ROUTLEDGE REVIVALS

From Bureaucracy to Business Enterprise

Legal and Policy Issues in the Transformation of Government Services

Edited by

Michael J. Whincop

FROM BUREAUCRACY TO BUSINESS ENTERPRISE

To Goldie, with love

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Legal and policy issues in the transformation of government services

Edited by

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2003 by Ashgate Publishing

Reissued 2018 by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN
711 Third Avenue, New York, NY 10017, USA

Routledge is an imprint of the Taylor & Francis Group, an informa business

A Library of Congress record exists under LC control number: 2002028114

ISBN 13: 978-1-138-71766-4 (hbk)
ISBN 13: 978-1-315-19598-8 (ebk)

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Preface

Increasing the efficiency of delivering government services has been a policy imperative felt by virtually every government in the world. In industralised Western nations, many policy instruments have been used. These include privatisation, competitive tendering for government procurement, increased transparency and accountability through administrative law processes, and the 'corporatisation' of government service delivery. Corporatisation involves organisational reforms to a government bureaucracy delivering services so that it is exposed as nearly as possible to the incentives and disciplines of a private firm. These themes have also played themselves out in economies emerging from state control, with varying degrees of success.

Some, including the ideologues of the Right, hailed these developments as a triumph over the forces of statism. However, if we expand our study beyond the restricted compass of our own generation, we might aptly conclude that these developments are but part of a cycle between market and state in which related problems recur and are solved imperfectly. Events as diverse as the recent woes of the British rail system, and the malaise of rural Australia foreshadow a return at the margins to greater levels of state control.

The chapters in this book do not therefore begin with any normative commitment to delivering essential services in one way or another. Rather, they study the neglected question of the governance processes (in the widest sense of that term) applying to corporatised governmental enterprises. Ethics, economics, public choice theory, and corporate governance scholarship are used to examine the dangers of uncritically assimilating the norms, laws, and practices of either public governance or private firms.

The chapters that make up this collection were developed in an interdisciplinary workshop, and presented to a conference audience in Brisbane, Australia in July 2001. Financial assistance in respect of the workshop and the larger research from which my own work is drawn was provided by the Australian Research Council and Queensland Treasury under a SPIRT Grant. I wish to thank my research assistants, A.J. Brown and Jon Leckie, as well as the administrative staff of the Key Centre for Law, Ethics, Justice and Governance, under Lynette Farquhar's incomparable direction, for their adept organisation of the conference and workshop.

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Chapter 1

Introduction

Michael J. Whincop

During the 1980s and 1990s, governments around the world critically examined their role in the delivery of services. A series of radical policy shifts occurred. In the liberal democracies of the Western world, there was a backlash against the idea of 'big government', culminating in privatisation programs and the reorganisation of government programs. In former Eastern bloc economies, the industrial organisation of production was restructured by substituting property rights and market transactions for central planning. At a global level, all of these programs were seen as the ascendancy of markets over government provision. Below the surface, however, the aims, methods, and extent of these programs diverged. Although economic ideology played an important role, specific factors in local economic and political equilibria influenced the translation of ideology into policy. For example, the fervour for privatisation was shaped by the fervour for nationalisation in previous generations and the extent of the malaise in nationalised industries. The devil was, as always, in the detail.

In the 1990s and the early years of the new millennium, there has been a backlash against this ideology of markets and competition. Cracks have begun to show in various places. Various anecdotal experiences are in point. In New Zealand and California, crippling failures in electricity supply in private, regulated industries have shaken popular faith in competition. In Australia, the microeconomic reform processes inspired by National Competition Policy have only served to ignite a wick of opposition to 'economic rationalism' by a loose alliance of malcontents (such as rural industries and the urban poor) and populists. In the United Kingdom, the spectacle of appalling rail crashes has put nationalisation back on the policy table, at a time when Baroness Thatcher remains a significant figure in British public life. Helping to unify these local experiences are international trends, such as the literally violent opposition to the globalisation of trade and the bodies sponsoring it. Even those defending the existing economic institutions have conceded that the entities delivering essential services, privatised or not, must be accountable in the *public* interest, not just to their shareholders.

