

Policy Framework

Government Trading Enterprises

**A Report by the Steering Committee on
Government Trading Enterprises**

September 15, 1988

Note: This electronic version for the OFM Intranet has been scanned from hard copy and may contain minor errors. Please refer to a hard copy if quoting from this document.

Preface

In a major policy speech prior to the N.S.W. election, the Premier committed the new Government to major reform of management practices in the N.S.W. public sector.

The 'management strategy' outlined in that speech incorporated the major elements of corporatisation: the establishment of clear objectives for government trading enterprises; strengthening managerial authority and responsibility; rigorous performance monitoring, with appropriate rewards and sanctions; and the creation of a position of competitive neutrality for government business.

The previous Government had committed itself to widespread commercialisation of government business activities, and at the time of calling the election had begun to implement some of those reforms.

Immediately upon election to office, the new Government fulfilled its election undertaking to institute a comprehensive audit of the State's assets and liabilities by appointing the State Commission of Audit.

Among many suggestions for financial and management reform, the Curran Commission indicated its support for "an immediate move to the corporatisation of Government business undertakings..."

As a result, the Premier established a Steering Committee on Government Trading Entities, which retained the services of private sector consultants to assist in the preparation of this report and began meeting on the 11th of August.

This report, the first produced by the Steering Committee, explains what corporatisation involves, the conceptual framework underlying it, and explores the major issues which the Government will need to address, if it decides to proceed with corporatising government trading enterprises.

It should be noted that the Chief Executives of a number of public authorities served on the Committee. They did so, not as representatives of their respective organisations, but as public sector managers who had already addressed a number of the problems inherent in commercialisation and corporatisation. Their contribution was a valuable addition to the Committee's resources.

This paper would not have been possible without the considerable efforts of Stephen Jennings and John Bastian of Jarden Morgan. Mr. Jennings, in particular, was able to draw on his experience in the New Zealand Treasury and, more recently, the private sector, in corporatising State-owned enterprises in that country.

Thanks should also be given to Kerry Aaby of Australian Industry Development Corporation for her assistance in developing a workplan for the Steering Committee and Mr. Stephen Lim, of the N.S.W Treasury for his secretarial services to the Committee.

Gary L. Sturgess
Chairman
Steering Committee on Government
Trading Enterprises

STEERING COMMITTEE ON GOVERNMENT TRADING ENTERPRISES

COMMITTEE MEMBERS

Gary Sturgess (Chairman)	Director, Cabinet Office
Richard Humphry	Director, Premier's Office
Percy Allan	Secretary, NSW Treasury
Ian Neale	Acting Assistant Secretary NSW Treasury
Chris Guest	Chief Economist, Economics and Revenue Division, NSW Treasury
Robert Wilson	Managing Director Sydney Water Board
John O'Neill	Managing Director State Bank of NSW
David Iverach	Secretary Ministry of Transport
Les MacDonald	General Manager Maritime Services Board

TABLE OF CONTENTS

	Page
Executive Summary	(i)
1.0 Introduction	1
2.0 Background on GTEs	2
2.1 The Nature of GTEs	2
2.2 The Potential for Improved Performance by GTEs	5
3.0 Conceptual Framework	9
3.1 How GTEs Affect Community Welfare	9
3.2 Productive Efficiency	11
3.2.1 Clarity of Objectives	12
3.2.2 Managerial Authority	14
3.2.3 Performance Monitoring	15
3.1.4 Rewards and Sanctions	16
3.3 Allocative Efficiency	17
3.3.1 Competitive Neutrality in Input Markets	18
3.3.2 Competitive Neutrality in Output Markets	19
3.4 Relationship Between Principles for Sound Performance by GTEs	22
3.5 Inherent Weaknesses of GTEs	22
4.0 Assessment of the Present Arrangements for GTEs in NSW	24
4.1 Clarity of Objectives	24
4.2 Managerial Authority	26
4.3 Performance Monitoring	27
4.4 Rewards and Sanctions	29
4.5 Competitive Neutrality	30
4.6 Overall Assessment	35
5.0 Programme for Corporatisation of NSW GTEs	37
Appendix 1 Financial and Administrative Reforms of the Public Sector Undertaken to Date in New South Wales	42
Appendix 2 Exposing GTEs to Further Market Disciplines	50

EXECUTIVE SUMMARY

The efficiency with which GTEs use resources will have a significant impact on the NSW economy.

The NSW Government employs 13 percent of the State's workforce and its capital works programme is equivalent to approximately 40 percent of total gross fixed capital expenditure in NSW, Government entities that are principally engaged in producing goods and services which are, or could be, sold in the market place, without compromising government's social or economic objectives (termed "government trading enterprises" or "GTEs"), make up a major part of the total public sector. Initiatives designed to improve the efficiency of GTEs can therefore have a substantial effect on the NSW economy as a whole.

Efficiency audits in NSW along with international experience suggest there is significant scope for improving GTE performance.

Efficiency audits, government enquiries and the work of the Curran Commission have identified serious weaknesses in the Management practices of a number of GTEs. This is consistent with increased concern in a number of countries regarding the quality of the performance incentives facing GTEs. A 5 percentage point improvement in the rate of return achieved by GTEs in NSW as a result of improved efficiency, would increase gross state product by the equivalent of \$670 per household.

Improved performance by GTEs would facilitate improvements in the community's social and equity objectives.

The reform of GTEs should not be used to lower the quality or level of the social services provided by government below that desired by the community. Improved efficiency by GTEs would allow the level and quality of non-commercial activities to be increased at no additional cost to society.

GTEs affect economic efficiency through the value of the resources they use to produce their output and the way they affect the mix of goods and services produced in the economy

GTEs may cause efficiency losses when: (i) they do not produce goods and services using the least possible consumption of resources ("productive inefficiency"); or (ii) they cause the mix of goods and services produced in the economy to depart from that which will yield the maximum benefits to society over time ("allocative inefficiency").

The quality of a GTE's performance is a function of the incentives it faces.

As with private sector organisations, the efficiency with which GTEs use society's scarce resources is largely determined by the rules and regulations within which they operate. These include the rules and regulations which affect the prices GTEs pay for their inputs and the conditions they face in their output markets and those which shape the external disciplines imposed on individuals within GTEs.

To ensure that GTEs use resources efficiently the following five conditions must apply:

The first four conditions outlined below are necessary to secure productive efficiency, the last to generate allocative efficiency. Each of the five conditions must be met for the full benefits of GTE reform to be realised.

(i) clarity of management objectives;

Clear objectives provide a direct focus for management and prevent management from using poorly specified objectives as an excuse for unsatisfactory performance. The most suitable objective for GTE managers is to maximise the value of the state's investment in the assets they manage. All social services provided by GTEs should be based on explicit contracts with government.

(ii) managerial authority;

An organisation's key internal decisions should be made by individuals with strong incentives to maximise the value of the organisation and who possess the requisite specific knowledge. Externally-imposed controls stifle managerial innovation and dilute and diffuse responsibility between management and the government agencies that impose the controls.

(iii) performance monitoring;

Other reforms are unlikely to generate significant efficiency gains unless GTE performance is subject to rigorous independent monitoring and assessment. The assessment of comparative performance requires specialist expertise.

(iv) rewards and sanctions,

A vigorously applied system of managerial rewards and sanctions is an essential requirement for sound performance. Reluctance by Ministers to reward good performance or apply sanctions the event of non-performance will greatly undermine the effectiveness of performance-based reward systems.

(v) competitive neutrality.

To ensure that goods and services are supplied by the most efficient competitor it is necessary to remove the special advantages and disadvantages that apply to GTEs by virtue of their ownership. If goods and services are not supplied by the most efficient enterprises, society will pay more than is necessary and valuable community resources will be wasted. Special advantages and disadvantages also undermine the reliability of standard commercial criteria as the basis for assessing GTE performance.

Efficiency is likely to be improved by implementing explicit regulatory provisions in the output markets of those GTEs with a significant degree of market power.

In situations where the market power of GTEs is likely to impair efficiency, government-imposed controls on pricing and industry structure will be necessary. These should take the form of explicit regulations based on careful analyses of the economic and technical issues concerned. This is necessary to prevent the abuse of monopoly power while maintaining the accountability of GTE managers in terms of clearly specified commercial criteria.

The GTE reforms introduced to date in NSW will improve the incentives for sound performance by GTEs

The initiatives taken to clarify GTEs' objectives will improve managers' incentives to maximise productive efficiency. The proposed extension of the "user pays" principle will help to ensure that the market signals received by GTEs reflect the value the community places on their inputs and outputs and is a necessary requirement for assessing GTE performance on the basis of commercial criteria.

The programme for reform developed in this paper complements the work of the Classification Task Force.

This report builds on the work of the Task Force on the Classification of State Organisations by developing a comprehensive policy framework for corporatising GTEs. The categories of organisation to which the GTE framework applies are identified and the way particular categories of organisation should be restructured to improve their performance is discussed. The framework may be extended to government organisations which are not financially self-sufficient, by imposing market disciplines on their subsidised activities. However, until genuine market disciplines are applied to non-Commercial entities, they should be subject to the control mechanisms recommended by the Classification Task Force.

GTEs will only realise their dimensions of corporatisation are implemented.

Additional efficiency gains would be likely to result from: further clarification of GTEs' objectives; increased managerial authority; improved monitoring and assessment of GTE performance; removal of the remaining special advantages and disadvantages applying to GTEs; and, implementation of explicit regulatory arrangements for GTEs whose market power impairs efficiency.

Each condition for corporatisation depends on the implementation of all other conditions in order to significantly improve the efficiency with which GTEs use resources.

The reforms required for competitive neutrality, together with those required to establish vigorous commercial behaviour by GTEs, represent a mutually reinforcing package. Efficiency will not necessarily be improved, and may be impaired, if the reforms are introduced on a piecemeal basis. For example, the establishment of aggravated existing distortions and costs if GTEs continue to be subject to special advantages and disadvantages by virtue of their government ownership. The sequencing of the reforms is critical. If the reforms are not introduced as a complete package there may be benefits in adopting special transitional arrangements until the entire package is in place.

1.0 INTRODUCTION

Over recent years the NSW Government has introduced a number of important policy initiatives designed to improve the efficiency of the public sector. Arrangements which encourage efficiency in the public sector are likely to have an appreciable impact on the overall performance of the NSW economy. The Government employs approximately 13 percent of the State's workforce. Its capital works programme is equivalent to over 5 percent of the NSW gross state product, or approximately 40 percent of total gross fixed capital expenditure in NSW.

This paper is concerned with the design of management incentives and regulations which promote efficient performance by those parts of the public sector that are principally engaged in trading activities, including the provision of goods and services to other parts of the public sector. The term "government trading enterprises" ("GTE") is used throughout this paper to describe business units engaged in such activities. GTEs range from specialist activities within government departments, such as the Government Motor Services Division of the Public Works Department and the School Furniture Workshop within the Department of Education, through to large government business authorities such as the State Bank. GTEs make up a major part of the total public sector and the efficiency with which they use resources has a significant impact on the NSW economy as a whole.

Efficiency audits have identified serious weaknesses in the management practices of a number of GTEs, including the Urban Transport Authority, the Public Trust Office and the Government Printing Office. Further examples of waste and inefficiency by GTEs have been highlighted by the recent Report on the State's Finances by the New South Wales Commission of Audit. A number of specific examples of unsatisfactory performance by GTEs are given in Section 2.2. The difficulties experienced raise questions regarding the efficiency of the management structures and incentive mechanisms applying to GTEs. These questions are matched by growing concerns around the world regarding the quality of the incentives for efficient resource use by GTEs and increased interest in the options for improving GTEs' economic performance.

Section 2.0 of this paper discusses the nature of GTEs and the potential for improving their performance and distinguishes GTEs from the "core" public service. Section 3.0 develops a framework for analysing the impact of alternative management incentives and regulations on the efficiency of GTEs, including their efficiency in providing social services for the community. The framework stresses the importance of clear objectives and vigorously applied accountability mechanisms in encouraging efficient performance. Section 4.0 applies the framework developed in Section 3.0 to describe how the recent reforms in NSW are likely to improve the incentives facing GTEs, and why significant scope for improvement remains. Section 5.0 outlines a programme for achieving further efficiency gains.

2.0 BACKGROUND ON GTEs

2.1 The Nature of GTEs

GTEs are organisational units within the public sector that produce goods and services which are, or could be, sold or tendered in the market place without compromising government's economic or social objectives. The GTE concept includes units within government departments that are engaged in trading activities and may include social services, the provision of which could be undertaken by such units on the basis of an arm's-length contract with government.

GTEs are involved in a very wide range of activities in NSW. They include businesses involved in banking, transport (buses and railways), water, forestry, fish marketing electricity and waste disposal.

