity and liquid fuels.

Furthermore, just as an unexploited niche in an ecosystem "invites" adaptation by organisms able to exploit it, monopoly profits in markets invite innovation and competition. Firms will scramble to invent new technologies that enable them to obtain a share of the monopoly profits. For example, the history of telecommunications in the United States is one of the

application of new technologies – microwaves, satellites, optical fibres, cellular technologies, and use of existing cable television and electrical transmission networks – to enable new entrants (like MCI, United States Sprint and so on) to compete with the incumbent.

Entrants to a market can also often obtain a foothold by discovering new consumers, or new products, that have not been exploited by the incumbent. For example, following the expiration of the original telephone patents in the United States, new entrants flooded into the telephone market to supply services to the rural and suburban areas that had been largely ignored by the Bell companies. Similarly, Apple computer was able to gain a foothold in the computer market partly because IBM had dismissed personal computers as being nothing but a toy.

The argument that private monopoly will result in an inefficient use of resources is not necessarily valid – particularly when the efficiency is measured relative to the level attained by realistic alternatives rather than the theoretical “first best” that is probably not achievable in practice. While a monopolist can raise profits by restricting output and charging a higher price, it can obtain even higher profits, while also producing a more efficient level of output, if it does not have to charge a uniform price for all its output. For example, in the lighthouse example discussed by Coase, annual charges per voyage varied as the number of voyages increased. If the monopolist could charge each consumer both a fixed price and a per unit price such that each of the consumers is barely indifferent between consuming the good or service and forgoing the pleasure altogether, and all consumers pay the same per unit price equal to the marginal cost of production, the output level would actually be efficient. The monopolist’s profits would also be at their maximum feasible level.

In practice, the monopolist is unlikely to be able to price discriminate to this extent – practical schemes may involve bulk discounts or differentiated fixed charges, but not individual specific fixed charges. Nevertheless, the monopolist has an incentive to avoid the inefficiency associated with sub-optimal output whenever it can do so without reducing its revenue.

The costs of monopoly power may also be reduced in some cases by isolating the monopoly elements of some industries. In recent decades, many countries have restructured industries such as electricity or natural gas supply to isolate the natural monopoly elements from the more competitive elements. The competitive elements of the industry can then be allowed to operate as a normal market. In the case of electricity, for example, generation is split into many competing entities and separated from the high voltage transmission grid. A competitive wholesale electricity market is then put in place.

Another way of separating industries into competitive and monopoly elements is to use contracting out for supplying competitive services. So called BOT (build, operate and transfer) schemes, where the private sector constructs a facility (such as a water treatment plant or toll road), operates it for a number of years under contract and then transfers ownership to a government entity, are an example of this. In the water and waste water treatment industries, concessions or franchises have also been used to allow

more extensive private sector involvement. Under these arrangements, the government retains ownership of the physical assets but contracts with the private sector to provide services using those assets for a fixed period of time. The right to provide services is periodically opened to competitive bidding. Even where monopoly is unavoidable, government ownership is not the only alternative to unfettered operation of markets. Private monopolies can have their prices regulated, as has been done in the United States for decades and has recently been done in the United Kingdom and many other countries. An impressive array of evidence has now been produced showing that regulated private monopolies are likely to produce a more efficient outcome than government-owned monopolies.⁶⁷

Efficiency of government enterprises and the New Zealand reform process

The general analysis of democratic political activity can explain why government ownership is unlikely to provide an efficient solution to the problems of providing public goods or correcting the deficiencies of monopoly supply. Management in government trading enterprises face weak incentives to minimise costs or produce the right mix of goods and services. Politicians do have an incentive to monitor the performance of managers in the public sector. However, as argued in the text, they are usually more concerned to ensure politically powerful interest groups are satisfied than that resources are not wasted. In particular, the link between inadequate returns on public sector investments and a politician's re-election chances is too weak to make cost minimisation or output value maximisation a prime target of political monitoring efforts.

