

# Regulatory Governance for Privatisation of Public Utilities: Upholding Regulatory Capacity

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## ABSTRACT

The introduction of liberalisation and public management reforms have arguably led to a shift from 'the entrepreneurial state' towards 'the regulatory state or to a transformation from a 'Keynesian Welfare state' to a more 'Hayekian regulatory state'. The purpose of this study is to explore the relationship between public management reform and privatisation and declares the reasons towards the regulatory state, especially re-regulation for privatisation in public utilities. It also clarifies a number of issues between regulatory governance and privatisation in a broader context. Based on the literature review, it is argued that regulatory governance is crucial to an understanding of the strengths and weaknesses of re-regulation for privatising public utilities to incorporate the missing public value into. In conclusion, this study employs institutional approach to research governance mechanisms for regulation and reveals the significance of regulatory capacity. Given the variety of statements in the field of public management, it is argued that governance mechanisms for regulation, especially regulatory capacity, provides a more effective response than narrow 'traditional' notion of new public management to 'privatisation deficiencies' of public utilities.

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*“Linking regulatory policy with governance will also cement acceptance of regulatory policy as a permanent feature of government and public administration and one that is central to its overall performance and ability to meet citizen’s expectations.”*

*(OECD, 2002: 112)*

## **1. Introduction**

“ Analysis public management reforms must begin with the understanding that this is an area of ‘contested’ concepts” (Minogue, Polidano, & Hulme, 1998: 17). Since the mid-1980s, the emergence of a new approach in the public sector management has been positive response to the traditional public administration. In practice, governments prefer to the business approach borrowed from private sector management, such as downsizing, resource-squeeze, cut-back management, 3Es-efficiency, privatisation, outsourcing, marketisation, quasi-markets, surrogate markets, new public management, contractualisation, customerisation, automisation, and agencification (Wright, 1997: 7). They all believe that public and private sectors are alike in all important respects and the efficient and effective approaches can be adopted in any enterprises.

However, the inventor of the term new public management (NPM), Gladstone Professor Christopher Hood of LSE himself does not to use the term NPM any longer. There are some reasons: firstly, the initiatives that are most characterised as NPM are no longer ‘new’; secondly, NPM is now a ‘over-loaded’ term -- it carries too much negative baggage in that too many people associate it with a particular political perspective or to privatisation or other specific initiatives they do not like. So, to these critics, when someone merely employs the term NPM they

are against whatever is written regardless of evidence; thirdly, the term it is too vague to practitioners and researchers. Those who work in the field of public management understand generally what NPM means to a certain degree, but the concept is not uniformly defined with clarity. Consequently, because NPM means so many different things to so many different people, it becomes so inaccurate and overboard in terms of analysis. So, 'public management reform' (PMR) is used alternatively to give more connotative meaning of NPM. This generic permits scholars to define, without the use of a 'loaded' term, what they are analysing. Indeed these reflections should be addressed to the question of governance mechanisms for regulation in the public utilities<sup>2</sup> which follows the introduction of market mechanisms into previously monopolistic 'public' utilities. This paper explores the relationship between PMR and privatisation and declares the reasons towards the regulatory state, especially re-regulation for privatisation in public utilities. It also clarifies a number of issues between regulatory governance and privatisation in a broader context. In conclusion, this paper employs institutional approach to research regulatory governance and reveals the significance of regulatory capacity. Given the variety of statements in the field of public management, it is argued that governance mechanisms for regulation, especially regulatory capacity, provides a more effective response than narrow 'traditional' notion of NPM to 'privatisation deficiencies' of public utilities.

## **2. NPM and Privatisation**

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2 Network utilities, or mass-market network industries have some characteristics relevant with 'market failure'. They are highly capital intensive, generally long-lived, and sunk assets. They also can be characterised by considerable economies of scale and economies of scope. Moreover, they are consumed by any necessary to the welfare of all households and those services they offer are critically significant intermediate inputs for other sectors of the economy (Newbery, 2001).

