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Question:

The Crown holds a large array of different assets, covering three broad portfolios:

- Commercial Assets
- Financial Assets; and
- Social Assets.

For more information on these asset classes see the 2010 Investment Statement of the Government of New Zealand.

Discuss the principles you think the Crown should apply in determining what assets it should own, what it should sell, and what it should invest more in, providing examples and the rationale for your conclusions.

Introduction

The Crown's overarching objective is to utilise its resources to increase the living standards of New Zealanders (New Zealand Treasury, 2013). This paper develops principles based on institutional economics and agency theory as to what assets the Crown should hold, invest more in, or dispose of, to achieve this objective.

Discussion

Ownership provides the residual right to control the asset, however the right to use the asset can be secured without ownership e.g. through contracting (Evans, Guthrie, & Quigley, 2012, p. 10). If the asset is necessary to deliver outcomes, and is available by other means without tying up the Crown's capital then the resources invested in the asset can be released to the highest and best alternate use. As at June 2010, the opportunity cost of capital was $18 billion per year or 25% of general government spending, a significant investment (English, 2010, p. 2). If a greater return on this investment can be achieved through utilising these funds to increase living standards, then as a general principle Crown should not invest further in assets, and divest its assets wherever possible. Ownership is a means to achieve societal outcomes and not an end in itself.

Theoretical support for reduction in the Government's asset portfolio is founded in the institutional economics, particularly agency theory and transaction cost economics. These theories provide the foundation to reorganise public sector management (what it owns and manages) by introducing incentives frameworks which increase performance and align managerial objectives with Government outcomes. These theories also identify issues including those of asymmetry of information between parties, existence of moral hazard and adverse selection in contracting and management, and the importance of competition and contestability (Evans, Guthrie, & Quigley, p. 4; Scott, p. 33). These are key considerations in developing principles to determine which assets should remain in public ownership.

The theories also explain why the costs of ownership and therefore the cost of provision of services provided through utilisation of assets may be higher or lower when provided by the public sector. Costs of production vary as a result of the differing institutional arrangements existing in the public and private sector. These variations in cost allow the Government arbitrage opportunities if private firms are able to organise themselves in ways which provide greater public value than what the public sector is able to achieve through its own institutional arrangements. For example, public sector may have a tendency to be risk adverse and overcapitalise or retain surplus assets, whereas private sector may be more likely to develop and maintain assets to meet minimum acceptable need so as to generate maximum return. Though the latter may also lead to what is referred to by Hart as "quality shading" i.e. where cost and quality are reduced by the private provider in ways unintended by the Crown, e.g. electricity blackouts occurred in Auckland as the electricity supplier underinvested in maintenance (Evans, Guthrie, & Quigley, p. 27; Hart, 2003, p. 71).

Therefore living standards may be increased by releasing public sector capital from assets into areas where it achieves a greater return. This may also reduce the Crown's operating costs where the private sector is better able to reduce total costs of ownership through its own institutional arrangements.

However, the Crown has substantially different objectives to those of the private sector. The private sector acquires assets in order to generate maximum return for the shareholder, whilst the government acquires assets in order to meet societal objectives. Only in limited cases, the Crown holds assets to generate financial return and consequently many of the assets it owns are of a specialised nature e.g. defence equipment, or are used to achieve societal goals such as environmental sustainability e.g. conservation land. Even commercial assets such as State Owned Enterprises have mixed objectives, and are not singularly focused on achieving a particular hurdle rate of return.

If public sector assets were to be transferred to private ownership, issues of agency would arise in areas where the government's objectives are not aligned with those of a private provider. Contract specification and regulation can be used to align incentives however contracts will always be incomplete and this may give rise, as noted above, to issues of quality shading and rent seeking.

The mere sale of assets to the private sector may also have unintended adverse effects for the Government's balance sheet. For example, conservation land could pass to private sector if the Government's conservation objectives could be preserved through clear specification in contract or through regulation. These limitations in use however would be reflected in the price paid for the asset, which is likely to be materially different to the value presently recorded on the Government's balance sheet. In turn, this would lead to a large write down of the asset's value, lowering the Government's net equity. Credit ratings may be affected as net asset backing is reduced.

Principles of Ownership

These theories can be used to develop a number of principles which can be used to determine whether assets should remain in government ownership. These are as follows: [1]

1. Existence of a Competitive Market: The Crown should divest / not invest in assets where there is competitive provision of similar assets in the private sector. Institutional arrangements in the private sector are likely to lead to lesser costs of provision, reduce the risk to the Crown of over-investment, and provide flexibility to the Crown to meet changing needs e.g. office buildings.

2. Innovation: Institutional arrangements in private sector promote innovation by providing incentives to increase returns on assets. Consideration needs to be given whether private sector ownership will improve the quality of the asset and associated service provision utilised by Government.

[1] Note that, although not to be taken into account whilst formulating policy advice, acceptance of recommendations and implementation of advice on asset ownership will depend on the ideological preference of the elected Government.