Inefficient resource allocation in public enterprises takes a number of guises. The New Zealand reform of government departments and enterprises in the mid to late 1980s was aimed, with varying degrees of success, at eliminating or ameliorating many of these inefficiencies.

Over-staffing and work standards. Since the government has the legislative power to attenuate competition, there is an understandable tendency for government departments to seek, and obtain, a monopoly on service provision. A secure monopoly position is likely to diminish incentives to control costs.⁶⁸

The reduced incentives of managers, and their political masters, to control labour costs will show up not only in excessive staffing. Public enterprises are also notorious for harbouring inefficient work practices and hostility to labour-saving innovations in production techniques.

The New Zealand reform process attempted to reduce these problems by increasing competition between departments (through allowing overlap in responsibilities) and applying the same employment conditions (under the Employment Contracts Act) to the public and private sectors.

Sources of equipment and supplies. A directive (or "encouragement") to favour local versus remote suppliers of equipment and supplies is also a likely outcome in an enterprise monitored by politicians. The beneficiaries of such a directive will be a concentrated local vested interest with political

influence. The costs will again appear as a loss in “general revenue” or an increase in prices that it will be difficult to associate with the non-competitive tendering process.

Under the New Zealand reform process, departments were given more freedom to allocate budgets as they saw fit while political directives to departments had to be explicit and open.

Budgetary constraints on investment. Access to investment finance is a major problem for most public entities. Since the returns to capital are dissipated by transfers to consumers, employees or other suppliers, they usually are unavailable to finance additional investments.

Publicly-owned enterprises are often dependent on general government finances as a source of investment funds. The acceptability of publicly-owned enterprises incurring costs then often depends on the “macro” governmental budget conditions rather than the micro fundamentals of profits and markets. Urgent expenditures may be turned off for purely political or budgetary reasons.

In an attempt to promote more efficient use of capital and non-capital inputs, the New Zealand reform process gave government departments more freedom to reallocate funds between capital and recurrent expenditures. In addition, a capital charge was instituted to encourage departments to take account of the opportunity cost of capital.

Soft versus hard budget constraints. While government enterprises often are constrained in their investment decisions, they also can usually escape the discipline of covering at least their operating costs through earning sufficient revenue. Politicians are reluctant to have a business fail and can be relied upon to make up operating losses through transfers from general revenue. This in turn reduces pressures to keep costs to a minimum. By contrast, privately owned businesses cannot engage in unprofitable activity for long. Impending bankruptcy usually forces a change in business strategy. As we argue further below, even corporatisation has not provided a good solution to this problem.

Risk taking and risk avoiding behaviour. Managers in the private sector have an incentive to increase profits as well as avoid higher costs or decreased revenues. Their remuneration typically reflects both types of changes in company fortunes. While shareholders are averse to highly variable returns, they also have opportunities to greatly reduce their risks through portfolio diversification.

Public sector managers, by contrast, typically receive much less from making good decisions than they pay for decisions that, with hindsight, turn out to be mistakes. This particularly applies to bad decisions where the costs are immediate and easily connected with the originating decision. Public sector managers also fail to benefit to the same degree as their private sector counterparts in recovering a higher income from taking risks that pay off by lowering costs, or raising service quality. Often the benefits of good decisions are indirect, or delayed in time, and thus hidden from public scrutiny.

Managers of government enterprises thus have an incentive to invest in system (and political) security by “gold plating” investments, and to behave conservatively and cautiously.

The New Zealand reform process attempted to cope with this problem by allowing government enterprise boards to determine the remuneration of chief executives, including an element for performance. Again, however, it is difficult to duplicate the functions of a private capital market in an organisation that has only one owner with a non-traded ownership claim. Furthermore, it is difficult to evaluate service quality, and therefore relate remuneration to output value, when outputs are not explicitly marketed. Customer service. A significant part of the total value that customers obtain from a service depends on the quality of the service and their interactions with the firm. Consumers value billing accuracy, responsiveness to complaints, rapidity of response to system failure or, even better, anticipation and avoidance of failure, and of course the quality of the services supplied. Different consumers often value different characteristics in goods or services.