As the fashion, NPM has caused a variety of evident changes all over the world and been criticised in many perspectives. The most critical challenge is from new public administration (NPA). Reinventing government (REGO) criticised by Frederickson that it is a popular electoral politics for politicians and is more radical than NPA. Moreover, REGO has less significant issues of rationality, methodology, and epistemology (1996). Kettl (1991) also challenged that the primary long-term legacy of REGO will diminish capacity of government to implement policy or create so-called 'hollow states'. Behn (1998) points out the advocates of the new management of the public enterprise have the burden of providing a correlative concept of 'democratic accountability'. Even though, there are some significant elements and revolutions of NPM in the UK context (see Savage & Atkinson, 2001: 19): it pays great attention to results or outputs and the personal responsibility of individual officials or managers (Hughes, 1998: 52); there is a move from tall hierarchies to flatter more flexible and devolved management structures, with flexible terms of employment (Horton & Farnham, 1999); institutional and individual objectives are clearly defined and include the establishment of key performance indicators against which to measure delivered outputs (Horton & Farnham, 1999; Hughes, 1998); there is greater attention to 3Es; this includes a greater commitment to procedures such as market testing and compulsory competitive tendering (Elcock, 1991; Hughes, 1998); this in turn is linked to a general commitment to reducing the role of government in the disposal of GNP and the provision of services in favour of privatised firms and the establishment of a market in areas previously viewed as the preserve of natural monopolies or public administrators (Hughes, 1998; Massey, 1993). Furthermore, the new paradigm envisions a public sector that will (OECD, 1995: 10): be less involved in direct service provision; concentrate more on providing a flexible framework within each economic activity can take place; regulate better, with more complete information about likely impacts; continually evaluate policy

effectiveness; develop planning and leadership functions to respond to future economic and social challenges; take a more participative approach to governance.

Amongst these approaches, privatisation is seen as a sparkling approach to REGO and introducing market mechanism into PMRs. Privatisation generally refers to policies adopted by the government to reduce the role of the government and enhance private sector involvement in the economy. More specifically, it has been associated with a transfer of ownership of part or all government-owned assets or shares to private shareholders (Beesley, 1997). However, the sale of government-owned assets may not fully explain the concept of privatisation. For Kay, Mayer and Thompson (1986) privatisation also incorporates deregulation and contracting out. The sale of a governmental monopoly to the private firm may not necessarily enhance its performance but could instead turn it into a private monopoly. Deregulation allows the government to introduce measures that encourages the private company to operate more efficiently.

Privatisation was an initiative, first introduced by the Thatcher's government in the United Kingdom in 1979, to change the boundary between the public and the private sector in the economy. In this context, Cook and Kirkpatrick (1988) view privatisation as a range of different government policies aimed at reducing the role of the state and enhancing the ownership and participation of the private sector in the economy. Therefore, privatisation represent wider measures including divestiture or denationalisation, liberalisation or deregulation, franchising, contracting out and lease of public assets, implemented by the government to achieve this objective.

An important element often associated with privatisation is 'competition'. This means that, in a wider sense, privatisation also refers to a process of 'marketisation' or bringing the enterprise under the disciplines of the market (Ramanadham, 1989). In other words, government-owned enterprises (GOEs) can be privatised through sale of ownership or allowing the private sector to take over

the management. GOEs can also be privatised by changing the operating environment and subjecting it to market discipline.

Privatisation has, therefore, acquired a wider meaning, that of denationalisation at one end of the spectrum to measures subjecting economic activities to greater market discipline at the other end. Privatisation is now a fact of life the world over, however, some propositions that emerge from existing research literature are (see, Minogue et al., 1998: 21):

I. Evidence for the superiority of private over public enterprises is mixed and inconclusive (Cook & Kirkpatrick, 1995; Shirley & Walsh, 2000).

II. The real issue is monopolised state and its associated inefficiencies rather than ownership (Cook & Kirkpatrick, 1994).

III. The link between privatisation and economic growth<sup>3</sup> has not been measured and demonstrated; privatisation should rather be seen as one of a bundle of measures necessary to successful economic reform strategies (Cook & Kirkpatrick, 1994; World Bank, 1996).

IV. Profitable and efficient GOEs exist in all types of economy, and there is no reason why efficiency goals cannot be attained through the rehabilitation or corporatisation of public enterprises, ensuring commercial operation under public ownership (UNCTAD, 1992).

As discussed earlier, privatisation bears a set of complicated conceptions, explanations and methods. The research on privatisation also has showed a number of evidences and mixed consequences. One of the main arguments for privatisation has been related with the need to free GOEs from governmental control and thereby enhance their performance and efficiency. However, the irony is that once they have been privatised, there seem to be doubts whether performance and

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3 The relationship between privatisation and economic growth in developing countries, DCs, is found out 'negative effect' by total factors productivity (TFP) in the study of Cook and Uchida (2001).

efficiency will improve, as well as doubts whether the private sector will behave responsibly or on behalf of the public interest, thus the need to regulate them. Furthermore, the paradox of NPM or privatisation process is that a ‘re-regulation process<sup>4</sup>’ is needed. Regulatory governance is a necessary condition for fair and efficient competition in public utilities.

