

CORPORATE GOVERNANCE IN THE PUBLIC SECTOR

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HORSES FOR COURSES:

THE DIFFERENT GOVERNANCE MODELS FOR STATE TRADING AND  
NON-TRADING ENTITIES

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PHIL BARRY

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## 1. Introduction

Governance issues have attracted widespread attention in recent years. The governance failures at companies like Enron, Parmalat and Worldcom have focused investors, policy makers and the media on what had previously been a rather arcane topic.

What though do we mean by “governance”? Governance is a term that can mean different things to different people. In my view the subject goes well beyond issues of board composition and appointment, important as they are. Governance is, as Michael Jensen, Professor of Business Administration at Harvard Business School puts it, about “the allocation of decision-making rights”.<sup>1</sup> That is, governance is about **who decides what** in an organisation or sector. For example, in the case of a company or other organisation, governance is about:

- who decides the best person to be CEO and what the CEO is paid?
- who determines the next tier of senior management and their remuneration?
- who decides the capital structure and dividend policy for the organisation?
- who decides whether a new investment/disinvestment goes ahead?
- who determines what prices the organisation charges for its goods and services?

In my presentation today I will review the different governance models that are evident in the public sector in New Zealand: the SOE model for government-owned trading entities, the departmental structure for core government departments and the different governance arrangements for the third group of public sector agencies, Crown entities. I will focus on the key governance challenges facing each of the three groups, review the progress that has been made in addressing those challenges in recent years and identify some priorities for reform in the future.

## 2. Key governance challenges in the New Zealand public sector

Governance problems in New Zealand’s state sector came to the forefront of public attention last year with the crisis at TVNZ. The crisis at TVNZ was crystallised by a dispute over pay for the top television presenters and culminated in the resignation of CEO, Ian Fraser.

The problems regarding TVNZ, however, go far deeper than just how much presenters like Judy Bailey are or are not paid. The fundamental problem relates to the muddled objectives for the organisation embodied in its Charter: is it to be a “public broadcaster” or is it to be a commercial player? Is it there to show programs that few people want to watch or is it there to meet the demands of the market and to make money?

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<sup>1</sup> There is extensive academic literature on the allocation of decision-making rights between different stakeholders. See for example Berle and Means (1932), Modigliani and Miller (1958), Jensen and Meckling (1976), Harris and Raviv (1991) and Shleifer and Vishny, (2001).

Problems of multiple and conflicting objectives and confused lines of accountability in the public sector are by no means limited to TVNZ. The electricity sector provides another clear example where the allocation of decision-making rights between different agencies is muddled. The government's role in the electricity sector includes being policy maker; regulator; owner of competing generators, of competing retailers and of the transmission network; social arbiter and environmental overseer. These multiple roles and the lack of clarity regarding which agency is responsible for them give rise to massive conflicts of interest within the government as a whole and to overlapping responsibilities between the different government agencies involved in the electricity sector.

Who is it, for example, that is accountable for electricity transmission investment and pricing decisions? Is it the board of Transpower, which is charged ostensibly with running a successful business? Is it the Electricity Commission, which is fast becoming the sector planner? Is it the Commerce Commission, which is claiming the responsibility for regulating Transpower's pricing (and therefore impacts on its investment decisions)? Or is it the Treasury, which advises Ministers on SOE performance, governance and SOE "portfolio" balance and seeks to ration equity and target certain credit ratings for SOEs? The allocation of decision-making rights between the different agencies is by no means clear.

The Housing NZ Corporation (HNZC) is another major state-owned organisation with mixed objectives and accountabilities. HNZC has both commercial and social goals, is policy advisor and a major player in the housing sector, and has real estate and related assets valued at around \$11,600 million.

The reforms of the public sector in the late 1980s and early 1990s were aimed at tackling governance problems of multiple and conflicting objectives, inappropriate input-based controls and confused lines of accountability.

The basic principles that underlay the establishment of the SOEs in the mid 1980s were:

- separating organisationally the trading from the non-trading activities of government agencies;
- establishing for the trading activities the primary objective of being successful commercial enterprises;<sup>2</sup>
- providing the SOEs all the normal powers of limited liability companies;
- permitting any social objectives the government has for SOEs to be achieved by commercial contract with the Crown;<sup>3</sup> and

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<sup>2</sup> Refer s4 of the SOE Act, 1986.