Such activities can be distinguished from the "non-market" activities of government, which are most effectively provided on a collective basis. There are many areas of activity which will be undertaken most efficiently by government on a non-commercial basis. The most important of these is probably the design and administration of the rules and regulations within which market arrangements take place. This includes the great majority of policy advisory, regulatory and social welfare functions. The nature of such services generally differs significantly from that provided by GTEs. For this reason the ideal incentive and control arrangements for the "core" public service differ significantly from those applying to GTEs, although there are important similarities in the broad management principles applying to each.

The origin of many GTEs can be traced back to earlier reservations about the ability of the market to maximise community welfare. In its paper on the Efficiency of Public Trading Enterprises the Economic Planning Advisory Council argues that Australian governments have chosen to produce goods and services through public enterprises to facilitate the control of natural monopolies, "safeguard" competition in some regulated industries, promote a longer term view of investment needs and opportunities, and facilitate the pursuit of social objectives.

The nature and extent of government ownership of trading activities should be that which maximises overall community welfare. While the analysis of ownership issues is very important, they are not the focus of this paper. Rather, this paper is concerned with whether there is significant scope to improve the ongoing contribution of GTEs while retaining government ownership and, if so, the nature of the reforms required to achieve such improvements.

A system for classifying state organisations for the purpose of establishing the optimal system of control for individual state organisations has been developed by the Task Force on the Classification of State Organisations ("the Classification Task Force"), which released a discussion paper in April of this year. The Classification Task Force identified government organisations on the basis of: (i) their financial status (i.e., the extent to which they are financially self-sufficient from the proceeds of user charges as opposed to being dependent on tax-based subsidies); and (ii) their market status (i.e., the degree to which the markets in which they sell their output are competitive as opposed to monopolistic). User charges are defined as a payment to a producer for the voluntary acquisition of a particular good or service of direct benefit to the payee. Taxes, by contrast, are compulsory payments to a government or government sponsored entity for the provision of goods and services, not necessarily of direct benefit to the payee.

On the basis of financial and market status the Classification Task Force identified the following types of government organisations:

- A. Public Service: Fully or almost fully subsidised monopolistic bodies such as the Department of Mineral Resources, Business and Consumer Affairs, Department of Main Roads, or central agencies such as Treasury and the Premier's Department.
- B. Community Service: Partly subsidised monopolistic bodies such as Registry of Births, Deaths and Marriages.
- C. Community Business: Partly subsidised semi-competitive bodies such as the SRA (passenger service), UTA or Home Care Service.
- D. Commercial Service: Self-sufficient monopolistic bodies such as the Sydney Water Board, Elcom or Maritime Services Board.
- E. Commercial Business: Self-sufficient semi-competitive bodies such as the County Councils or the TAB.
- F. Commercial Enterprise: Self-sufficient fully-competitive bodies such as the GIO, State Bank and State Brickworks.

The Classification Task Force recommended that the less dependent an organisation is on the Consolidated Fund or other tax-sourced income for financing its resources, the more autonomy it should be allowed to exercise over the way it uses resources. The Classification Task Force also recommended that the more competition an organisation faces from alternative sources of supply, the more autonomy it should enjoy in determining the type, quantity, quality, pricing and distribution of its goods and services.

This report builds on the work of the Classification Task Force by developing a unified policy framework for GTEs. The framework suggests that special contractual funding arrangements should be developed for GTEs that are not presently self-sufficient. Such arrangements would be consistent with existing principles of parliamentary budget appropriation and Ministerial accountability for program spending priorities. It also argues for the development of regulatory and monitoring arrangements for organisations with a significant degree of monopoly power.

The corporatisation framework developed in this paper applies directly to the commercial organisations in the Classification Task Force's categories D-F and to some of the community organisations in categories B and C. The policy framework also provides valuable insights for the management and control of some of the public service organisations in category A. Because the public service and community organisations in categories A-C often face particularly confused objectives and very weak incentives for efficient performance, the potential gains (in percentage terms) from the application of the corporatisation framework are often greater for such organisations than for the commercial organisations in categories D-F. However, it is important to stress that the applicability of corporatisation to any government-owned organisation is subject to the imposition of market incentives on their subsidised activities (see Section 3.2.1) and the implementation of efficient regulatory arrangements for organisations whose monopoly power raises policy concerns (see Section 3.3.2). Until those changes are in place, organisations in categories A-C should continue to be subject to the control mechanisms recommended by the Classification Task Force. Organisations in Categories D-F, even after corporatisation, will be subject to broadly similar control mechanisms to those recommended by the Classification Task Force.

As recognised by the Classification Task Force, some organisations are multi-faceted and incorporate operations from several categories. This report further complements the Classification Task Force by identifying those situations where multi-faceted organisations incorporating GTE activities should be restructured to improve their overall performance. In particular, the report identifies ways in which the social services provided by some organisations in categories B and C can be "corporatised" (i.e. supplied for government through an arm's-length contract) without reducing the quality or level of the social activities concerned. This would entitle such organisations to some of the management freedoms enjoyed by the commercial organisations in categories D and E. However to ensure that efficiency improvements result, the flexibility of corporatisation must be accompanied by market disciplines (see Section 3.2.1). The case for dividing hybrid organisations into separate units, or for applying different control and incentive arrangements to different parts of hybrid organisations, is also discussed (see Sections 3.2.1).

2.2 The Potential for Improved Performance by GTEs

The potential benefits of reforming the institutional arrangements applying to GTEs have been highlighted by the recent Report on the State's Finances by the New South Wales Commission of Audit (the "Curran Commission"). The Curran Commission identified numerous examples of non-performance by GTEs involving serious waste of the State's scarce resources. Examples include the following:

- massive operational inefficiencies in the major authorities including manning levels which the Commission considered to be 20 percent or more above realistic levels required for the work in hand;
- 8 percent or 3000 of the SRA's staff are on "light duties" at a net cost of \$40 million per annum;
- the SRA's labour productivity is half that of many foreign railways due to factors such as inefficient work practices and absenteeism;
- the consultants used by the Commission to evaluate the Grain Handling Authority ("GHA") found 81 separate restrictive work practices, some of which were described as demonstrating a "high degree of originality". Many of these practices have subsequently been rectified as the GHA has become more commercial;
- the costs per kilometre for the UTA's bus operations are 50 percent higher than benchmark costs even though the UTA's revenue and patronage is comparable to that achieved by other bus systems in Australia;
- Elcom's original design capacity exceeded the 1987 maximum winter peak demand by 73.5 percent. While in normal circumstances this would represent a massive overcapacity, Elcom's low plant reliability (the lowest in Australia) due to technical deficiencies and inefficient work practices means that a reserve margin of 45-50 percent is required. Even with such a high reserve margin Elcom has overcapacity of around 25 percent, representing surplus investment in the order of \$2 billion, excluding approximately \$925 million which has been spent on the unfinished Mt Piper Power Station; and
- the Commission found that the Maritime Services Board (MSB) could achieve savings of 25-50 percent in its engineering work by using outside contractors. Some of these savings have already been achieved as the MSB has commercialised.

There are numerous other examples of non-performance by GTEs in New South Wales. These include the following:

- a study of the UTA by transport consultants Travers Morgan Pty Ltd in 1985 found that private sector bus services could be provided for approximately half the cost of running the UTA and that around \$90 million of taxpayers' money could be saved if the UTA services were transferred to the private sector at current UTA fare levels and frequency of service;
- the efficiency audit of the Government Printing Office in 1982 found that its productivity was 27 percent below the industry average. Potential savings of \$8 million per annum (1982/83 dollars) were identified. A number of major recommendations such as a 20 percent reduction in production capacity and the transfer of some work (excluding Parliamentary and confidential material) to the private sector await implementation;
- Elcom spent \$70 million between 1982 and 1987 building a washery for coal from the Ravenworth No 2 and Swamp Creek mines destined for Liddell Power Station in the Hunter Valley. A Public Accounts Committee Inquiry (Report October 1987) concluded that the decision to build the washery did not receive systematic and detailed consideration within a long term strategy. It also found that the perceived need for the washery "would have no longer have been current by mid-1982 when the final decision was made to proceed with construction";
- an efficiency audit conducted in 1987 found that the Government Cleaning Service could make savings of \$70 million per annum if current cleaning services were provided by private sector contractors. The audit found that day labour staff are not cost competitive with services provided by private sector cleaners due to constraints imposed by existing industrial agreements;
- an efficiency audit this year of the ferry services run by the Urban Transit Authority estimated that annual savings of \$11 million can be achieved by removing restrictive work practices, rationalising services, better control of the Balmain maintenance facility, reducing fare evasion through the new ticketing system (introduced August 1988) and abandoning the Hydrofoil service to Manly;
- a 1988 Public Accounts Committee report found the monitoring of investment performance by statutory authorities to be "extremely limited". Even authorities whose prime function was the investment of funds failed to adequately monitor returns. The State Superannuation Board, which at the time had investments of \$2,900 million, only started subscribing to the IMS investment survey during 1985. Total investment funds of statutory authorities at the time exceeded \$10,000 million; and
- the State Lotteries Office maintains nine ticket-selling branches at an annual cost of \$3.7 million. An efficiency audit (1988) revealed that savings of at least \$1.7 million per annum could be achieved by replacing the branches with agencies.

The recent experience with corporatisation in New Zealand provides further evidence of the potential gains from the reform of GTEs. The two central and interdependent aspects of the reform process in New Zealand have been the establishment of clear commercial objectives and management structures for GTEs, and the creation of a "level playing field" in GTEs' input and output markets by removing the advantages and disadvantages applying to GTEs by virtue of their government ownership.

While these principles have not been applied exclusively or exhaustively in New Zealand, the corporatisation process has been rigorously applied to a broad spectrum of organisations and activities. The New Zealand "experiment" therefore provides valuable information concerning the design of institutional arrangements for GTEs and the potential benefits from reform.

The efficiency gains from corporatisation in New Zealand have generally exceeded expectations in terms of both the magnitude of the gains and the speed at which they have been achieved. Related to this is the increasing awareness that the extent of the waste and inefficiency within the government's commercial activities was considerably higher than was generally thought to be the case.

The benefits of the reform process have been highlighted by the first annual reports of the GTEs which commenced life as corporate entities on 1 April 1987. The following examples illustrate the progress being made:

- Coal Corporation of New Zealand limited ("CoalCorp")

CoalCorp was formed from the operations of State Coal Mines ("SCM") which made losses in 20 of its last 22 years of operation. Some miners were employed in uneconomic mines at an annual cost of around \$122,000 per job. SCM's 1985/86 annual report reveals that it achieved only six of its twelve performance indicators that year. In its first full year of operation CoalCorp turned SCM's previous year loss of \$23 million into a small profit.

- New Zealand Post Limited ("NZ Post")

NZ Post was formed from the postal business of the former New Zealand Post Office. Although the postal business incurred losses of \$38 million in 1986/87 and was expected to incur losses in the order of \$50 million in 1987/88, NZ Post actually achieved a substantial profit in that year, its first year of operation. The profit turnaround occurred despite there being no price increases for basic postal services and price reductions of 30 to 50 percent for unaddressed mail.

Dramatic profit turnarounds and improved efficiency have been experienced by a number of other GTEs in New Zealand following their corporatisation. While the reforms have been in place for only a relatively short period of time, it is already clear that they will generate major improvements in the overall economic performance of GTEs in New Zealand.

Initiatives which improve the economic performance of GTEs in NSW stand to have a major bearing on the overall performance of the State economy. For example, the value of the assets managed by the ten largest non-financial GTEs is conservatively estimated to be in excess of \$25 billion. A five percentage point improvement in the rate of return achieved by these GTEs as a result of improved efficiency would allow, for the same level of resource utilisation, an increase in gross state product of over \$1.2 billion. This is equivalent to \$670 per annum for every household in NSW.

The following section of the paper outlines a framework for analysing the way GTEs affect the community's welfare and for establishing institutional arrangements designed to maximise GTEs' contribution to the community's economic and social objectives. The framework is then applied to evaluate the quality of the present arrangements for GTEs in NSW.

3.0 CONCEPTUAL FRAMEWORK

3.1 How GTEs Affect Community Welfare

By definition, GTEs are principally engaged in trading activities or in activities that could be provided through the market place without compromising government's social or economic objectives. The main way a GTE affects the community's overall welfare is through the efficiency of its commercial performance in undertaking those activities. The concept of economic efficiency refers to the extent to which society's scarce resources (of people, knowledge, physical capital and environmental resources) are able to satisfy competing wants. The efficiency with which GTEs use society's scarce resources is a function of the management incentives and external regulations within which they operate. These encompass the rules and regulations which affect the prices GTEs pay for their inputs and the competitive conditions they face in their output markets, and those which shape the external disciplines imposed on individuals within GTEs.