3. Contract Specification: Where asset ownership is required to provide an output which cannot be efficiently specified in a contract then the risk of quality shading and rent seeking needs to be considered. In these circumstances, transaction and agency costs increase (National Infrastructure Unit of the Treasury , 2009, pp. 10-11). If these risks and costs are significant then these assets should remain within Crown ownership as it is more likely that the output associated with the asset will not be delivered, or delivered in a way that will not achieve intended outcomes (e.g. output delivery at an efficient price).

4. Assets in Transition: Some assets may be held where the net present value of the future cash flows exceed the value the private sector places on the asset. This may be because of economic conditions such as recession. Such assets are referred to here as assets in transition, meaning they are to be held until they can be sold and full value realised.

5. Moral Hazard and Allocation of Risk: The Crown retains residual risk relating to failure by the private sector to deliver outputs associated with assets. The risk that the Government would be required to offer a bailout to private firms post asset transfer needs to be considered. Assets should remain in public ownership if private providers are unable to provide appropriate indemnity to the Crown in the event of a failure. This is a particular issue with privatisation of key infrastructure assets. Lessons learned from Tranz Rail and Toll Holdings, show that these companies were able to extract returns by running rail infrastructure down, and leaving significant liabilities for the taxpayer to address. Such effects may not be able to be mitigated through contract specification or regulation whilst the asset is in private ownership (NZPA, 2003).

6. Holder of Last Resort: The Crown may be holder of an asset as owner of last resort where the private sector will not invest in the asset type, or will only invest if excess returns are received. For example, private sector may not be willing to invest in assets which may be destroyed at war. Further, the private sector may not be able to insure its interest in such assets. From the public sector view, the Crown may not be willing to compensate the private sector by providing excess returns commensurate with risk to the private sector for investing in such assets and can enjoy lower cost provision by the Crown continuing to own the asset.

7. Treaty of Waitangi Obligations: Crown will need to retain certain assets to meet its obligations under the Treaty of Waitangi.

8. Other Considerations: Some assets may require to be held to diversify portfolio risk, as well ensuring there is liquidity in the portfolio to match the duration of its liabilities (English, p. 7).

Application of Principles to Asset Types

Using these principles, the following conclusions can be drawn as to asset ownership:

Commercial Assets

This category includes assets all sixteen SOE's and the stakes in Mighty River Power and in Air New Zealand (English, p. 70). With the exception of monopolies such as Transpower, some parts of NZ Post and the New Zealand Railway Corporation, there is a contestable market for the goods and services provided by commercial assets. In these cases there is a strong case that these assets should be sold to private interests, and further assets of this nature should not be invested in.

These assets are already run with a profit objective, and innovation is already apparent However whilst these assets are in public ownership, restrictions on the Crown on capital for further investment and structure of managerial incentives may be limiting factors in profit growth (and reflected in higher charging for service delivery to consumers). Hence more effective service provision may be made by private sector ownership (English, p. 10). Contracting by the Government for service provision would not incur significant agency costs. Issues of moral hazard must be considered in terms of risk, and possible risk mitigation. SOE's that hold significant land assets such as Landcorp must be retained to settle Treaty of Waitangi obligations (Landcorp, 2013).

Financial Assets

This category includes assets such as NZSF and ACC. These funds should be held by Government as a result of the inability of the Government to specify contracts which control private sector policies and processes in governing and managing the funds. Private sector incentive structures such as bonus payments may drive risky behaviours placing Crown funds at risk, poor policies and procedures may result in rogue behaviour which the Crown is unable to monitor. These risks could lead to unacceptable loss to the Crown. Policies and processes to manage these funds should remain under the direct control of the Crown and be subject to audit.

Social Assets

If similar assets are owned in the private sector and there is existence of a competitive market then there is an opportunity for sale of these assets to the private sector. This would free capital and allow reallocation of capital to be invested into programs which achieve increase living standards. It may also reduce Government liabilities which attach to the asset e.g. the Government owns leaky school buildings and is now liable for repair at a cost of $1.5 billion, diverting capital away from investment in areas which increase educational performance, such as teacher quality and smaller class sizes (Tait & Jones, 2013).

However, there may be significant issues of agency in sale or transfer of assets to private sector. Outputs or/and outcomes are not easily specified and monitoring costs and capability are an issue. The latter leading the Auditor-General to comment that the capability of the Government to monitor contracts in the public sector may be lacking and this would lead to inferior completion of governmental outcomes (Controller and Auditor-General, 2011, p. 22).

Removing assets related to key social services from public sector, may diminish the ability to the Government to change policies after an election or through unforeseen circumstances. Renegotiation of contracts may costly. These aspects can lead to inflexible governing arrangements and opportunities to rent seek. These assets would need to be considered on a case by case basis.

Conclusion

In conclusion, by applying these principles the government will be able to free up capital allowing the Crown to achieve an optimal asset mix and reallocate resources to increase the living standards of New Zealanders.

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