<sup>3</sup> Refer s7 of the SOE Act, 1986.

- ensuring the SOEs operate, as far as possible, without competitive advantages or disadvantages, so that commercial criteria could be used to assess managerial performance.

Following the SOE reforms, there was a dramatic improvement in the performance of the Crown’s trading activities. Instead of large losses that required financial support from the Crown, the Crown’s trading investments began earning substantial profits, and paying dividends and taxes.

However, despite these gains, the SOE model is very much a second-best solution. The plain fact is that when it comes to running commercial enterprises, the private sector is typically better at it.

As the Treasury concluded recently in its briefing to the incoming government, “the international empirical literature is clear that, on average, commercial enterprises perform better in private ownership than in state ownership.”<sup>4</sup> This conclusion is nothing new: the limitations of the SOE model were recognised at the time the SOEs were established back in 1986: indeed all SOEs were to be prepared for sale.

A survey in the *Journal of Economic Literature* (JEL)<sup>5</sup> provides a comprehensive summary of the evidence of the benefits of private ownership of commercial entities. The JEL paper found:

- of ten studies examining the relative efficiency of private and public enterprises operating in the same industry, eight found the private sector firms performed better, while two found no significant difference between the privately and publicly owned firms. No studies found the public sector was more efficient;
- of the twenty-two studies examining the effects of privatisation in developed countries, all but one study found privatisation was associated with improvements in the operating and financial performance of the divested firms.

The gains to be achieved from privatisation are not minor. The JEL study presents the results of three studies that examined a total of 211 privatised firms, comparing the three-year average performance of the firms pre-privatisation with that post-privatisation. On average:

- the profitability of the firms (measured by net income as a percentage of sales) increased from 8.6 percent to 12.6 percent;
- sales per employee increased by 19 percent;<sup>6</sup>
- investment by the firms increased from 14 percent to 19 percent of sales; and
- the number of employees engaged by the firms increased by 1 percent.

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<sup>4</sup> The Treasury (2005), p.44.

<sup>5</sup> Megginson and Netter (2001).

<sup>6</sup> Note that this increase in sales per employee may have been achieved, at least in part, by increased use of contracting out by the enterprise.

In addition to the gains in firm performance, privatisation is likely to make the whole market the form operates in perform better. SOEs can act, either intentionally or unintentionally, to undermine competition in the markets they operate in. The electricity sector is a case in point: how can we expect a level playing field with so much state domination?

The reasons why private businesses typically perform better than state-owned ones have been well documented. In brief, owners of private-sector companies have better incentives and a better ability to monitor their company's managers.<sup>7</sup> In the private sector, ownership is more concentrated than is the case of public ownership, where each and every citizen has only a small stake in the enterprise. Private owners have a greater incentive to monitor the performance of their managers and to align the managers' interests with their own. In the public sector, on the other hand, taxpayers (the ultimate owners of SOEs) have relatively little incentive to monitor the performance of SOEs. In addition, governments often find it difficult to resist intervening in SOEs for political ends.

The current New Zealand government has tried to counter the inevitable adverse effects of its long-term ownership of commercial businesses through its "long-term hold" reviews of each SOE. To date six SOEs have been reviewed.

The government's "long-term hold" strategy for the SOEs has four key elements:

- i. shareholders providing the SOEs with a clear statement of their expectations. This has led to the creation of "Statements of Shareholder Preferences", a tool by which ministers seek to influence the strategic directions of SOEs;
- ii. more closely defined consultation requirements which in practice result in more active involvement by officials in the decisions of the company. Officials are now encouraged to be more active in asking questions of the company about their strategic direction and investment plans; and
- iii. a review of the SOE's capital structure focusing on increased debt on the balance sheet of SOEs and targeting of a BBB flat credit rating; and
- iv. SOEs' requests for equity for significant investments are now incorporated into the regular budget process, "where commercial realities allow."