In some circumstances GTEs may also represent a cost-effective means of delivering government's social or equity objectives. To establish whether this is the case, the non-commercial roles performed by GTEs should be examined to determine whether they in fact advance society's objectives and, if so, whether there are more efficient means of achieving these.

The reform of GTEs should not have as an objective the reduction of social services below the level and quality desired by society. Rather, improved efficiency by GTEs provides opportunities for lowering the cost to the community of the present level and quality of social services or, alternatively, of raising the level and quality of social services at the current cost. There are no economic or social reasons for retaining systems for GTEs which encourage or tolerate wasteful management practices.

Two dimensions of efficiency should be considered in developing an incentive environment that maximises GTE's economic contribution. To maximise "productive efficiency" an enterprise must produce goods and services in a way which uses the least possible amount of resources (in value terms). In dynamic terms, productive efficiency involves maximising the market value of the assets being managed.

A GTE's productive efficiency depends crucially on the quality of management performance in day-to-day operations and in making investment decisions. In turn, the quality of management performance in terms of productive efficiency largely depends on the extent to which managers bear the consequences of their actions. A system which closely aligns the personal rewards and sanctions facing management with their success in maximising the value of the assets they manage is a fundamental requirement for productive efficiency.

The concept of "allocative efficiency" relates to whether the levels of goods and services produced by organisations are consistent with the mix of goods and services which will yield maximum consumption benefits to society over time. Situations of "monopoly power" may involve losses in the community's effective purchasing power because, at the prices charged, some consumers will not buy additional output of a service despite being willing to pay the cost to the community of producing the service concerned. Consumers may instead purchase substitute services that are more costly to produce than the service in question. Of course, whether or not such a loss is inefficient depends on whether or not it can be avoided by an alternative set of legal and regulatory rules that does not involve other, more serious, costs. Such losses in allocative efficiency could arise if Elcom charged prices considerable in excess of the cost of supplying additional units of electricity. This could force consumers to substitute more expensive forms of energy for electricity and to reduce their overall energy consumption even though they are more than willing to pay the cost of supplying additional units of electricity.

Similarly, allocative efficiency losses may arise if the prices an organisation charges for its services do not cover the full cost - including the cost of capital - of supplying them. An exception occurs where government considers that society places a value on the service which exceeds the price users are willing to pay. In such a case a subsidy may be justified to increase consumption to its desired level. Prices (including the appropriate subsidy) which do not cover the cost of supplying the service encourage production which is worth less than the value of the resources consumed. Investment may also be required to produce the higher level of service and this will divert further resources from more highly valued uses. This type of allocative efficiency loss frequently occurs when GTEs retain market share by earning an inadequate rate of return on their capital.

Allocative efficiency losses may also occur when the cost of resources to a particular organisation are below the value of those resources to society in alternative uses. Such organisations may be able to take market share from more efficient competitors with the result that a greater value of resources is required to produce the same level of goods and services. Similarly, regulatory barriers to competition and captive government business may allow a GTE to produce output that would be produced more efficiently by its competitors. For example, the Government Printing Office ("GPO") benefits from a significant amount of captive government business which it receives regardless of how efficient it is. This involves a risk that the GPO will produce services that would be produced at a lower resource cost by its competitors. As a result, for the same cost society would receive a lower quantity and/or quality of services.

A series of principles for applying the concepts of productive and allocative efficiency to GTEs are outlined below. The principles for productive efficiency are based on standard private sector arrangements. While the private sector is by no means perfect in a text-book sense, the pursuit of self interest in a competitive market place provides powerful incentives for the development over time of management arrangements which maximise productive efficiency. In spite of the fundamental differences between private and public ownership the arrangements which have evolved in the private sector provide valuable insights for the design of management incentives for GTEs. As discussed in Section 3.4, the relationship among the principles outlined below is very important. It is particularly important to recognise that standard commercial objectives and performance evaluation procedures for GTEs can only be relied upon as a means of promoting economic efficiency when GTEs face a level playing field in their input and output markets. As with private sector organisations, a commercial orientation for GTEs should be combined with a legal and regulatory environment that aligns the incentives facing GTEs with the interests of the wider community.

3.2 Productive Efficiency

Productive efficiency is most effectively promoted by giving an organisation's key decision-makers, its senior managers, strong personal incentives to produce its services in a least cost manner and to seek out innovations which improve the value of goods and services produced relative to their costs. The quality of the incentives for managers to be productively efficient is largely a function of:

1. the clarity of management objectives;
2. the degree of management autonomy and authority to make key resource-use decisions;
3. the rigour of the independent performance monitoring and assessment to which managers are subject; and
4. the effectiveness of the reward systems applying to managers.

Each of these aspects, and the relationships among them, are discussed below in the context of establishing efficient incentives for GTEs. Because GTEs are primarily involved in the provision of tradeable goods and services, useful insights for the design of optimal incentive arrangements for GTEs may be gained by examining the mechanisms which promote sound performance in the private sector.

3.2.1 Clarity of Objectives

No organisation can be expected to operate efficiently if it has poorly specified or contradictory objectives. Clear objectives provide a direct focus for management and prevent management from using multiple objectives to excuse unsatisfactory performance.

By definition, GTEs are principally engaged in tradeable activities. The main way a GTE affects the community's overall welfare is through the quality of its commercial performance in undertaking those activities. The most suitable objective for GTE managers is therefore the achievement of a commercial performance (i.e. rate of return on assets) commensurate with that achieved by private sector organisations with similar risk characteristics. A more robust objective for management, which directs attention to the time dimension of management decisions, is to maximise the market value of the state's investment in the assets being managed.

The focus on commercial performance provides GTE managers with a clear non-contradictory objective. It also reserves decisions regarding social matters for Ministers, rather than managers. This gives Ministers, society's elected representatives, responsibility for deciding what costs should be financed collectively by the community through general taxation in pursuit of such social objectives.

The establishment of commercial objectives for GTEs does not remove the need for them to act as responsible corporate citizens, and may in fact increase the incentives for GTEs to be concerned with maintaining a reputation for community awareness and fair dealing (e.g. equal employment opportunities, sensitivity to consumer complaints). As with most large private sector organisations, the public image of GTEs will affect their commercial success.

If government judges that a particular social objective should be pursued through a GTE, conflicts of objective can be avoided by "corporatising" the task. This would involve the government specifically contracting with the GTE to provide the community service in return for an explicit fee. Where possible, this should involve the GTE competing with other organisations to provide the non-commercial function in return for an explicit fee. A competitive tender approach was used for allocating Commonwealth Government air subsidies in the 1920s and 1930s. Subsidies for the provision of home care services could be organised on such a basis with the existing government entity tendering for work against private competitors. Private and public school bus services could compete for subsidies on the same basis. This approach avoids conflicts of objectives and encourages the least cost provision of the non-commercial function itself. In situations where a GTE is the only feasible supplier of a product which government wishes to subsidise, the terms for the supply of the subsidised activity should be based on arm's-length negotiations between government and the GTE concerned.

In some, relatively rare, situations a GTE may be the only supplier of a service government decides to subsidise. In principle, government's position as a user of the service will be no different to that facing major private sector users of the service. In such situations the arm's length negotiations between GTEs and government for the provision of subsidised services should be modelled on private sector norms. This extends to private sector practice concerning information disclosure and the use of external advisors. In the great majority of cases GTEs will face competing suppliers and/or substitutable services.

When managers are given discretion to make decisions regarding the provision of social services and the mix of social and commercial activities, for example through cross-subsidisation, it is extremely difficult to hold them accountable for either commercial or non-commercial performance. In such situations it is difficult for "outsiders", including Ministers and their advisors, to quantify the level and cost-effectiveness of social services provided and their impact on commercial performance. Similarly, "procedural" approaches to this problem, such as detailed corporate plans and day-to-day Ministerial involvement, do not in themselves make trade-offs explicit or measure the impact of non-commercial roles on overall performance. The use of an explicit contractual arrangement for the provision of particular social activities is therefore necessary to maintain clear incentives for GTE managers and to ensure accountability for commercial and non-commercial functions. Such an approach would allow budget appropriations for social activities to be maintained so that the Minister, Treasurer and Parliament would continue to have responsibility, and would therefore be accountable, for the manner in which such funds are allocated.

It should be recognised that cross subsidisation is not confined to government businesses, but is widely practised in the private sector. Cross subsidisation should only be considered to be a commercial practice, however, when it increases an organisation's overall returns.

The arguments for clear delineation of, and accounting for, social activities are not based on any judgement regarding the ideal level of those activities. Rather, the approach is intended to promote sound economic performance by GTEs and encourage the efficient provision of social services. However, the "corporatisation" approach does make the cost to society of providing non-commercial activities more transparent and thereby increases Ministerial accountability. Corporatisation thereby improves society's ability to make its own cost/benefit evaluation of the issues involved, including the most cost-effective means of achieving the social objectives concerned.

GTEs often have important regulatory and policy advisory roles. In general, GTEs' incentives for the sound performance of trading and regulatory functions will be improved if these activities are entirely separated from each other. Responsibility for policy advice creates frequent conflicts with the trading interests of GTEs. The removal of the regulatory and policy roles undertaken by a GTE into a separate specialist advisory body accountable to the Minister, is necessary to establish clear and non-conflicting objectives for the GTE's managers and to ensure that managers are not distracted from their central task of managing the GTE's commercial affairs. In terms of the work of the Classification Task Force, such restructuring will generally involve splitting the activities of an organisation into those parts which should be corporatised and those activities of government which will be undertaken most efficiently on a collective basis.

3.2.2 *Managerial Authority*

Clear management objectives will not be successful in generating sound economic performance unless managers are given the authority to make the key decisions required to achieve efficient commercial outcomes. The key determinants of organisational performance are the major investment and strategic decisions and decisions regarding the internal structure of incentives and controls for middle managers and other employees. Business decisions, such as those concerning recruitment, remuneration and dismissals, procurement and purchasing of materials and equipment, production, distribution, marketing and pricing, are complex and often require a considerable degree of industry - and organisation-specific knowledge. It is essential that an organisation's important internal decisions are made by individuals with strong incentives to maximise the value of the organisation and who possess the requisite specific knowledge. The central person in this regard should be the organisation's chief executive.

The internal incentives and controls affecting overall organisation performance cannot be effectively imposed from outside the organisation since, in general, neither Ministers nor control agents have the requisite information and organisation-specific knowledge. The involvement of external agencies should focus on monitoring overall organisation performance with interventions concerning the use, management and combination of resources kept to a minimum. Externally-imposed controls stifle managerial creativity and innovation, and dilute and diffuse responsibility between managers and the government agencies which set the controls, with the frequent result that nobody is called into account.

These principles concerning management authority apply equally to the commercial and non-commercial roles performed by GTEs. Once a GTE has contracted with government for the provision of a particular service, government should focus on monitoring the GTE's success in meeting the terms of the contract rather than imposing detailed controls on internal management decisions. GTE management should have complete discretion, within the terms of the contract concerned, to determine the manner in which the service will be produced and delivered. In turn, management performance should be assessed on the basis of the end results produced.

The establishment of management authority for the day-to-day management of GTEs need not compromise Ministerial responsibility to Parliament for the economic performance of GTEs. In fact, by clarifying the role and objectives of GTEs, Ministerial responsibility for GTE performance may be strengthened. To avoid subjecting Ministers to conflicting objectives Ministerial responsibility for the commercial success of GTEs should be separated from the responsibility for associated regulatory functions and responsibility for the appropriateness, effectiveness and efficiency of the social services provided by GTEs. Ideally, this would be achieved by vesting these three areas of responsibility in different Ministers.

3.2.3 Performance Monitoring

Clear objectives and authority for managers to make key resource-use decisions will only be effective in promoting productive efficiency if managers are held personally accountable for GTE performance. Other reforms are likely to have little impact on the efficiency with which GTEs use resources unless their performance is subject to rigorous monitoring and assessment, with managers being rewarded and retained or dismissed on the basis of their performance.

GTEs are subject to much less market-based performance monitoring than are private sector organisations. For example, GTEs are not subject to takeovers or the risk of bankruptcy and are exposed to less scrutiny by the equity and debt markets than comparable private sector firms. Because GTEs are subject to far weaker market disciplines, it is necessary for government to develop surrogate monitoring and incentive mechanisms.

The most important requirements for the effective monitoring of GTEs are the provision of adequate information to allow the monitoring of results, the necessary analytical skills and the political commitment required to rigorously assess performance.