Whether or not there is merit in these policy trends, they suggest that moves from markets to government provision occur within a larger cycle. This suggestion is confirmed by experiences in previous generations – concerns regarding efficiency, accountability, and the public interest have recurred constantly in policy debate (Brown, this volume).

The cyclical oscillation between public provision and market procurement, and between efficiency and accountability, focuses scholarly attention on the governance of the firms and enterprises delivering essential services. A study of governance is important because it demonstrates first how, in practice, public interest considerations, efficiency, and private interest group concerns are reconciled. Second, it illustrates how credibly a government has committed to a particular balance between these considerations. Luigi Zingales (1998) states that corporate governance is the set of constraints on how parties to a contract divide its economic surplus, and on the capacity of parties to renegotiate the allocation of surplus. By analogy, a study of governance in the provision of essential services shows the constraints on the government in attempting to alter, in a different political environment, a balance between efficiency and other considerations.

This book examines governance in government business enterprises (GBEs) and, in particular, government owned corporations (GOCs). The GBE is an organisational arrangement internal to government which organises the delivery of essential services, utilities, infrastructure, and other business services as a discrete operational unit, separate from regulatory or policy-making functions. As a discrete unit, it becomes possible to examine the extent to which the GBE is recovering its costs, and the magnitude of any implicit subsidy its operations afford. GOCs are a subset of GBEs which are given a mandate to operate commercially and to maximise the value of the firm while remaining in government ownership. The process of creating a GOC – dubbed *corporatisation* – usually aims to emulate some of the governance processes applying to corporations with exchange-traded stock. These processes include the autonomy of the board of directors and management, subject to explicitly defined governance entitlements of the executive government.

The study of GBEs and GOCs is important for two reasons. First, much less has been written about governance in GOCs than the other organisational and contractual devices used in modern service delivery, such as privatisation and competitive tendering (for example, Graham and Prosser 1991; Rimmer 1994). Most economic analysis examines the productive efficiency of GOCs (MacAvoy *et al.* 1989), rather than taking a microanalytical approach to their governance, despite the many fascinating comparisons that could be made with the governance of privately owned corporations. There is almost *no* law and economics literature on the GOC, and most legal scholarship is restricted to doctrinal analysis.

Second, the current political environment suggests that the GOC may be an important locus for service delivery. In the 1980s and early 1990s, the GOC was seen as a transitionary stage between bureaucracy and privatisation. In the current environment, however, public interest concerns suggest that the trade-off between efficiency and the public interest inherent in the GOC may be a more feasible political equilibrium than either a regulated, privatised firm, or to a bureaucracy situated within a government department.

To recognise the existence of a trade-off between efficiency and the public interest implies that it will rarely be possible to examine GOCs solely in terms of a narrow economic efficiency calculus. Demands will be placed on the GOC that are not just hard to measure, but sometimes hard to articulate formally. The chapters in this book bring wide-ranging theoretical material to bear on GOC governance. The principal discipline is economics, but the contributors to this volume also make use of management theory, ethics, public choice theory, and public administration – moreover, the economic analysis often reveals how different modeling assumptions lead to contrasting conclusions. Nonetheless, these diverse perspectives sound a surprisingly unanimous note of caution. *To attempt to govern GOCs in a manner that emulates, as much as possible, the behaviour and regulation of private corporations is only occasionally optimal.* The idiosyncratic properties of GOC governance require specific identification and analysis; analogical solutions are rarely appealing.