Each of the above elements has some justification. But each element also highlights the contradictions inherent in government ownership of commercial businesses:

- i. it can be argued, quite legitimately, that an active role for shareholders is normal for closely-held companies. But ministers of the Crown are not normal shareholders – they are politicians subject to all the pressures of political office. The SOE Act sought to

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<sup>7</sup> Private sector monitoring can be far from perfect, as the collapse of Enron highlighted. The issue though is in which system – public or private ownership - is the monitoring likely to be "least worse" on average and over time.

manage the resulting tensions by making ministers largely passive shareholders, with an arms-length relationship between ministers and the board. The SOE Act did allow ministers to direct the SOEs and amend the SOEs' Statements of Corporate Intent (SCIs), but the scope of such ministerial directions to amend an SCI is closely defined by s14 and Part 1 of the Act and all such directions must be tabled in the House and therefore made public. In contrast, Statements of Shareholder Preference are not, at least as yet, in the public domain. Furthermore releasing them publicly would be likely to undermine the commercial interests of the SOE;

- ii. the rationale for increased involvement by officials is the absence of monitoring of SOEs by equity analysts and the lack of the threat of a takeover. The problem is real enough, but the solution of increased official and ministerial involvement raises inevitable tensions. If officials and ministers second-guess the company's investment decisions by requiring consultation regarding commercial risk and return ahead of board decisions (rather than monitoring financial results), can the board truly be held accountable for the company's performance? Further, what position is a board placed in if it effectively receives or is aware that there are two sets of conflicting or at least inconsistent advice on a proposal, one from management and the other from officials to the shareholder?<sup>8</sup> and
- iii. in the case of increased debt and equity rationing, it is true that it is not unusual for closely-held companies to have relatively high gearing levels. However, to pitch a balance sheet on the basis of a low investment grade rating is not something a director exercising diligence and skill would do in the absence of assurance around equity issues or an ability to sell assets. Directors will need to ask themselves whether ministers will be as willing to put capital back into the organisation as they are to take it out? Or will ministers find they have more compelling uses for the available capital, such as roads or hospital?

The problems in state ownership of businesses are endemic and cannot be simply wished (or analysed) away. As the World Bank has concluded:

“The World Bank's position on (the desirability of privatisation) is derived from long experience with failed attempts at reforming public enterprise. For years, the Bank supported efforts of governments to improve public enterprise performance but with little success. The efforts either did not bring the desired results or the improvements were not sustained....Observing the immense difficulties of reforming public enterprise without changing ownership, the Bank emphasises divestiture as a means of locking in the gains from reforms.<sup>9</sup>

Turning now to government departments, the principles underlying the governance model applied to government departments in New Zealand are similar in many respects to the principles that underlie the SOE model. In particular, the State Sector Act 1988 and the Public

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<sup>8</sup> The existence of conflicting or inconsistent advice to the shareholder would appear to limit the ability of the board to rely on management advice under s138 of the Companies Act.

<sup>9</sup> <http://www.worldbank.org/html/fpd/privatesector/priv-ent.htm>.

Finance Act 1989 are based on the same principles (that underlie the SOE Act 1986) of clear managerial authority, unambiguous organisational objectives and effective systems of accountability.<sup>10</sup>

However, while there are many similarities in the governance frameworks for SOEs and departments, there are, nevertheless, three key ways in which non-trading state organisations differ from trading enterprises. These relate to the non-trading characteristics and are:

- the government's relationship with departments has a purchase as well as an ownership dimension. Thus, the government funds the outputs that departments produce, whereas for SOEs, their outputs are funded by their multiple private and public sector customers;
- the outputs that government departments deliver are often difficult to measure, in terms of their quantity and quality, thus making monitoring of their performance more difficult; and
- Ministers often lack effective choice on who will provide the core outputs of government departments. While there can be a degree of competition at the margin, there is at the end of the day only one army, one police department and one criminal courts system.

These differences in the nature of the services provided by departments have significant implications for corporate governance. In particular, they open up the question of how far it is appropriate to delegate decision rights for control on inputs.<sup>11</sup> With no single benchmark like profits against which to measure performance and little or no effective competition in supplying their services, how much autonomy should departments have in terms of how much they spend on staff, accommodation and major investment decisions?

There are few simple answers in the field of core public sector management. Certainly, the shift in focus from inputs used to services provided has been a positive one. However, many basic challenges remain. For example, how is the success of departments to be measured? How do we know if a departmental CEO is doing a good job? And how can the CEO be held accountable for his or her performance? The fundamental challenge remains to get the incentives right so that managers have an incentive to perform.