A reliable flow of quality information from GTEs to independent monitoring agents is an important requirement for the effective assessment of performance against targets. Without such information it is extremely difficult, and sometimes impossible, for monitoring agents to evaluate performance. The monitoring arrangements for GTEs should clearly specify GTEs' information disclosure and reporting requirements in order to facilitate both ongoing monitoring and ex-post audits of performance.

The assessment of GTE performance should focus on the returns achieved relative to those earned by comparable private sector organisations. Performance can only be regarded as satisfactory when a GTE has used resources at least as efficiently as its competitors. If the same value of output could be produced by a private sector organisation using fewer resources, the GTE concerned has wasted society's resources and its performance should be regarded as unsatisfactory.

The assessment of comparative performance requires specialist expertise which central regulatory agencies such as Treasury departments may not always possess. The share market provides major profit opportunities for analysts who are able to rapidly and reliably interpret the economic information content of accounting measures and other financial information and thereby identify undervalued assets. The share market therefore promotes the development of high levels of expertise in the gathering, analysis and interpretation of widely-dispersed information as a basis for assessing comparative performance.

The risk that monitoring agents will be "captured" by the GTEs they monitor is an important consideration in designing effective monitoring arrangements. The monitoring function involves providing advice to the shareholder (i.e. the government) which has an important bearing on the income and employment prospects of the parties being monitored. It is therefore very important that monitors are subject to strong incentives to provide high quality and impartial analysis and to avoid being influenced by personal considerations.

Private sector monitors have important advantages in this regard, as they have incentives to establish and maintain a reputation for impartial, high-quality analysis. These incentives can be enhanced by providing competing lines of advice to Ministers by, for example, using more than one private sector monitoring agent for large GTEs with well-designed monitoring arrangements, the market incentives facing analysts will be similar to those to which credit rating agencies are subject.

Monitors within government, on the other hand, are less likely to suffer serious losses in future earnings potential as a result of poor quality analysis. Such parties benefit from captive government business and are less exposed to competition as providers of performance assessment services than private sector analysts. The Treasury, however, does have an incentive to monitor the financial performance of GTEs because of the impact of GTE dividends on the State budget.

3.2.4 Rewards and Sanctions

The monitoring of GTE performance will be effective in motivating managers only if there is a well understood and vigorously applied system of managerial rewards and sanctions. The system of incentives should be based on a rigorous assessment of GTE performance in light of the objectives initially established for GTE managers. The details of the reward system itself should be based, so far as possible, on private sector practices. This includes the level of remuneration, its break-down into salary, bonus and other components, the basis for salary reviews, and the criteria for terminating employment. The design of reward systems for executives in the private sector is an integral part of the ongoing struggle between competing firms and forms of organisation. The survivorship qualities of widely-used private sector compensation structures is generally testimony to their efficiency. In designing reward systems and setting compensation, GTE boards and managers should find the assistance of private sector remuneration consultants useful.

Any unwillingness by Ministers to reward good performance or apply sanctions in the event of non-performance will greatly undermine the effectiveness of performance-based reward systems in promoting efficient resource use. Ad hoc departures from accepted procedures in the case of any individual GTE are likely to reduce the effectiveness of performance monitoring for the GTE concerned and for other GTEs. A costly symptom of this may be a reduction in the quality and flow of information from GTEs to monitoring agents.

Ministers will find it more difficult to correct unsatisfactory performance when they, and central control agencies, have been closely involved in the detailed day-to-day decision-making of GTEs. If GTE executives are given the authority to manage their businesses and an arm's-length relationship is maintained between Ministers and GTEs, it becomes easier for Ministers to apply sanctions and take any other steps required to correct unsatisfactory performance. Ministerial rewards and sanctions should be applied to boards of directors which in turn should reward and discipline chief executive officers.

3.3 Allocative Efficiency

As discussed in Section 3.1, when designing the incentive environment for GTEs it is important to consider not only the manner in which the resources consumed in producing goods and services are used (productive efficiency) but also the question of whether the service level of particular GTEs is ideal from the viewpoint of society (allocative efficiency). Losses in allocative efficiency may occur because either: (i) the prices charged by a GTE for the resources it uses do not cover the value to society of those resources in alternative uses; or (ii) a GTE possesses a significant degree of monopoly power in the market for the services it provides. It is emphasised that for either of these aspects to involve a "loss" in allocative efficiency which is in any sense relevant to policy makers, it must be possible to identify alternative arrangements that would improve allocative efficiency without imposing more-than-offsetting costs.

3.3.1 Competitive Neutrality in Input Markets

When competing firms all face the full cost to society of the resources they use, competition promotes the survival of those firms that deliver the goods and services demanded by consumers in the most efficient manner. However, if a GTE enjoys special advantages or suffers special disadvantages by virtue of its ownership, the resources controlled by the GTE will be influenced by its ownership status and will not be determined solely on the basis of its comparative efficiency. In the absence of a "level playing field" relatively inefficient firms may prosper, diverting resources from more efficient competitors or more highly-valued end uses.

In addition to the direct efficiency costs of such distortions, special advantages and disadvantages applying to GTEs undermine the reliability of incentive structures based on commercial criteria as mechanisms for promoting efficient performance by GTEs. In such circumstances, performance and its assessment will be affected by the special advantages and disadvantages rather than solely reflecting performance in satisfying consumer demands in competition with other suppliers.

The identification and removal, so far as possible, of such advantages and disadvantages is necessary to ensure that the amount of resources controlled by GTEs is determined by their efficiency, and is a pre-condition for using commercial criteria as the basis for GTE accountability.

The establishment of efficient costs for the resources used by GTEs requires that each GTE be examined on a case-by-case basis to identify and remove any special advantages and disadvantages applying to it. Such an examination should consider, inter alia: the cost of debt to GTEs; the availability of equity capital for GTEs and the pressure on GTEs to achieve a return on equity capital in line with the riskiness of the assets employed; the capital structure of GTEs; GTEs' tax status; the cost of inputs provided by other GTEs; and the labour market regulations applying to GTEs.

A difficulty in ensuring that GTEs face the opportunity cost of the debt finance they use arises because of the way debt markets evaluate the credit risk of GTEs. Even in the absence of an explicit government guarantee, sophisticated lenders tend to discount the credit risk of GTE debt because of the likelihood of government intervention should default become an issue. This distortion tends to be exacerbated in the case of GTEs that are engaged in high-risk activities.

The implicit government guarantee of GTE debt can be thought of as the provision of "off-balance sheet" equity finance by government. Debt markets expect that in the event that a GTE becomes technically insolvent, government will draw on the off-balance sheet equity to meet outstanding liabilities. Unless GTEs are required to generate a return on such implicit off-balance sheet equity, they will not face the full economic cost of the resources they use.

One means of accounting for the implicit guarantee of GTE debt is for government to charge an explicit fee for the interest cost advantage it provides. The advantages of this approach in terms of incentives and accountability need to be balanced against measurement problems and administrative costs on a case-by-case basis.

Competitive neutrality requires that GTEs have access to equity capital to help finance investment opportunities which are expected to achieve at least the market rate of return for assets of comparable riskiness. If, in such circumstances, government does not provide equity or allow GTEs to retain profits or raise equity in the market place, the GTEs affected will be disadvantaged relative to their private sector competitors and society may forego profitable investment opportunities. Once investments are made by GTEs it is essential that GTE managers are subject to rigorous performance monitoring and effective reward systems to ensure that an adequate rate of return on the state's investment is actually achieved.

3.3.2 Competitive Neutrality in Output Markets

"Market power" raises possible efficiency concerns when some consumers are unwilling to buy more of a service at the market price despite being willing to pay the cost of producing that service. Such a situation represents a policy problem only when some alternative regulatory environment would result in a net improvement in society's welfare.

In analysing possible allocative efficiency losses through market power, economists no longer focus on the number of players in the marketplace. Instead, they acknowledge the importance of potential domestic and international competitors in constraining the behaviour of incumbent firms and recognise that in many situations "monopolistic" or "anti-competitive" behaviour provides profitable opportunities for substitution on both the demand and the supply sides of the market. On the demand side, customers may be able to change to substitute services. On the supply side, existing facilities may be adapted to produce the service in question, with competing firms increasing their output or new players entering the market.

The most severe and enduring losses in allocative efficiency from situations of market power tend to arise where government has legislated barriers to entry that prevent competition from other organisations. Where legislated barriers to entry are effective, competing firms are unable to enter the market regardless of the inefficiency or monopoly profits of the incumbent supplier. Captive government business, based on government decree rather than comparative efficiency in producing the goods and services demanded, often has similar effects.

Regulatory barriers to competition in the markets supplied by GTE and GTEs' captive Government business should be removed unless there are special reasons for their retention. Such advantages in GTEs' output markets significantly heighten the risk of allocative efficiency losses occurring through GTEs taking market share from more efficient competitors.

Regulatory barriers to competition and captive government business also reduce the competitive discipline for GTEs to produce services in a least-cost manner, i.e. to be productively efficient. In competitive markets, firms which are able to provide consumers with the best value for money, while generating the required return on capital, are most likely to survive. Management teams which are less successful in this regard risk loss of market share, decreasing earnings potential.

Because GTEs are not subject to the capital market incentives and monitoring associated with the share market and the takeover market, competition in the markets they supply is probably more important for ensuring efficient resource use by GTEs than for comparable private sector organisations. However, this will not be the case if GTEs are allowed to keep their prices artificially low by earning inadequate risk-adjusted returns on capital. This underlines the importance of rigorous monitoring of the performance of GTEs with managers being rewarded and retained on the basis of their success in maximising the value of the state's investment in their organisations.

As well, artificial advantages received by GTEs in the markets they supply complicate the process of assessing GTE performance by comparing the returns achieved by GTEs with normal market returns. High accounting rates of return achieved by a GTE operating in sheltered markets may reflect protection from competition rather than management success.

In some industries, even in the absence of regulatory barriers to competition, there may be valid policy concerns regarding market power which are not easily dealt with by general competition legislation such as the Commonwealth Trade Practices Act. Such concerns typically arise when high market shares provide important economic benefits, and where potential market entrants are faced with high "sunk costs", i.e. costs which cannot be recovered if new suppliers subsequently leave the industry.

For example, the electricity industry is characterised by a high degree of interdependence between its component parts and considerable efficiencies are obtained through co-ordination and co-operative activities. The very high market shares that may arise in an unregulated setting, along with the high sunk costs associated with electricity transmission and distribution facilities, provide grounds for carefully evaluating the possibility that significant efficiency losses might result from an unregulated electricity industry.

Public ownership is often suggested as a response to serious competition problems. This is based on a belief that public monopolies act in the public interest and therefore do not raise their prices to extract monopoly profits, and that government control of monopoly power can be achieved more efficiently through public ownership than by regulation of public companies.

Apart from general concerns regarding the efficiency of state ownership (see Section 3.5), there are strong reasons for skepticism regarding the view that state ownership per se provides the ideal solution to serious competition problems. For the reasons outlined above, clear and non-conflicting objectives and rigorously applied reward systems based on those objectives are key requirements for improved GTE performance. If aggressive commercial behaviour is constrained by loosely specified concerns regarding market power, GTE managers will face conflicting objectives and accountability will be undermined.

State control does not prevent a GTE from exercising monopoly power. Publicly-owned telecommunication systems around the world have featured prices for some consumers well in excess of the additional cost of supply, with the excess revenue being used to cross-subsidise others. Monopoly profits are often dissipated by managers in terms of an easier life and more perquisites, and by workers through soft wage settlements and restrictive work practices.

The design of the best achievable set of market and regulatory incentives for industries possessing considerable monopoly power often requires extremely complex analysis. For example, in the case of the electricity industry, should prices be constrained by government and, if so, what is the most efficient configuration of prices and process for adjusting prices? The Government has committed itself to the establishment of external pricing reviews, initially for Elcom and AGL, modelled on the U.S. system of public utility price regulation. Alternatively, should generation capacity be split up to establish a wholesale market for Power and, if so, how should the transmission facilities be owned and regulated? Major costs may be imposed on society if pricing and output decisions by GTE managers are based on back-of-the-envelope analyses of such issues, or are determined by politically-motivated directives from Ministers.

The constraints imposed on GTEs in the markets they supply should take the form of explicit regulatory provisions based on detailed analyses of the relevant economic and technical issues. This is necessary to ensure the efficient resolution of the underlying concerns regarding monopoly power. Explicit regulatory rules in the markets GTEs supply also avoid confusing the objectives of GTE managers. By making the constraints in GTEs' output markets explicit it is possible to maintain the accountability of GTE managers in terms of clearly specified commercial criteria.

3.4 Relationship Between Principles for Sound Performance by GTEs

The relationship among the conditions for corporatisation outlined above is very important. Each principle depends on the implementation of all other principles in order to have a major impact on the efficiency with which GTEs use resources.