A Theoretical Model of the GOC

We need to understand the differences in the stakeholders associated with private corporations and GOCs, and how these impact on the proper objectives of a system of corporate governance. The 'classical' private firm is a bilateral arrangement between a principal and an agent. The principal must find the optimal contract to encourage the agent to maximise the value of the principal's investment in the firm. The principal's incentives in choosing the contract, and the governance mechanisms it requires, correspond closely to social welfare. The principal bears the residual wealth effects of the contract chosen, and by maximising his wealth he should maximise social welfare (Jensen and Meckling 1976). Since the historic work of Berle and Means (1932), it has been recognised that, where the principal is a highly diffuse body of shareholders, the incentive to choose an optimal contract and take actions when required may be distorted by the effects of collective action problems. Various market effects, however – such as the capital market and the market for corporate control – limit the scope for self-interested behaviour by managers. The government assists this process by providing standard form contracts that decrease the transaction costs associated with selecting contracting and corporate governance processes (Easterbrook and Fischel 1991). Every corporation has a range of non-equity stakeholders (such as employees and creditors), but their interests rarely figure in corporate governance processes. Stakeholders with low transaction costs are better off relying on explicit contracts than the collective processes of the board, and those with high transaction costs can rely on tort law and other legislation.

Shareholders vary in their involvement in corporate governance (Roe 1994). Institutional shareholders holding substantial blocks of equity, such as pension funds and other financial institutions, are less likely to act passively. They are more willing to vote, to interact personally with directors, to make governance proposals and so on. Are the interests of institutions perfectly aligned with those of the other shareholders? Possibly not; the most active institutions in the United States have been managers of public pension funds. These managers act at times more like politicians-in-the-making (Gillan and Starks 1998; Romano 1999). However, there are limits on institutional self-interest – they rely on the support of other shareholders to be effective, and their own performance will be gauged on financial criteria.

The governance milieu of the GOC is different in fundamental respects. First, the GOC's business often partakes of elements of natural monopoly – the sort of consideration that caused it to be publicly owned in the first place. In this respect, the government experiences an inescapable conflict of interest between its interest as shareholder to maximise the value of the corporation (which requires the firm to maximise its monopoly rents) and its duty as guardian of the public interest to maximise social welfare (by setting marginal revenue equal to marginal cost).[1]

Second, many enterprises are located in the public sector in order to permit the pursuit of goals thought socially desirable. An example is providing essential services to rural areas, such as postal services. A firm maximising its value would rarely choose to perform these services. Various devices can be used to address this problem, of which a specifically funded government directive (called a 'community service obligation' (CSO) in Australia and New Zealand) is common. Although this desirably reveals the cost of such social subsidies, it suffers from three problems. Governments may use their power over the GOC to circumvent the need to use the CSO mechanism. They may do this either to conceal the full magnitude of the subsidy for policy reasons or to use the funding in areas with a higher political payoff. In addition, the funding of the CSO is complicated by the monopsonistic aspect of the demand for such services – establishing the opportunity cost of devoting GOC resources to the problem can be difficult. Finally, there is the risk, given both monopsonistic demand and monopolistic supply, that the subsidy provided for the activity funds anti-competitive behaviour by the GOC in other, more contestable market segments. For example, Sidak and Spulber (1996) propose limiting the business of the United States Postal Service to its statutory monopoly over letter mail. This is in order to prevent the use of its monopoly rents to subsidise actions that would undermine competition in other markets (such as express post).

Third, shareholdings in the GOC are economically unique. In the classical firm, the shareholder is the principal, who owns the firm's residual income. In the modern exchange-traded corporation, the rights of institutional investors may be exercised by agents with self-serving motives. In the GOC, the ultimate owners, the public, must also be represented, typically by a member of the executive government – a Minister of State in the Westminster system. Despite the 'agents watching agents' analogy, the difference between an institutional investor and a Ministerial shareholding in a GOC is profound. An institutional investor will always be monitored on portfolio returns, and competes with other institutions on that basis, whereas maximising the value of GOCs will rarely win many votes in the electorate given free-rider problems. Ministers, by contrast, are likely to seek to maximise electoral support, by responding to the demands of well-organised interest groups (Buchanan and Tullock 1965; Peltzman 1976). Interest group politics may affect governance.