### **3. What progress has been made?**

The Crown Entities Act passed in 2004 represents a useful step in the right direction for governance of Crown entities. The Act provides, for the first time, a comprehensive and generic framework that can be used for reporting and monitoring of Crown entities. The Act focuses entities and their boards on achieving and reporting results and enables ministers' participation in setting medium term goals and direction.

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<sup>10</sup> The way those principles translate into governance arrangements is different, reflecting the difference between commercial and core (public good) activities.

<sup>11</sup> See, for example, Wilson (1989).

The Act defines five categories of Crown entity. The five categories (and subcategories) are:

- i. **statutory entities:** bodies corporate that are established by or under an Act. Three different types of statutory entities are identified:
  - a) Crown agents, which must *give effect to* government policy when directed by the responsible Minister. Examples are the ACC, Civil Aviation Authority, District Health Boards, the Housing NZ Corporation and Transit NZ;
  - b) Autonomous Crown entities, which must *have regard to* government policy when directed by the responsible Minister. Examples include
  - c) Independent Crown entities, which are *generally independent* of government policy. Examples include the Accounting Standards Review Board, the Broadcasting Standards Authority, the Commerce Commission, the Securities Commission and the Takeovers Panel;<sup>12</sup>
- ii. **Crown entity companies:** companies incorporated under the Companies Act 1993 that are wholly owned by the Crown, such as Crown Research Institutes, Radio NZ and TVNZ;
- iii. **Crown entity subsidiaries:** companies incorporated under the Companies Act 1993 that are controlled by Crown Entities;
- iv. **school boards of trustees;** and
- v. **tertiary education institutions.**

The Act provides a framework customised to each of the five different categories, reflecting the relationship of each category of entities with the responsible Ministers (including the Minister's ability to direct on government policy) and their distinctive character (most notably in regard to the treatment of tertiary education institutions). Some provisions of the Act apply generally and others to one or more categories or subcategory. The Act substantially amended individual entities' Acts to bring them into line with the umbrella legislation.<sup>13</sup>

Despite the progress provided by the generic legislation, significant problems remain in the governance arrangements for many Crown entities. I've already pointed, for example, to the problems of multiple objectives and confused lines of accountability affecting entities like TVNZ, Housing NZ and the Electricity Commission.

In the health sector, confused lines of accountability were re-introduced in the late 1990s, with the majority of board members of District Health Boards (DHBs) elected by local constituencies,

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<sup>12</sup> A notable exclusion from the Crown Entities Act is the Reserve Bank of NZ.

<sup>13</sup> Further, s4(2) of the Crown Entities Act states that the Act applies to a Crown entity, and prevails over an entity's own Act, except to the extent that the latter expressly provides otherwise.



yet the DHBs are funded by the central government. In the last five years, government spending on health has increased on average by almost 8% a year. It is difficult to see what improvements in health outcomes or services have been achieved for that additional spending.

In the education sector, also, significant governance problems are evident, as highlighted by the recent education sector review which found more clarity on the roles of the different public sector agencies was required.<sup>14</sup>

Further important governance problems facing the Crown entity sector arise from:

- the political nature of many Board appointees;
- remuneration for Board members being often inadequate to attract high quality members;
- the full-time nature of some Chair positions, with the respective roles of Chairs and CEOs becoming confused as a result; and
- the relevant government departments lacking the skills in-house needed to monitor the Crown's multi-billion dollar investments in organisations such as the housing, roading, health and educational Crown-owned entities.

Looking beyond the Crown entities, progress over the last decade in addressing the governance challenges facing the public sector has generally been limited. Indeed, in some important areas, the governance reforms have gone into reverse.

Privatisation of SOEs has been halted. While in other countries governments of various political persuasions have been getting out of the business of running commercial enterprises, in New Zealand, there has been a blanket ban on the sale of state enterprises. Indeed, rather than privatising SOEs, we have seen a return to nationalisation of some major activities. The government is now back in the banking business with the establishment of Kiwibank, while businesses like Air New Zealand and running the rail-track have reverted to public ownership.<sup>15</sup>

In addition, the scope for private sector contributions to providing public services has also been curtailed in important areas. In the case of prison services, for example, private sector management of prisons was banned by legislation in 2004. Less than two years later, it is ironic, but no great surprise, that we are seeing a major budget blow-out in the cost of new state prisons.