Clear objectives, managerial authority and effective performance monitoring and reward systems are all necessary requirements for a high standard of commercial performance by GTEs. Clear objectives will have little impact on management performance unless managers expect to be assessed and rewarded on the basis of their organisation's success in meeting those objectives. Similarly, a well-designed system of rewards and sanctions will be of little benefit unless GTE managers are given the authority to take the key decisions determining overall performance.

The establishment of a "level playing field" for GTEs, including the implementation of efficient regulatory provisions in their output markets, is fundamental to promoting sound commercial performance by GTEs and improving their overall economic contribution. The effectiveness of standard commercial criteria as the basis for assessing management performance may be seriously eroded if GTEs are subject to advantages or disadvantages in their input or product markets. Measured performance may merely reflect the advantages or disadvantages rather than comparative efficiency.

Rewarding management on the basis of private sector norms could create its own distortions and economic costs if GTEs are subject to advantages or restrictions in their input or output markets. It is only when all firms confront the full economic cost of the resources they use that commercial objectives, in conjunction with the competitive process, promote the allocation of resources towards the highest valued uses and most efficient users. In this sense, the establishment of a level playing field for GTEs in terms of the cost of the resources they use and the conditions they face in the markets they supply, validates the assessment of GTE performance against standard commercial criteria.

3.5 Inherent Weaknesses of GTEs

Implementation of the incentive structures for GTEs outlined above, along with initiatives to establish competitive neutrality in GTEs' input and output markets, would be likely to significantly improve the economic performance of GTEs. However, there still remain fundamental differences between the incentives for efficient resource use under private and public ownership which suggest that, even with substantial restructuring, GTEs are unlikely to consistently achieve the level of performance reached by successful private sector organisations.

A distinguishing characteristic of a private property system is its ability to accurately reward individuals for efficient resource utilisation. Private ownership gives rise to powerful market mechanisms which strengthen the incentives of managers to act in the best interest of owners and therefore to use resources efficiently. Although none of the mechanisms employed in the private sector operate perfectly, they are powerful in aligning the actions of managers with the interests of shareholders.

The inability to transfer ownership under state ownership severely weakens the mechanisms which would otherwise act to align the actions of management with the interests of shareholders. In particular, GTE managers and directors are not threatened by competing management teams through the market for takeovers. GTEs are also subject to less scrutiny by the share market and lenders and are not exposed to the threat of bankruptcy. To the extent that lenders perceive GTE debt to be government guaranteed (either implicitly or explicitly), lenders' incentives to monitor particular GTEs are reduced and sound management performance becomes less important in gaining access to low cost debt finance.

Because GTE managers are not subject to the full range of market disciplines they have weaker incentives to make information available to external parties. Poor incentives and the difficulty of interpreting information on performance mean that the markets for managerial labour and director services are less capable of promoting good performance. The absence of clear signals from input markets about the quality of performance makes it singularly difficult for managers of GTEs either to measure performance or to see where performance might be improved. In this sense, state ownership handicaps not only owners (the general public) but also managers.

If GTEs continue to perform poorly relative to comparable private sector organisations once they have been corporatised, serious consideration should be given to privatising them to ensure that they are exposed to real rather than surrogate market disciplines. A number of possible options for exposing GTEs to further market disciplines are outlined in Appendix 2.

4.0 ASSESSMENT OF THE PRESENT ARRANGEMENTS FOR GTEs IN NSW

The recent financial and administrative reforms in NSW affecting GTEs indicate a recognition of the importance of the incentive environment facing GTEs in determining their economic performance and a general willingness to improve GTEs' incentives for sound performance. A chronology of these reforms is given in Appendix 1 to this paper.

The recent GTE reforms and the present institutional arrangement for GTEs are evaluated below in terms of the five principles for sound economic performance by GTEs outlined above (Section 3), i.e. clear objectives, managerial authority, rigorous performance monitoring, effective reward systems and competitive neutrality.

4.1 Clarity of Objectives

The majority of GTEs have their own Acts of Parliament. These grant responsible Ministers the authority to set the objectives of the organisation and in many cases grant Ministers very general powers of direction.

The proposed system of target rates of return for major government business authorities, announced by the previous Premier in July 1986, is a valuable step in the direction of providing GTEs with a clear commercial focus and improving their economic performance. The Treasury's analysis of rate of return measures has correctly focussed on the development of a System of accounting which reflects the economic value of the resources employed. To this end, the Treasury has devoted considerable effort to the development of a system of accounts which will provide a reliable measure of the economic performance of GTEs.

Since the announcement of the proposed target rates of return, two discussion papers concerning the accounting basis for the rate of return targets have been released by the Government. The accounting framework for the targets has yet to be resolved and, as a result, the target rates of return have not been implemented.

Efforts to develop an accounting system that reflects economic measures are commendable. However, accounting measures involve inevitable weaknesses and should be regarded as mere proxies for underlying economic values. In the private sector, accounting measures are subject to critical examination and interpretation, and are seldom used in isolation as a basis for setting objectives and monitoring performance. To assist in dealing with the inevitable measurement problems with accounting data, it may be useful to tap specialist private sector skills in the analysis and interpretation of accounting and other information. As discussed above this could be achieved by using private sector analysts to assist with the monitoring of GTEs.

Many GTEs presently fulfil a combination of commercial, social and regulatory functions. For example, in addition to its main transport services, the Urban Transport Authority ("UTA"), provides advice to government on a range of policy issues affecting its own business activities. Similarly, the Forestry Commission is a major forestry business as well as the principal source of policy advice to government on forestry matters. The combination of such roles within the one organisation involves a fundamental conflict of interest. By splitting regulatory and commercial roles into separate organisations the potential for such conflicts would be avoided and risks of management being distracted from their principal task reduced.

GTEs are often subject to Ministerial directions concerning pricing policies, community service obligations and industrial relations. Examples referred to by the Curran Commission include the requirement that the SRA accepts uneconomic business and intervention to prevent the forced transfer of redundant staff. The Commission concluded that Ministerial direction and intervention "not only weakened management responsibility and accountability, but has directly impaired the Authority's ability to operate on a commercial and cost effective basis".

The enabling legislation for most GTEs establishes the broad objective of the provision of services to particular groups of consumers. As discussed by the Curran Commission, references to the cost or pricing of services are usually expressed in general terms and there is usually no requirement for full cost recovery. The non-economic activities provided by GTEs are generally funded either by cross-subsidisation, or by the organisation earning less than a market rate of return on the assets employed. For example, the below-market pricing of the SRA is met through government funding of the SRA's deficit. The Water Board pensioner rebate is funded 50 percent by government and 50 percent by the Water Board through cross subsidies and /or a lower return on assets.

Because the social services provided by GTEs are generally not separately accounted for the Community often has little information regarding the cost of providing such services. It is not widely known, for example, that many long distance train travellers receive a subsidy of more than \$100 per trip.

The Curran Commission suggested that the lack of a clear commercial focus for GTEs is reflected in the composition of their boards. Board members of the UTA, for example, include representatives of the taxi industry, the bus proprietors, the SRA, the Labor Council, UTA employees, private bus and taxi-cab employees, commuters generally, and the Commissioner for Motor Transport.

4.2 Managerial Authority

The majority of the members of public authority boards are either nominated or directly appointed by the responsible Minister. In most cases responsible Ministers do not have the authority to dismiss board members for financial non-performance nor to set the remuneration for the non-executive members of government authority boards. These Ministerial powers are fundamental to the creation of an environment which promotes efficient resource use by GTEs. Ministerial responsibility would be greatly undermined if Ministers were unable to hire, and set the compensation for their agents, in the control of GTEs.

Boards and managers of GTEs are often subject to restrictions which seriously limit their ability to make important decisions regarding internal control and incentive systems and the way resources are used generally. In most cases boards of directors have very limited powers to hire, fire and set remuneration for senior executives in business authorities. The chief executive is either appointed or nominated for appointment by the responsible Minister. Other senior executives are recommended for appointment by a selection panel comprising the Chief executive, a member of the board and an individual from outside the organisation. The salaries and allowances of chief executives and their deputies are set by the Statutory and Other Officers Remuneration Tribunal. The remuneration of other senior executives is generally subject to the approval of central government agencies.

It is not possible to hold boards of directors accountable for GTE performance unless they have the authority to appoint the chief executive and have some capacity to influence the selection of other senior executives. Boards should also have the authority to establish incentive-based compensation systems and dismiss non-performing executives. While in practice directors will generally need to consult with Ministers regarding the appointment of the chief executive, the authority of boards to appoint the chief executive is a fundamental requirement for establishing effective incentives for GTEs. The present arrangements are likely to significantly undermine the incentives for sound performance facing directors and the ability of directors to influence the quality of performance by GTEs.

GTEs are also subject to considerable day-to-day Ministerial intervention. For example, the Curran Commission concluded that Ministerial intervention, including lack of support for Rationalisation proposals, has been "significantly detrimental" to the SRA's efficiency. Ministerial interference in the day-to-day business operation of GTEs generates conflicting objectives for GTE managers, complicates performance assessment and undermines the accountability of GTE managers.

Further constraints on management authority are provided by the Ministerial Capital Works Committee, which must approve the capital works programmes of public authorities. One function of the Ministerial Capital Works Committee is to ensure that the borrowings of government departments and business authorities are within the global level of borrowing agreed to by the Loan Council of Australia. The entities subject to the global limits include semi-government and local authorities and all companies and trusts which are wholly-owned, or partly-owned and effectively controlled by governments. Once the global limit for NSW is established, the State Government is free to determine the distribution of the global total among individual authorities.

The present arrangements discriminate against entities covered by the global limits, and therefore violate the principle of competitive neutrality.

4.3 Performance Monitoring

The effective monitoring of GTE performance requires the provision of quality information on GTEs and the application of analytical skills and political commitment required to rigorously assess performance.

The Public Finance and Audit Act is the principal legislation governing the administration, accounting and auditing of the finances of departments and authorities. Uniform accounting and reporting standards for departments and authorities are prescribed in two Annual Reports Acts, one covering statutory authorities, the other departments. Statutory authorities with a commercial charter have accrual accounting, departments with a social or regulatory charter use cash accounting. The Government intends to eventually extend accrual accounting to all parts of the public sector.

A number of efficiency audits of government departments and business authorities, undertaken by the former Public Service Board, uncovered serious deficiencies in the financial information and other measures of performance generated by those organisations. For example, the efficiency audit of the Government Printing Office last year found long-standing managerial problems concerning financial information and control.

Similar problems were identified by the Curran Commission which found that, in general, GTEs' "management information systems do not relate to profit/cost centres and as such the profitability of individual business areas can not be identified". The Commission also reported that the Transport Authorities, as a result of provisions in their enabling legislation and exemptions granted from reporting requirements, prepare financial statements which do not reflect commercial realities.

In the private sector, managers have strong incentives to provide accounting and other information on organisational performance. GTE managers are unlikely to provide high quality and timely information unless they are subject to similar disciplines. The ability of boards of directors to reward performance and apply sanctions for non-performance is fundamental to providing GTE managers with incentives to provide the board with satisfactory information.

As discussed above, there are difficulties in using accounting information in isolation to evaluate GTE and management performance. The quality of performance assessment would be improved by increasing the involvement of specialist private sector analysts in the monitoring process.

The Efficiency Audits undertaken by the Public Service Board have been an important part of the monitoring arrangements for government departments and business authorities. Seventy- one audits have been completed since their commencement in 1980. The grounds for Efficiency Audits by central control agencies should be considered within the context of the overall incentives facing GTE directors and managers. If these parties are given clear objectives and are effectively rewarded on the basis of their success in achieving those objectives, interference by central agencies may impose unnecessary costs and distractions on GTE managers. Such interference may also hinder the development of a commercial culture and be perceived as involving unnecessary interference. Any detailed reviews of a GTE's business operations should be initiated by the shareholding Minister(s) and should be seen as complementing the ongoing monitoring of GTE performance. The structure of such reviews should be modelled on the use of business and management consultants by holding companies and boards of directors in the private sector.

As long as directors and managers are subject to effective incentive mechanisms, performance monitoring should generally focus on overall performance rather than the "efficiency" of specific components of the business. More detailed involvement in the affairs of GTEs should generally be limited to situations where the main incentive mechanisms have broken down and performance is suffering as a consequence. Even then, the principal concern for government should be to re-establish effective objectives, performance monitoring and reward systems for GTEs. This task may be facilitated through management strategy reviews ("MSRs"), which concentrate on corporate strategy and broad structural issues, rather than detailed efficiency audits.