It is even unclear what objective function a 'public-regarding' government should maximise in governing the GOC. In private corporations, the contractual nature of investment necessarily selects value maximisation as the objective for managers. But the nature of citizenship in a polity does not carry that implication for GOCs, especially when citizens are consumers of GOC services. Just as citizens are both consumers and investors in GOCs, so too Ministers shoehorn responsibilities as governance agents, regulators, and customers. Those varying responsibilities complicate accountability relations and are apt to enable the governance parameters established for the GOC to be exceeded, either for political gain or public interest.

The government department that a Ministerial shareholder administers also complicates matters. A department bureaucracy will have its own unique interests, such as maximising its budget, or maximising its role in the determination of policy and the application of discretionary funding (Niskanen 1971; Dunleavy 1991). Strategic planning in GOCs may often be distorted by the need to form (or to counter) issue-based coalitions designed to further self-interested aims between the Minister and the department, the GOC and the department, or the Minister and the GOC.

Based on this analysis, we may identify three goals that might desirably be furthered in the GOC. First, the agency costs of management need to be minimised. This is true of all corporations. Overreaching and expropriation continue to be undesirable in GOCs – although the proximity of interest groups to GOCs creates a new category of 'political' conflicts of interest that challenges traditional fiduciary norms (Whincop 2001). Unlike listed business corporations, the GOC lacks market mechanisms that signal its success in reducing these costs.

Second, it is desirable to minimise the agency costs of governance. Ministerial shareholders or other members of the executive government exercise governance powers in GOCs. Although objectives in the GOC are more confused than in private firms, Ministerial shareholders should exercise their power for public-regarding purposes, not for political gain. There is no analogous norm limiting the shareholder's governance power in private corporations (cf. Romano 1999).

Third, GOCs should be constrained from acting anti-competitively, particularly where they operate a natural monopoly. There may be cases where it is desirable for the GOC to expand into new areas of business, but at the least the subsidisation of new operations should be apparent.

It seems likely that there will be relatively few governance mechanisms that serve all three purposes simultaneously. This is especially true for the first and second principles, since strengthening governance entitlements is likely to trade off lower agency costs of management with higher agency costs of governance. For these reasons, the practice of corporate governance in private firms can only be applied to GOCs with care.

An Outline of the Chapters

Chapters 2 and 3 provide historical overviews of the role of corporatisation in microeconomic reform and public administration. In Chapter 2, A.J. Brown develops the idea of a political cycle in the governance of public services, oscillating over time between efficiency and public interest concerns. His chapter reviews a range of governance developments in public administration in Australia, the United Kingdom and the United States over the last century.

In Chapter 3, John Quiggin analyses in more detail the Australian experience with GOCs in the microeconomic reform processes of the last two decades. He makes the case that corporatisation has ceased to be viewed as an interim measure preceding privatisation. He uses economic methodology to examine how corporate governance processes can encourage GOC managers to respond to social interests in addition to the maximisation of value.

In Chapter 4, Stephen King provides an economic analysis of how the behaviour of a corporatised firm varies with the degree of corporatisation. King models corporatisation not as an either/or decision, but in terms of the variability of a manager's remuneration according to the value of the GOC. Because there is no market valuation, but merely a reported valuation, increasing the degree of corporatisation increases the incentive of the manager to substitute activities increasing the reported valuation for activities increasing true value – the former activities crowd out the latter, and may be harmful in their own right. In addition, given the multiple objectives of a GOC, highly corporatised entities have incentives to charge supra-competitive prices, which may decrease social welfare. King shows why corporatisation can never exactly replicate the incentives of a private firm.[2] Finally, King develops a model showing that GOCs with more intense managerial incentives than other forms of GBEs are more likely to act anti-competitively and drive out private competition. Comments on the Quiggin and King chapters by Allan Brown follow in Chapter 5.