In a government enterprise, managers tend to become preoccupied with delivering services with a quality that is laid down in the statute. Inevitably, this results in reduced variety and a tendency to overlook dimensions of service that cannot be specified in a statute. By contrast, private competitive firms have an incentive to find and exploit any actions that can raise customer satisfaction or reduce the costs of service. The desire to improve customer service was one reason the New Zealand reform process emphasised competition, user fees and market instruments in place of regulation. We argue that, in the conservation area, this process of introducing a more explicit market for the outputs from government enterprises could be taken much further.

Cross-subsidisation. Another consequence of political, as opposed to shareholder, monitoring is that government enterprises will need to attend to politically sensitive consumer groups. The “community view” or “political judgment” that some groups should receive services at subsidised rates leads to so-called community service obligations. Such subsidies will represent an inefficient allocation of resources, although they could be judged desirable on other grounds.

Using a competitive industry to supply output does not prevent a government from offering cross-subsidies. A difference between a government enterprise and a competitive industry, however, is that the cross-subsidies will need to be explicit in the competitive industry rather than “buried” in the enterprise’s internal accounts. Governments would need to make a case for direct support for groups deemed deserving by the political process, and fund the subsidies out of the relevant department budget (for example, the Ministry of Education would fund transport, water or electricity services for schools). This may make it more difficult for governments to implement cross-subsidies, but we believe there are benefits in a democratic political system from making political interventions explicit and matters of debate rather than keeping them hidden.

- The New Zealand reform process attempted to limit cross subsidies by:
- making political directives more explicit;
 - giving enterprises more transparent and explicit objectives;
 - introducing greater competition in the supply of services; and
 - relying more on user fees and market trades to fund departmental activity.

We argue in chapter 4 and elsewhere, however, that in the conservation area significant subsidies to powerful vested interest groups remain and these subsidies continue to adversely affect the efficiency of resource use.

Non-price rationing. A problem governments often face when they attempt to force public enterprises to cross-subsidise groups of consumers is that the enterprise may respond to the low prices by limiting the quantity or quality of services it supplies to the subsidised group. The resulting non-price rationing of demand (through queuing or first-come first-served policies, or degradation in the quality of service) is likely to be less efficient than higher prices. When demand is reduced by increased prices, the least valuable uses of the good or service are eliminated first. All consumption that is valued at less than the price being charged is voluntarily forgone. With non-price rationing, however, there is no guarantee that the least valued demand is eliminated first. Some of the demand that is rationed could actually have a very high value to consumers.

We shall argue in chapter 4 that significant non-price rationing exists in the market for conservation services and that this rationing represents a continuing waste of resources.

Corporatisation versus privatisation

Many of the costs of public ownership identified above apply to the most extreme form where there is continual and extensive intervention and oversight by politicians. The results of such intervention include poorly specified objectives, a multiplicity of contradictory objectives and a weak relationship between managerial performance and managerial rewards or penalties.

One of the motivations behind many of the New Zealand reforms of the mid to late 1980s is that corporatisation can eliminate some of these defects. The firm is re-constituted along commercial lines with a board of directors who are responsible for achieving more transparent and focused objectives. Political directives have to be explicit and open to public scrutiny. Managerial rewards are closely related to achievement of the stated objectives.

There are nevertheless a number of differences between a corporatised publicly owned firm and a private business that often lead to reduced incentives to serve customers and minimise costs. The legislation rarely specifies as narrow a commercial objective for the public firm as exists for private firms. This may be partly a recognition of the potential efficiency losses from exploitation of monopoly power, but it does reduce incentives to maximise net benefits.