If shareholding Ministers decide to conduct MSRs on GTEs experiencing major difficulties after corporatisation, they should continue the present practice of using private sector consultants to undertake those reviews. As outlined in the discussion of performance monitoring in Section 3.23, private sector analysts are on-going operators in a competitive market for analysis. The importance of reputation in this market provides strong incentives for impartial and quality advice and means that private sector analysts are generally less likely than public sector monitoring agents to be "captured" by the entity being monitored.

GTEs are currently subject to a number of obligations, restrictions and monitoring procedures by virtue of their ownership. These arrangements include those administered by or under the Auditor-General, the Ombudsman, the Independent Commission Against Corruption, the Parliamentary Public Accounts Committee, the Director for Equal Opportunity in Public Employment and the proposed Freedom of Information Act and Administrative Appeals Tribunal. While a full analysis of the most desirable role for each of these is outside the scope of this paper, the general principles which should be adopted in order to maximise the economic contribution of GTEs are relatively clear.

First, subject to the application of rigorous shareholder monitoring arrangements, GTEs should be required to meet the same community obligations and standards of conduct as comparable private sector organisations in order to achieve competitive neutrality.

Second, the monitoring arrangements for GTEs should be based on clear and direct lines of accountability. Shareholding Ministers should delegate day-to-day management authority to GTE managers and should have the full authority to monitor GTE performance. Ministers in turn should be responsible to Parliament for the performance of GTEs. Parliament and the Auditor-General should focus on the performance of shareholding Ministers in their role as agent for taxpayers, the ultimate shareholders. To avoid the overlap and confusion of monitoring responsibilities it will be important to clearly delineate the functions and responsibilities of Ministers, Parliament and government agencies at the outset of the corporatisation process.

4.4 Rewards and Sanctions

As mentioned above, boards of directors presently have very little authority to recruit or dismiss senior executives. The remuneration of the most senior executives in each business authority is set by the Statutory and Other Officers Remuneration Tribunal. These arrangements preclude GTE boards from developing effective reward systems for senior executives.

Senior executives are the key internal-decision agents in terms of an organisation's expected economic performance. They are also the principal point of contact for the board of directors. In the private sector, the board of directors exercises its role as agent for shareholders by ratifying and monitoring major policy initiatives and applying a system of incentives and controls to senior executives. The role of outside (i.e non-executive) directors is especially important in applying incentive mechanisms to executives. Outside board members tend to play a dominant role in tasks, such as setting executive compensation or replacing underperforming managers, that involve potentially serious conflicts between internal managers and shareholders. Boards of directors, in both the private and public sectors, are simply unable to perform these tasks unless they have the authority to apply a rigorous system of rewards and sanctions to executives.

There are also weaknesses in the reward systems currently applying to the directors of GTEs. The only executive directors of GTEs are the chief executives and their deputies, whose remuneration is set by the Statutory and Other Officers Remuneration Tribunal. The remuneration of non-executive directors is determined by the responsible Minister. However, departures from the schedule of directors fees set by the Premier are rare.

In the private sector, directors' income is often directly linked to organisational performance, particularly through the ownership of shares or options. Directors' behaviour is also constrained by the possibility of takeover and the impact of organisational performance on their reputations as specialist directors.

While the performance of many GTE directors will be influenced by their professional ethics and sense of duty to the community, in general these considerations cannot be expected to provide adequate incentive for sustained high performance. Pecuniary rewards tied, to the extent possible, to GTEs' business success are essential to achieve a highly-focused commercial approach from directors. A convention of expeditiously replacing non-performing directors should also be adopted. Unless such rewards and sanctions are adopted there is a serious risk that board members will be captured by some interest group associated with the GTE (e.g. executives, labour unions, suppliers, customers) or will simply fail to put in the time and energy required from a director.

4.5 Competitive Neutrality

An important requirement for efficient resource use by GTEs is the establishment of a "level playing field" in terms of the prices they pay for the resources they consume and the conditions they face in the markets they supply. This includes the removal of GTEs' special advantages and disadvantages (where there are no special reasons for their retention), and the implementation of explicit regulatory regimes where there are valid efficiency concerns regarding the monopoly power in GTEs' output markets.

Government has taken a number of important steps to increase the competitive neutrality of GTEs' operating environments. In particular, the report of the Interdepartmental Committee on Public Service-Wide Payments and Services has outlined a number of important principles and valuable recommendations designed to encourage government agencies to base their resource-use decisions on the cost to society of the resources they use. Important statements of principle by the Committee, which are consistent with the concept of competitive neutrality discussed in Section 3.3, include the following:

- The 'user pays' principle is central to the notion of accountability. If Departments are to be fully accountable to the Parliament it is important that they reflect the full cost of all resources required for the delivery of the government services for which they responsible.
- Adoption of the 'user-pays' principle will encourage the rational use of services. If Departments are required to pay for goods and services, managers will need to assess relative priorities among competing demands, and then decide whether continued use of the service is feasible and/or warranted.
- It would be expected that better service delivery would result from the introduction of the 'user-pays' principle. If Departments are required to pay for services provided by other Departments they will be more inclined to demand a high standard of service. If not provided, pressure will arise for access to services provided more efficiently from external sources." ["Financial Management Arrangements for Public Service-Wide Payments and Services", NSW Treasury Technical Paper, December 1987, paras 4.2.1 - 4.2.31

Departments and authorities providing a major service primarily for the benefit of other government departments include the Government Cleaning Service, the Courier Service, the Office Accommodation Bureau, Building Maintenance Services, Supply of Motor Vehicles, and Document Reproduction Centres.

Apart from recommending that "[a]s a general principle, the 'user-pays' philosophy should have application through the Inner-Budget Sector", the committee made two important recommendations concerning the application of the user-pays approach.

The first of these is the recommendation that the responsibility for all aspects of managing and maintaining office accommodation be assigned to one government agency which would charge market rentals, including a management fee, to all departments and authorities occupying government-owned accommodation. As the committee noted, "in this way, profit (if any) in the Government owning office buildings would be apparent and the managing agency's performance would be assessed in the light of property management standards prevailing in the private sector".

The second important recommendation is that departments be required to bear debt charges attributable to additional capital works and services allocations made from the Consolidated Fund. As the Committee noted, the question of whether or not departments and authorities are charged the debt servicing costs of their capital works programmes has a major bearing on the way they make investment decisions. In the absence of such charging, there is little incentive for the agencies concerned to make efficient investment decisions and there is a serious risk of wasteful investment.

As the Government moves towards eliminating borrowings in the central budget (i.e. Consolidated Fund) sector, consideration might be given to charging departments for the cost of their capital funds, even though they will be wholly derived from tax-based revenue. Otherwise there will be a tendency to overuse and waste such funds because they are a "free" resource.

The Committee also discussed the possibility of exposing the providers of multiple-agency services to competition from private sector organisations and recommended that the issue of competition be reviewed on a case-by-case basis after the implementation of the user-pays principle. The termination of captive government business for GTEs is fundamental to providing them with sound incentives to use resources efficiently. Competition in the markets firms supply is an important mechanism for promoting efficiency in both the private and public sectors. The battle for survival between competing firms and alternative ways of organising activity is the most effective means of ensuring efficient resource use over time. This is particularly so for GTEs since the capital market incentive mechanisms to which they are subject are much weaker than those applying to comparable private sector firms. The existence of captive government business for GTEs also undermines the effectiveness of using commercial benchmarks as the basis for assessing GTE performance.

The labour market arrangements applying to GTEs violate the principle of competitive neutrality and generally disadvantage GTEs relative to private sector organisations. As outlined above, the remuneration and conditions of employment for GTE directors and senior executives are generally considerably more restrictive than those applying in the private sector. This is also the case for the other employees of GTEs.

The labour market arrangements for the core public service and some small business authorities are specified in the Public Sector Management Act. The terms and conditions of employment for most other authorities are contained within their own Acts which, although involving elements from the Public Sector Management Act, vary significantly from authority to authority. The labour market arrangements applying to GTEs are generally less flexible than those in the private sector. This disadvantages GTEs relative to comparable private sector organisations and undermines the validity of assessing GTE performance using commercial criteria.

The issues to be considered in designing the best achievable labour market institutions are the same for GTEs and private sector organisations. The preferred policy approach is to determine the best achievable set of institutions and to apply these to both GTEs and the private sector. This would ensure that all commercial organisations were subject to efficient labour market arrangements, avoid artificial distortions between GTEs and their competitors, and maintain the integrity of other GTE reforms.

Since 1983, all of the debt funding for public authorities has been raised by the Treasury Corporation with an explicit government guarantee. The Public Authorities (Financial Arrangements) Act 1987 provides for the payment of a guarantee fee which has subsequently been levied on all statutory authorities and electricity County Councils with outstanding debt guaranteed by government. The fee has been set at 0.5% of the government guaranteed debt outstanding.

The government guarantee of GTE debt effectively shifts a proportion of the debt cost to NSW taxpayers and artificially lowers the cost of debt to GTEs. Lenders are prepared to accept a lower interest rate because they know government is standing behind the GTE with its equity and powers of taxation. However, the lower interest rate does not lower the cost of debt to society but simply disguises a proportion of the debt burden.

In fact, the explicit guarantee is likely to raise the cost of GTE debt to society. The guarantee gives GTEs an artificial competitive advantage which may distort their market position and complicate the assessment of their performance. Explicit guarantees also encourage GTEs to engage in high risk activities and to be highly geared to increase the size of the interest cost subsidy" associated with the guarantee. In other than exceptional circumstances, which are usually temporary, there are strong economic reasons for removing explicit government guarantees of GTE debt.

The explicit guarantee may vary substantially between GTEs and may vary over time. The flat fee charged for the explicit government guarantee may encourage some GTEs to abuse the guarantee by engaging in high risk ventures or specialising in activities where fine debt cost advantages are of major competitive significance. Even if the explicit government guarantee is removed GTEs will continue to benefit from an implicit government guarantee of their debt.

Competitive neutrality requires that GTEs with profitable investment opportunities have access to the equity capital required to finance them. The investment opportunities of some GTEs, in particular the State Bank, have been severely constrained by the reluctance of government to provide additional equity or allow the level of retained earnings desired by the State Bank and because of the inability of GTEs to raise equity in the market place because of government-imposed restrictions.

Competitive neutrality also requires that GTEs adopt a dividend policy, including the reinvestment of retained earnings, which is in line with private sector practice. Dividend have been paid by the State Bank since its inception and the GIO has been subject to a dividend requirement since 1986. Dividend requirements for other public authorities were announced in July 1986 and have been levied on an interim basis since 1986/87 for Elcom, the Water Board and the Hunter District Water Board. The MSB makes a non-dividend contribution to the Consolidated Fund. To establish GTEs as commercial businesses and increase the incentives for managers and directors to generate a normal rate of return on equity, a dividend policy based on relevant private sector norms should be developed for all GTEs.

As a general principle it is desirable to develop tax regimes which are neutral as between GTEs and private sector organisations. However, special concerns are presented by the exemption from Commonwealth tax enjoyed by state authorities. In lieu, "commercial" authorities pay to the State Government the Commonwealth income tax a commercial organisation would normally provide. From the perspective of NSW citizens it is important that this source of revenue for the NSW Treasury be retained rather than redirected to the Federal Treasury.

The regulatory arrangements applying to many GTEs with a significant degree of market power are not based on careful analyses of the best achievable pricing arrangements and industry structures for the organisations concerned. The pricing and output decisions of many such GTEs are largely based on political directives rather than a careful evaluation of the costs and benefits to society of the alternatives.

In the case of those industries where policy concerns are raised concerning market power, there should ideally be an in-depth study of the relevant economic and technical issues with the objective of establishing an explicit regulatory regime for the industry concerned. In some cases industry restructuring may significantly reduce the need for price or rate of return regulation. For example, as noted by the Curran Commission, the division of the MSB into individual port companies would create the opportunity for competition between NSW ports, the potential benefits of which would need to be weighed against the possibility of foregone economies of scale. Similar issues apply to electricity where private power plants could compete with publicly-owned Elcom plants to supply power to a common grid.

Finally, the consumer protection laws and restrictive trade practice regulations contained in the Commonwealth Trade Practices Act 1974 do not specifically purport to bind authorities of state governments. It is a principle of statutory interpretation that a statute does not bind the Crown unless it does so expressly or by necessary interpretation. The Courts have found that entities that are agents of the Crown in right of a state, are not bound by the Trade Practices Act. However, last year NSW in effect adopted the consumer protection segments of the Trade Practices Act by incorporating those segments (with only minor amendments) into the Fair Trading Act 1987 (NSW). This new Act binds all of the state's business activities to place GTEs on an equal footing with their private sector competitors. There is still a need to subject GTEs to the restrictive trade practice provisions of the Trade Practices Act or comparable legislation. The Government's business deregulation and license reduction unit recently recommended such a change.