In Chapter 6, I study the agency costs of governance, in particular the difficulty of enforcing the governance parameters established to delineate the role of the Ministerial shareholder and the management of the GOC. The Minister may exceed these governance parameters, by appointing a board sharing his policy commitments, backing a statement of his wishes with a credible threat, or reaching an informal deal. I report the results of a survey of GOC directors revealing that the behaviour of Ministerial shareholders is likely to occasion excessive deadweight governance costs without economising on the agency costs of management. I examine some proposals which might permit both forms of costs to be reduced.

In Chapter 7, David Skeel begins by providing a detailed argument for the appropriateness of the three corporate governance objectives in GOCs that are sketched above. He then reviews three proposals directed to achieving these objectives. The first is the increased use of contract-like performance incentives (like King, he expresses agnosticism on just how much these would achieve). The second is to require GOCs to be financed by the use of puttable subordinated debt, to create a source of independent discipline where agency costs of management and governance are excessive. The third is to create, in effect, a stronger board through the use of staggered director terms, which are not terminable at will by the Minister. In Chapter 8, Bernard McCabe comments on Chapters 6 and 7.

In Chapter 9, Maxwell Stearns uses insights from United States constitutional law to demonstrate how standing to litigate can be used as a device by which to limit a GOC using its public subsidy or the rents from operating a natural monopoly to drive out competition. Both King and Skeel raise this matter as a central concern. Stearns illustrates how litigation can overcome the lack of market information concerning the parameters of competitive market behaviour. His point is that to obtain this 'competitively neutral' result, the law must sometimes treat GOCs as if they were private firms, but sometimes needs to do the opposite. Like the normative analysis in Chapters 4, 6, and 7, Stearns highlights that it may often be optimal to treat GOCs and private firms in a functionally non-equivalent manner.

In Chapter 10, Bryan Horrigan continues that theme by demonstrating the problems arising in various areas of the substantive law applicable to the corporate governance of the GOC, when the organisation crosses the public-private divide. One of these is Crown immunity, a topic linked to the more general analysis of anticompetitive behaviour in Chapter 9. The second is the law on directors' duties, having particular regard to the more complex objectives of GOCs. Horrigan also studies aspects of the application of rules of agency, authority, and *ultra vires* to GOCs.

In Chapter 11, Spencer Zifcak addresses the accountability issues arising in industries transformed by privatisation and corporatisation. He focuses on industry ombudsman schemes, taking as his case study the operation of the Energy and Water Ombudsman of Victoria. This scheme has clear 'private' elements, despite the 'public' character of the essential services provided. Zifcak demonstrates its deficiencies in its accountability to the public. Stephen Bottomley comments on these three chapters in Chapter 12, examining the accountability issues linked to the public-private divide.

In sum, these chapters bring a wide range of scholarly perspectives to bear on the corporate governance of the GOC. That analytical diversity renders all the more striking the unanimity of the 'metathesis' of the book – to attempt to govern GOCs in a manner that emulates, as much as possible, the behaviour and regulation of private corporations is only occasionally optimal. It is hoped that the chapters encourage increased attention to the complexity of governance in GOCs, as corporatisation becomes increasingly important.

Notes

1 Evidence suggests that where GBEs operate in competitive industries (for example, air transport or education) they operate as efficiently as privately owned firms (Zeckhauser and Horn 1989). This underlines the difficulties associated with natural monopolies, rather than with government ownership *per se*.

2 That point may reflect Williamson's claim about the impossibility of selective intervention (Williamson 1996).

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Chapter 2

Halfway House or Revolving Door? Corporatisation and Political Cycles in Western Democracy

A.J. Brown

What drives the government owned corporation (GOC)? Let us first consider (and dismiss) three explanations that have dominated recent debate on the subject. Clearly, a GOC is not just about efficiency – it may be expected to maximise returns, but something other than entrepreneurship was also responsible for its creation. Nor is it simply a restructured public service agency. Corporate forms are no more *inherently* accountable than bureaucracies – where one requires political control, administrative law and anti-corruption watchdogs, the other needs consumer protection, enforcement of fiduciary obligations and competition safeguards (Aronson 1997; Whincop and Keyes 1997). Nor, as we shall see, is a GOC created simply to make a bureaucracy a more marketable product for the purpose of divestiture.