The legislation establishing a corporatised firm may also assign regulatory or oversight roles to the corporation in addition to a commercial role. The firm can then abuse its regulatory role by limiting competition for customers and employees and restricting the adoption of competing new technologies. Outcomes of both the regulatory and commercial processes are likely to be superior when the two roles are placed in separate organisations, as has typically been the case in New Zealand. Governments also retain a financial interest in corporatised firms. They therefore also have an incentive to legislate to protect the firms from competition. In addition, management of a publicly owned corporation may believe they can rely on government to rescue them from financial distress. A private firm may also be judged to be vital to the economy. The ability to mark down the value of its assets and sell them to others means, however, that physical survival of the firm is not tied to the financial survival of its current owners. The new owners can continue to use the assets to supply output. In contrast, if the government wishes to retain ownership of a vital public corporation in financial distress there is no alternative to rescuing the firm. Knowing this, the managers have reduced incentives to control costs and avoid financial distress.

Corporatisation also may be favoured by politicians as a way of retaining cross-subsidies or community service obligations. Even if this is not formally the case, corporatised entities are usually required to report to the legislature, and cross-subsidies, along with employment and procurement practices, are a likely focus of legislative scrutiny. Managers of a corporatised firm will learn that their life is likely to be easier when they attend to such sensitivities. Another set of differences between corporatised and privately owned firms arises because ownership shares in the latter are traded on share markets (or are otherwise available for sale to the highest bidder).

Management of a private firm has an incentive to maximise the market value of the firm. Market value provides a continuous and easily observed measure of managerial performance. When assets are not being used efficiently, the market value of the firm declines. This makes it a target for the acquisition of a controlling interest. Often, managerial compensation is explicitly linked to the market value of the firm, for example, through stock options.

In a corporatised publicly owned firm, there are no ready sources of information on managerial performance. Management usually is judged by reference to various accounting measures of profits, costs, market expansion and so on. These accounting measures reflect arbitrary rules, for example on depreciation or what constitutes operating and capital expenses. They also focus on past performance rather than likely future performance as is reflected in share values.

Capital markets also provide other services that are absent for corporatised public firms. The market return on private ownership claims (or private debt instruments) reflects the costs of the risks associated with the income flow attached to those assets. There is no comparable source of information on the appropriate risk-adjusted return on investments made by the corporatised firm. This makes it difficult to determine the efficient level of investment by the firm. Securitising the income flow to the government

owners of the publicly owned firm may provide a partial solution to this problem. The government could float assets analogous to non-voting shares. The market return on those shares would reflect the risks of investing in the business – although there would also be a premium to compensate for the investor’s lack of control over management decisions.

Another consequence of the absence of marketed ownership claims in corporatised firms is that different individuals bear the risks of fluctuations in net returns. In private capital markets, individuals are paid to voluntarily bear risks. Those who are most willing to bear a risk will buy the corresponding asset when its expected return is very low. Thus, the market return on any asset reflects the compensation that has to be paid to the least willing investor.

In contrast to private firms, risks of fluctuations in net returns to public firms will not be borne by those most willing to do so. Fluctuations in the net returns of a public enterprise do not flow to investors. Taxpayers, recipients of other government spending, or consumers involuntarily bear the risks associated with publicly owned assets. Furthermore, many individuals bearing risks under public ownership may find it very costly to do so – they may be very risk averse, and if they have a low income a fluctuation in that income could have very undesirable consequences. The use of taxation to pay interest is also very expensive as a result of the losses from compliance and collection costs, and also the forgone economic activities due to taxes as discussed in the text.

⁶⁷ This evidence has been surveyed in many books and journal articles, including many studies by the World Bank. See, for example, Bishop and Kay (1988), Boardman and Vining (1989), Shirley and Nellis (1991), Kikeri, Nellis and Shirley (1992), Galal et al. (1994) and Megginson et al. (1994).

⁶⁸ This problem is not restricted to government departments. Private firms with a relatively secure monopoly position, for example because they are protected by trade barriers, own patents on a crucial technology or have “natural monopoly” assets such as port facilities, also have reduced incentives to control costs and are vulnerable to employee pressure to increase wages and relax working standards.