4.6 Overall Assessment

The GTE reforms introduced to date in NSW improve the incentives for sound performance by GTEs and are significant steps in the development of an efficient package of incentive and monitoring arrangements for GTEs. In particular, the initiatives taken to clarify GTEs objectives and apply the "user-pays" principle are essential to the development of an efficient incentive environment for GTEs.

However, considerable scope for further improvement remains. The trading activities of the State are being undertaken in a range of organisational forms, a number of which are inappropriate for GTEs. A related problem is the large number of GTEs with poorly defined or conflicting objectives. Many GTEs are heavily engaged in cross-subsidisation and GTEs are frequently subject to Ministerial directions concerning industrial relations and pricing and output decisions which are not separately accounted for. Because of GTEs' conflicting objectives and the high level of interference in their day-to-day business affairs, GTE managers generally have only very weak incentives to maximise the value of the state's investment in the businesses they manage.

Major deficiencies in the accounting information provided by GTEs have been identified. The quality of information provided by GTE managers would be likely to be improved by subjecting them to more rigorous reward systems. Performance monitoring should also focus more heavily on the overall performance of GTEs rather than the efficiency of detailed aspects of GTEs' business activities.

A further serious weakness with present arrangements is the lack of authority held by boards of directors concerning key management issues, particularly in terms of their ability to apply effective rewards and sanctions to individuals within their areas of responsibility. Other reforms are likely to be of little benefit unless directors and managers are given the flexibility to respond to other policy changes and to apply their specialised skills and knowledge without political interference. Ministerial intervention should be confined to explicit social objectives which should be defined in an explicit contract between the Minister and the relevant GTE Board.

Finally, reform is required in a number of areas to remove special advantages and disadvantages in GTEs' input and output markets. A number of GTEs benefit from captive government business. The termination of such arrangements is necessary to ensure that the success of GTEs is based on their efficiency and to avoid undermining the validity of using commercial criteria as the basis for assessing GTE performance. In the case of a number of GTEs with a significant degree of market power detailed analysis of the most efficient regulatory arrangements for the markets they supply are required.

The application of the Loan Council's global borrowing limits to GTEs discriminates against such entities even though they have the same objectives and broad functions as private sector organisations. The cost of debt facing GTEs is distorted by their explicit government guarantee and the use of a flat explicit guarantee fee. To remove this distortion GTEs should pay a fee set on a case-by-case basis for any explicit guarantees as well as for any underlying implicit guarantee of their debt.

Unless all the conditions of corporatisation are applied to a GTE, its efficiency and effectiveness is unlikely to match that of a private entity given the same task. If the government wants to maintain public ownership of GTEs, it will have to ensure that such ownership does not retard their performance. Otherwise public demands will grow for privatisation.

5.0 PROGRAMME FOR CORPORATISATION OF NSW GTEs

Because GTEs are principally engaged in trading activities, the most suitable objective for GTE managers is the achievement of a commercial performance commensurate with that achieved by comparable private sector organisations. While the process of corporatisation will often be simpler in the case of financially self-sufficient entities, the potential efficiency gains from corporatisation are often greater for public service and community organisations. The "corporatisation" of non-commercial (i.e. subsidised) functions enables subsidised activities to be provided on a contract basis by a commercially-orientated GTE without confusing objectives, compromising management accountability, or lessening Ministerial accountability to Parliament for the nature, quality and quantity of the activities concerned.

In addition to providing a clear focus for managers, the adoption of a commercial objective for GTEs enables the organisational, monitoring and incentive arrangements to be modelled on private sector norms. This involves the major advantage of drawing on a system of organisation and incentives with proven efficiency advantages. As mentioned above, competition in the private sector extends to the choice of alternative ways of structuring organisations and internal incentive and control arrangements. Those practices that have been widely used over a period of time and that have survived generally provide important efficiency advantages.

The listed public company is the dominant private sector organisational form in large scale economic activity in Western economies. Important features of this model which are informative as to the structure of GTEs are:

- shareholders delegate decision control to specialist boards of directors with shareholders retaining approval rights on key issues such as board appointments and the choice of auditor. The board of directors exercises control of internal managers by ratifying and monitoring major policy initiatives, setting executive compensation and replacing underperforming managers;
- within the limits set by the major policy objectives adopted by the board of directors, the chief executive is given considerable discretion in establishing internal incentive and control systems and making important resource-use and pricing decisions;
- sophisticated reward systems for motivating directors and managers are widely used and rigorously applied. In the case of senior executives these feature market-based mechanisms which link compensation to the value of the firm;
- the share market and the takeover market provide incentives for professional analysts to monitor organisational performance for current and potential investors. Monitoring by analysts is continual and involves looking behind accounting measures to underlying "fundamentals" in order to assess comparative economic performance;
- the capital markets generate powerful incentives for managers to provide information to investors concerning comparative performance and to "bond" the reliability of the information provided through the use of independent auditors. Independent credit rating agencies regularly assess the short and long term financial strength of major borrowers.

While these aspects of publicly listed companies provide useful insights for the design of organisational structures and incentive arrangements for GTEs, it is important to recognise and account for the fundamental differences between private and public ownership. The fact that a taxpayer's ownership stake in GTEs is inalienable and non-transferable severely weakens the incentives to monitor GTE performance and take steps to correct unsatisfactory performance. Accountability to ultimate owners is considerably less direct for GTEs than private sector organisations. Politicians are the agents for their constituents in the control of GTEs. This increases the risk of political interference (that is, interventions by politicians not in the ultimate interest of the majority of the community) in GTEs' business affairs and also means that the organisational and monitoring arrangements must provide for Ministers' accountability to Parliament for the GTEs for which they are responsible.

On the basis of the features of publicly listed companies outlined above, and the differences between public and private ownership, the recommended broad organisational structure and incentive arrangements for corporatising GTEs are as outlined below.

1. All significant business units within the public sector that are principally involved in the delivery of services which are, or could be, traded in the market place without compromising government's social or economic objectives should be established as commercial entities with ownership vested in the responsible Minister(s).
2. Any regulatory and policy advisory activities which are presently undertaken by organisations which contain GTEs should be undertaken by separate bodies.
3. Boards of directors should be established for each GTE with board appointments being made by the shareholding Minister(s) in conjunction with the Premier and Treasurer on the basis of commercial expertise.
4. Subject to any special regulatory conditions, boards of directors should be given the objective of maximising the return on the GTE's assets. Ministers should reward and apply sanctions to directors on the basis of performance achieved.
5. Boards should be given full discretion to hire and fire senior executives and to set their remuneration on the basis of standard commercial practice with the assistance of consultants expert in such matters.
6. Formal contact between shareholding Ministers and boards of directors should be kept to the minimum level required to preserve management autonomy and accountability.
7. Wherever possible, the subsidised functions performed by GTEs should be awarded on the basis of a tender process, with GTEs competing on a commercial basis with alternative providers of the activity or service concerned. The subsidised services provided should be based on a formal contract, involving explicit compensation, between government and the GTE concerned. Cross subsidies within GTEs should be avoided except where they can be justified on commercial grounds.
8. Boards should negotiate an annual "Statement of Commercial Intent" with shareholding Ministers covering the broad scope of each GTE's activities, targets against which commercial performance will be assessed, major financial ratios, and dividend policy.
9. Clearly-defined and well understood information reporting requirements based on private sector practice for wholly-owned subsidiaries should apply to GTEs. Sanctions should be applied in the event of unsatisfactory information disclosure.
10. Specialist private sector analysts should assist officials in monitoring and assessing GTEs' commercial performance. Monitoring should involve evaluating information provided through official reporting channels and continuous analysis of other information relevant to the assessment of comparative performance.

Points 1 to 7 are designed to achieve clear objectives, and management authority and accountability. Points 8 to 10 provide for Ministerial responsibility to Parliament and recognise that the boards of directors of GTEs are subject to considerably less market-based monitoring than the boards of comparable private sector organisations.

Specified arrangements for setting targets and providing information on performance, and the use of professional analysts in continuous performance assessment, are designed to substitute for the ongoing assessment of comparative performance which occurs in the private sector through the share market.

The reforms outlined above would be likely to greatly strengthen the incentives for GTE directors and managers to maximise the market value of the government's investment in GTEs. However, they will not necessarily improve overall efficiency unless GTEs face efficient price signals in their input and output markets. The initiatives which are required to complete corporatisation are outlined below.

1. The exemption of the senior executives of GTEs from the Statutory and Other Officers Remuneration Tribunal and changes to bring the labour market arrangements of GTEs into line with private sector practice.
2. The termination of all captive government business received by GTEs. Normal commercial criteria should apply in government's selection of suppliers and service providers including, where appropriate, the social activities it wishes to supply through commercial organisations.
3. The introduction of an explicit fee for GTEs for the government guarantee of GTE debt. The proceeds of such a fee would accrue to the consolidated fund. The fee should be set on case-by-case basis using a specialist agency to assess the credit rating of each GTE on the assumption that there is no government guarantee of GTE debt.
4. The adoption of arrangements which enable GTEs to raise the equity capital required to finance investment opportunities which are expected to at least achieve the relevant market rate of return.
5. A thorough analysis of the optimal regulatory environment for each GTE with a potentially harmful degree of market power (e.g. natural monopolies such as the Water Board). Following a comprehensive study of each industry concerned, an explicit regulatory regime (e.g. for prices charged) should be established for each industry, with GTEs being given the objective of maximising returns within the restrictions imposed by the regulatory environment.
6. The making of representations to the Loan Council to exempt GTEs which have been fully corporatised from the global borrowing limits.
7. The application of a neutral tax environment for GTEs.

The sequence with which the reforms are introduced is critical. If the reforms are not introduced as a complete package there may be benefits in adopting special transitional arrangements until the entire package is in place. For example, complete managerial authority should not be introduced until high quality incentives for performance by boards of directors are established and directors of requisite quality have been appointed. If other elements of the reform package are implemented before this is achieved, consideration should be given to retaining some detailed management controls for a transitional period. Similarly, for the reasons outlined above, commercial objectives (i.e. rate of return on the government's investment) should not be introduced until a level playing field is established in GTEs' input and output markets.

The reforms required for competitive neutrality, together with those required to establish vigorous commercial behaviour by GTEs, represent a mutually reinforcing package. The establishment of efficient price signals for GTEs validates the establishment of commercial objectives for GTEs. It is also central to the assessment of GTE performance against private sector norms and establishing effective incentive structures. Because of the breadth and consistency of the reform, it would be likely to greatly improve the economic performance of GTEs and thereby raise standards of living in NSW. However, if major difficulties are experienced in implementing corporatisation, it may be necessary to subject GTEs to further market disciplines to achieve these benefits.

**FINANCIAL AND ADMINISTRATIVE REFORMS OF THE PUBLIC SECTOR
UNDERTAKEN TO DATE IN NEW SOUTH WALES**

1978 Management Strategy Reviews

In 1978 the Government undertook a long-term program to review progressively the objectives, activities, organisational structure, management procedures and future strategies of individual departments and authorities. The purpose of such review is to ensure that public bodies comply with government priorities and effectively serve community needs. The reviews are undertaken by private management consultants.

1980 Efficiency Audits

An additional feature of the government's management review includes assessing the efficiency with which departments and authorities administer their tasks. This is undertaken by a special section in the Public Service Board (now Office of Public Management). Since commencement of efficiency audits in 1980, seventy-five have been completed.

The scope of audits has been extended to incorporate program appropriateness and effectiveness as well as economy and efficiency.

Nov, 1981 Borrowing and Investment Powers

In 1981, the Government rationalised the borrowing powers of statutory authorities, bringing them all within one act and its associated regulations. This act was recast in 1987 as the Public Authorities (Financial Arrangements) act. The new act updated the 1981 legislation to take account of the great changes in financial markets in the intervening five and a half years. It also provided machinery for a rationalisation of the investment powers of authorities, in a similar way to the rationalisation of borrowing powers provided for by the 1981 legislation. An investment advisory committee comprising investment experts from the private and public sector, has been established to advise the Treasurer on the application of the new legislation, particularly with respect to the types of investment powers appropriate for individual authorities, the criteria for the appointment of funds managers from the private sector and assessment of investment performance.

May, 1982 Monthly Financial Statement

Since May 1982 a Niemeyer Statement has been published each month showing the receipts, payments and total cash and securities balances of payments and total cash and securities balances of the State Government for the financial year to date. To assist the public in interpreting the statement, the Treasurer attaches a written explanation of variations in receipts or payments from budget. A supplement in the Government Gazette setting out receipts and payments is published on a quarterly basis to assist detailed interpretation of budgetary trends.