In the core public service, the number of people employed in the public service has increased by 27% over the last six years, exceeding the growth in employment in the private sector by almost a

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<sup>14</sup> The review focused on the Ministry of Education, Tertiary Education Commission and New Zealand Qualifications Authority. The problems at the New Zealand Qualifications Authority and concerns about the NCEA related primarily to educational philosophy rather than governance.

<sup>15</sup> There have been asset sales by some SOEs – such as Meridian's sale of its Australian generation business, Southern Hydro, and NZ Post's sale of a 50% share in its courier business – but the total assets of SOEs have grown significantly since 1998.

third. It is hard to say whether this increased spending and employment in the public sector represents value for money or does it reflect old-fashioned empire building? Similarly, there has been a rapid increase in the number of policy analysts. While this has been good news for Wellington landlords and the local construction industry, has it lead to better quality advice to the government?

The 2004 amendments to the Public Finance Act 1989 allow Ministers more flexibility to shift resources across outputs. The challenge will be to use this to achieve better outcomes given in many areas we are still a long way short of specifying measurable outcomes or the contributions government agencies make towards the desired outcomes. As the Treasury notes, the public management system is “data rich but information poor”.<sup>16</sup> If misused, the increased flexibility provided by the 2004 legislative changes could result in a loss of transparency, or even control, over government expenditure so improved performance monitoring will be crucial.

#### **4. Priorities for Reform**

Looking ahead, there are numerous opportunities for improving governance in the public sector.

In the case of the SOEs, if full privatisation is too difficult for the current government, should we not at least be looking at the advantages of partial privatisation as suggested by the United Future party before the last elections? Partial privatisation has been implemented in many other OECD countries. It can take a variety of forms – it could involve a listing of ordinary shares on the stock exchange, but it could also involve a majority or 100% sell-down of major assets by an individual SOE or it could involve the use of quasi-equity instruments, such as convertible shares or “equity bonds”,<sup>17</sup> by the SOE.

For the Crown entity and core public sectors, I see four key priorities for reform:

- i. firstly, separating out the trading activities of the agencies from the non-trading activities so as to reduce conflict of interests and to improve accountability. In the case of TVNZ, for example, the commercial activities should be sold and a purely public broadcasting arm - if indeed one is needed - retained in Crown ownership, in much the same way as was done for the state’s radio broadcasting activities almost a decade ago;
- ii. secondly, removing the artificial barriers to the private sector funding and/or delivering services currently provided by government agencies. In areas like education, health, housing and roading there is enormous scope for harnessing the innovative talents of the private sector to help achieve the government’s goals. In the UK, the Blair government has made it mandatory for the potential for public-private partnerships to be investigated when any new major public spending decision is being considered;
- iii. thirdly, promoting other measures to better use market-based mechanisms in the core public sector, through, for example, increasing the choice of service provider and

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<sup>16</sup> The Treasury (2005), p. 39.

<sup>17</sup> The issuance by SOEs of “equity bonds” - a form of non-voting shares - is already permitted under s12 of the SOE Act, 1986.

greater reliance on user-charges where individual users derive a lot of the benefit of the service provided; and

- iv. fourthly, improvements in the regulatory environment including, for example, reviewing the role and powers of the Electricity Commission.

## **5. Conclusions**

In this paper I have reviewed the governance challenges facing the three broad classes of public entities: SOEs, Crown entities and government departments. Given the different nature of these enterprises, it is not surprising that the governance challenges facing each group differ. Nor is it surprising that the reforms needed for each group differ also.

The limitations of the SOE model are clear and well known. The evidence is overwhelming that New Zealanders would be better off if the government quit its investment in SOEs and left the private sector to own and run commercial businesses.

In the case of the Crown entities, the priorities are to establish clear and non-conflicting objectives, separate out the trading activities from the non-trading ones and remove barriers to private sector funding and delivery of services. For the core public sector, gains could be expected from introducing greater market-based disciplines and incentives.

With public sector spending equal to around 40% of the economy, the contribution the public sector makes to our economic performance is going to have to improve significantly if New Zealand is to return to the top half of the OECD in the foreseeable future. Governance reforms are likely to lie at the heart of any such improvements in public sector performance.

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