None of these economic, legal and management rationales sufficiently explains the governance *purposes* and *priorities* of GOCs. GOCs are not self-directing contractual entities as business corporations are – they begin and end as creatures of public policy. This realisation may perplex those who have relied on corporatisation as a means to specific financial and management ends in recent times. However, it forces us to take a longer view of the history not only of individual corporations, but of broad government involvement in different industries. This is important for two reasons.

First, GOC governance is now at a time of 'policy cusp'. As Quiggin (this volume) stresses, the model of GOC governance that has dominated the last two decades is changing. This not only reopens the substantive merits of policy, but provokes broader questions for those who manage and regulate GOCs. What preceded the present policy phase; what is coming next? Second, besides examining policy change over time, we must also study experiences in different places. Every jurisdiction has its own variations on corporatisation trends, and its own politics impacting on their application. As the empirical evidence in this collection shows (Whincop, this volume), the *realpolitik* of GOC governance may only be truly intelligible at this practical level.

Where does the prospect of further policy change leave those concerned with continual improvement in GOCs? The idea of continually revolving policy doors seems to threaten further instability. Are we to throw out the most recent corporatisation policy model, imported 'off the rack' from New Zealand and the North Atlantic, and seek out an entirely new model again?

This chapter suggests that a practical answer might flow from a reality check on the utility of the current, imported model. Features of this reconsideration have been evident for some time, leading to arguments for 'a well-established theory of organisational life cycles' to inform the rise and fall of different approaches to GOCs (Wettenhall 1995, p. 22). This chapter reinforces that view, arguing such a theory is imperative from a public policy perspective. We must undertake a task omitted by the reformers of the 1980s and 1990s – scrutinise the policy model for principles central to the ongoing task of GOC governance, rather than principles of broader economic reform based on public sector contraction and enhanced competitiveness. This remains a critical step in the revival and revalidation of previous lessons in corporatisation policy, as well as progress in reforming GOC governance.

The first part of the chapter restates the extant conception of the GOC, and uses this to pursue a search for key governance principles underpinning the international policy context. Having found but one principle, the second part returns to Australia to review separate local traditions in public enterprise, and how this tradition came to be lost in the interplay between Australian, British and United States postwar political cycles. The third part of the chapter continues this approach by locating some of the major phases of Australian corporatisation policy against these broad political cycles. The result better explains why recent corporatisation policy seems to have contributed so little to the practical task of GOC management. It also reopens the way to assessing the importance of local experience in advances in GOC governance; and enables GOC managers and regulators to assess future trends in public sector expansion and contraction likely to influence further reform.

The Government Owned Corporation as 'Halfway House'

The 'Halfway House' Metaphor

The conception of the GOC as a 'halfway house' governance system has been dominant in public policy since the late 1980s. It is based on the fact that, by definition, the GOC remains in government ownership, and therefore cannot be regarded as fulfilling the norm, or ideal, of a private company. Nevertheless, it is also defined by the need to ensure that this ideal is approximated to the greatest possible extent. This description is prominent in retrospectives on the policy wave beginning in the 1980s:

> It is certainly true that corporatisation has been a necessary precursor to privatisation in some instances, but in other cases it has been a preferred option. Opposition to privatisation and/or a desire to retain government ownership in particular industries has prompted the growth of corporatised state owned enterprises ... [The 1986 New Zealand] lead has since been followed by countless national and provincial governments seeking an alternative to privatisation or a 'halfway house' approach (Greiner 1999, p. 3).

That is, a GOC is halfway to being a 'full' house, which is a business that has been fully divested – the epitomy of total exposure to the market. This implies a model of business organisation whose new, or renewed, importance is derived from its relative position in this self-styled corporatisation and privatisation 'frenzy' (Greiner 1999, p. 4).