July, 1982 Program Budgeting

The State Budget processes have been changed to facilitate analysis of departmental expenditures and staffing in terms of programs and activities. This gives government greater control over the priorities of its expenditure so that it can be more selective of its expenditure in promotion or pruning of government functions, programs and activities.

The Treasurer announced the introduction of program budgeting in July 1982. From 1983-84 to 1985-86 budget estimates of all departments were presented in program budget format for the information of Parliament.

In the 1984-85 budget, six administrations were appropriated on a program basis. This represented the first stage of formal implementation of program budgeting with a further seven administrations appropriated on a program budget basis in 1985-86. All departments have been appropriated on a program basis since 1986-87.

Sept, 1982 Revamped Budget Papers and Public Accounts

The improved presentation of these documents has facilitated greater public understanding of the State's finances. The Budget Papers were first expanded in 1982-83 when substantial additional explanatory material was added. Since 1982-83 there has been an ongoing revision of the format of the Public Accounts. Each year up until 1985-86, a further substantial revision has taken place, which has resulted in the elimination of much of the detailed information concerning payments. Detailed information is available in either department annual reports or in the Budget Papers. As with the Public Accounts and Annual Reports, the payments from the previous year shown in the Budget Papers are certified by the Auditor General. Following a review of the nature and purpose of all accounts within the Special Deposits Account, the format of the Special Deposits Account section within the Public Accounts has been changed to clarify presentation.

Oct, 1982 Improved Financial Monitoring

Since the 1982-83 budget, departments have been providing Treasury each month with forward estimates of their expenditure. From 1986-87 they also provided projections on staffing. These procedures allow better monitoring of the progress and likely outcome of the annual budget. In the case of the larger spending administration (e.g. Transport and Health), the Treasurer meets regularly with the responsible Minister and officials to review financial operations. In 1987, the Treasurer extended these meetings to include the Education, Police and Youth and Community Services administrations. Departments have been given increased flexibility in transferring funds between programs, so as to encourage more efficient resource use.

Nov, 1982 Reformed Parliamentary Public Accounts Committee

In 1982 the Government legislated to widen the powers of the Public Accounts Committee so that the financial operations of government Departments and authorities could be subjected to closer Parliamentary scrutiny. At the request of Ministers the Committee has already prepared important reports on particular aspects of government which have resulted in significant savings and improved procedures. Other reports of the Committee have examined the superannuation liabilities of statutory authorities, the investment powers and practices of statutory authorities, and performance review practices in government departments and authorities.

1983 Restructuring of Statutory Authorities

The Government has taken specific action to restructure the Public transport authorities, the State Bank, Government Insurance Office, Electricity Commission, the Water Board and Maritime Service to separate the day-to-day management of these bodies from policy responsibility. The new arrangements enable the relevant Board to concentrate on policy and chief executives to be responsible for ongoing management - a division of responsibility and specialisation of tasks consistent with modern management practice. New legislation has also been enacted to enable the GIO to become more commercially based in its operations.

May, 1983 Capital Works Ministerial Committee

A Capital Works Ministerial Committee was established in May 1983 to set priorities in the Capital Works Program and ensure co-ordination of projects undertaken by different departments and authorities. The Treasury and the Premier's Department unit servicing the committee have developed a centralised computer data bank on all capital works which facilitates monitoring of progress on individual projects.

June, 1983 Treasury Corporation

The New South Wales Treasury Corporation was established in June 1983 as the State's central borrowing authority for raising funds on behalf of all semi-government authorities and electricity county councils as well as providing short term bridging finance and an investment facility for authorities. The initiative was directed at achieving a more efficient and co-ordinated approach to loan raisings as well as creating a more marketable security and hence minimising borrowing cost. The Corporation has undertaken borrowings in Europe, Japan and the Eurodollar market. In its five years of operation the corporation has established itself as one of the leading public sector borrowers, achieving an overall borrowing cost at a very fine margin over the relevant Commonwealth bond rate.

Nov, 1983 Public Finance and Audit Act

In November 1983 the Government replaced the Audit Act of 1902, the principal legislation governing administration, accounting and auditing of the state's finances. The new Public Finance and Audit Act emphasised accountability, strengthened financial control and introduced flexibility. It has led to improved and more efficient financial administration procedures. A special feature of the Act is a new emphasis on internal audit.

May, 1984 Annual Reports Legislation

The development of uniform accounting and timely reporting standards for departments and statutory authorities is essential for proper parliamentary and public scrutiny of their activities. Increasing the accountability of government administration encourages more efficient and effective use of scarce resources. An Annual Reports Act covering statutory authorities was passed by Parliament in May 1984 and in November 1985 for departments.

May, 1984 Internal Audit

Treasury guidelines for internal audit of financial and related operations were issued to all government bodies in May 1984.

A central internal audit bureau attached to Treasury undertakes audits of certain small departments and authorities on a fee for service basis.

July, 1984 Program Evaluation

Procedures for the adoption of comprehensive management auditing, whereby departments and authorities undertake regular reviews of the efficiency and effectiveness of their programs, were adopted by the government in July 1984. A special unit was established in the Public Service Board to provide training and assistance to departments on conducting program evaluations. Departments and authorities have prepared five year plans covering evaluation of nearly all their activities.

July, 1984 Special Deposits Account

Following a review of all special deposits accounts within Treasury, the Government decided that generally each department or authority should operate through only one account for non-Consolidated Fund transactions.

As a result of this decision the Special Deposits Account was streamlined with several dormant accounts abolished in line with recommendations of the Auditor General. Overall, the number of accounts has been reduced by about 100 to around 250.

A further stage of the ongoing review process relating to the treatment of Commonwealth payments resulted in the channelling of State related payments through the Consolidated Fund in 1986-87.

As from 1 July 1987, the Road Transport and Traffic Fund within the Special Deposits Account was closed and the transactions of this fund reflected through the Consolidated Fund.

The trend flowing from these reviews is to reduce the number of accounts outside the budget and to increase the passage of government expenditure and revenue flowing through the budget, thereby increasing Parliament's control over annual expenditure.

July, 1984 Computerisation

The Government initiated a very large program of improved administration through the use of modern technology.

Many departments upgraded their accounting equipment in 1984-85 using microcomputer hardware bought under a government-wide contract together with special accounting system software developed by the Public Service Board to Treasury specifications. Computerisation of other government functions is also proceeding quickly with \$28 million made available for such purposes within the budget sector in 1985-86, (almost triple the amount spent in 1984-85) \$30 million in 1986-87, \$45 million for 1987-88 and \$75 million for 1988-89. Development has continued on new computer projects including computerisation of land titles; records of births, deaths and marriages; court records of writs and judgements; processing of licences for factories, shops, hotels and irrigation water; engineering and architectural design and drafting; records of TAFE enrolments and examination results; administration of the Community Employment Program and Youth Employment Scheme; prison and police records; registration of heritage properties; integrated information system, Department of Finance and simplification of licensing systems in Department of Industrial Relations and Employment.

1985 Management Improvement Plans

The Government announced the introduction of management improvement plans in 1985 to achieve greater organisational efficiency and effectiveness by departments. The plans involve setting specific objectives and targets for organisations to achieve over a set time period. The areas to be covered include procedures, performance and productivity measures, career and systems development, streamlining administration and regulation.

May 1985 Early Advice on Budget Allocations

Because of past reduction in Federal Government funding and the limited scope for raising taxes, it has been necessary for the State Government to maintain vigorous control over its recurrent expenditure. To give Ministers as much notice as possible of forward expenditure limits, in May 1985 it was announced that individual departmental allocations would be provided to departments in June each year to give them a full year to adjust their expenditure programs.

July, 1986 Financial Performance Targets and Dividends

The Premier announced in July 1986 that a dividend requirement would be introduced for the government's major business authorities. The dividend policy is an element of a financial target system being introduced to further improve the efficiency of the Government's business authorities.

The other elements of the system will be:

- ◆ target rate of return on total assets as the primary expression of financial performance; and
- ◆ strategic planning and other performance targets.

Dividends were levied on three authorities under this policy in 1986-87. Interim dividends were again levied in 1987-88 while reporting arrangements and rate of return targets are being finalised.

1987 Development of Management Skills in the Public Sector

One of the initiatives set out in the Government's Economic Development Strategy is to improve the standard of management in the public sector. A Management Development Branch has been established within the Public Service Board (now Office of Public Management) to pursue this aim.

The Management Development Branch will evaluate the senior management development needs of public sector organisations and assist them in formulating management training programs emphasising corporate aims and strategies.

1988 Commercialisation of Central Service Agencies

Agencies which provide services to other departments (e.g. cleaning, courier) will be placed on a commercial footing so that they will fully recover costs from charges made on the users. This will remove such agencies from the inner budget sector since they will no longer receive direct budget appropriations. Ultimately it is intended to expose most of these agencies to competition from alternative sources of supply.

1988 Apportioning Government Overheads between Departments

All major government overheads, such as debt charges, employer superannuation contributions and payroll tax will be charged directly to departments and their programs. Currently, most of these charges are paid on departments' behalf by Treasury.

1988 Commercial Activities

Departments will be permitted to operate commercial activities (i.e. self funding or profitable), separately from their social (i.e. subsidised) programs. Earnings from a commercial activity will be retained in a departmental working account and not paid into the Consolidated Fund. Such activities will be considered to be off-budget since they do not require Parliamentary appropriation.

APPENDIX 2

EXPOSING GTEs TO FURTHER MARKET DISCIPLINES

There are a range of options available for increasing private sector monitoring of GTEs and strengthening the incentives for sound performance provided by the capital markets. Several of these are briefly discussed here.

The issuance of non-voting equity shares in GTEs enables government to retain control while creating incentives for share market monitoring of GTE performance. This mechanism was used by the Bank of New Zealand last year when the Bank raised new equity by issuing non-voting equity securities representing 13 percent of its expanded capital base.

The performance of GTEs with non-voting equities outstanding would be subject to continuous monitoring by professional analysts employed by stockbroking firms, investment companies and institutional investors. Share price movements, in conjunction with the level of dividend payments, would provide a relative measure of the gross returns on the government's investment.

The performance of directors and managers of large GTEs with non-voting equities on issue would also be subject to review by private sector analysts and investors. Managers and directors would be well aware that significant resources were being devoted to gathering and analysing information on their organisation's commercial activities and results. Much of that analysis would become available to Ministers and the wider public because of the difficulties of protecting property rights to such information. As a result, monitoring by private sector analysts would be likely to strengthen GTE managers' incentives to maximise the value of the government's investment.

The information provided by the share market would also assist government's monitoring agents in evaluating GTE performance. It would enable government to efficiently harness private sector expertise in information gathering and analysis. Non-voting equity securities would also provide the managerial labour market with a low cost source of information on GTE managers and would permit the use of market instruments, such as share options, in remunerating GTE managers.

The NSW Government does not have a Policy of widespread privatisation and does not propose to use corporatisation for that purpose. For that reason, in order to provide the best possible incentives for efficient performance while retaining government control, it may be desirable to create minority private shareholdings in GTEs.

The sale of less than 50 percent of a GTE's equity in the form of voting shares is a further means of exposing GTE management to share market monitoring without government losing effective control. However, in itself, the granting of voting rights is very unlikely to significantly improve GTE's performance as long as government exercises its controlling shareholding and is expected to continue to do so.

If government credibly signals its intention to not exercise control, the incentives facing GTE managers may be improved significantly if managers feel exposed to the threat of replacement through a takeover. This has been the situation with Fanmac Ltd, the mortgage corporation in which government has a 26 percent equity stake. Fanmac was established under the leadership of the NSW Treasury, but the Secretary of the Treasury stood down as Chairman after the corporation had been successfully established and made it clear that the government would not use its large shareholding (which exceeds that of any individual private equity holder) to exercise control over the operations of the entity. However, as long as government remains in effective control of GTEs the risk remains that it will interfere in their commercial activities or step in to prevent a partial takeover designed to replace underperforming management. The expected future economic losses arising from such actions will be capitalised into the price investors are willing to pay for shares at the time they are issued.

Non-voting shares and government control of partially privatised GTEs protect incumbent management teams and boards of directors from the threat of replacement through the takeover market. In the private sector this is the key means of controlling management incentives in the event that the firm's internal control mechanisms break down or fail to operate effectively. Ongoing government ownership also means that the implicit government guarantee of GTE debt will be retained with the associated reduction in pressures for performance from bond markets.

Full divestment by government may be necessary if the maximum benefits of the incentive and monitoring advantages associated with private ownership are to be realised. However, in NSW the Government has ruled this option out as a general solution to GTE inefficiency. As long as government retains a significant shareholding in an organisation, rigorous surrogate monitoring mechanisms will be required.