PMR’s research agenda also needs to be reinforced with institutional analysis in order to strength its potential as theory for explaining public sector reforms and also as set of tools for reforming public sector. Mainly to analyse and orient public sector reforms to long-term changes. This is also relevant because PMR’s theoretical framework must be capable of explaining how changes are generated in public sector (considering institutional structures for incentives and agreements) and why some reforms fail while others succeed. On the other hand, because of the fact that both institutions and regulations can be considered as ‘rules of the game’, all regulatory reforms can be analysed as institutional reforms. Thus, it is important to develop regulatory governance regarding both institutional issues and analysis.

### **3. Importance of Institutional Approach**

Innovations in the field of PMR recently represent what Thomas Kuhn referred to as ‘*paradigm shifts*’. The application of market economics to political decision-making has influenced an approach to institutional reform and design utilising public choice analysis, the new economics of the organisation, and

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4 The concept of regulation has been defined differently (either more narrowly or more broadly) in different contexts and at different times (Kirkpatrick, 2001). Kirkpatrick suggests that regulation can be broadly defined as ‘any government measure or intervention that seeks to change the behaviour of individuals or groups. This broad definition of regulation is used in relation to the general development objectives of a country. The aim of regulation policy is to change private sector behaviour in ways that are more consistent with development goals.

models of decentralised governments (Self, 1993). PMR has offered the basis for studying into the age-old politics-administration dichotomy by providing a theoretical framework through which there can be the integration of politics and administration. It also allowed a chance for research that evaluates government's behaviour based on accountability and performance measurements, outcomes that evince 'better governance' and its capacities. This reform movement has generally manifested itself in developing countries (DCs) through calls for entrepreneurial governments, privatisation, and public-private partnerships (PPPs). PMR treatises, however, have yet to contribute to sound answers as to the role of institutions and organisation design in creating performance-oriented government entities (Lynn, 1996).

New institutional economics (NIEs) extends the scope of traditional economics by including politics and the evolution of institutions to evaluate policy reforms. By integrating policy and economic institutions, it focuses on the behaviour of policy elites and politicians, voters, political parties and interest groups. It submits the modality by which an analysis can be made of the role of leadership, management and institutions in creating democratic and accountable governments. The focus of NIEs on integrating economics and politics and studying institutions based on social structures and performance-oriented administration has generated a change advocated by some public administration theorists. That suggests the possibility of linking the macro-economic development while addressing issues of microanalysis by incorporating individual and group behaviour, information, and the administrative capacity of government. By the same token, it provides a means whereby issues of politics and administration can be studied under the purview of public administration and PMR. In the end, employing institutional analysis as the basis, such integration establishes the framework for pursuing comparative analyses of policy reforms in both advanced and DCs including participation, property rights, citizenship, transparency,



capacities, and accountability.

Institutional analysis, however, transcends the problems of polarising public and private in the development studies; separating politics and economics in PMR literature; dichotomising politics and administration in public administration literature; and ignoring politics and culture in the pure economic development literature. Institutional approach, through its holistic approach, attempts to relate policies implemented by government to economic performance. Economic performance is also affected by incentives schemes, contract performance, property rights, transaction costs, and participation evidenced in private sector and government. The microanalysis of the economics of organisations and other features of PMR implied by institutional approach proposes the framework for improving administrative performance in the public sector. This, in essence, establishes the basis of economic development.

A new perspective on regulatory governance is emerging. It derives from the desire to open or explore the ‘black box’ of institutions<sup>5</sup> that is assumed in the economic literature that focuses on concepts from the fields of public choice, NIEs<sup>6</sup>, new institutionalism, and the new economics of organisations. In his book, Majone (1996) states that there are two common elements of institutional theories

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5 The general presumption is that institutions have a great impact on how well people achieve their economic and other objectives and that people normally prefer institutions which enhance their freedom of choice. However, institutions will not always serve these objectives without certain types of rules which may have invaded social welfare, freedom, and other human values (Kasper & Streit, 1998).

6 NIEs has focused on theorisation of the way economic production should be organised. It postulates that free and full information is not available and that people is bounded rationality. It also assumes that people are selfish and seek to maximise self utility. These central assumptions help to develop theories of economic transactions and or principal-agent relationships. Economic transactions produce costs. These costs might stem from search for information, monitoring and enforcing post-contractual performance, uncertainty in determining prices, and investment in transaction-specific assets. To economise such costs is the focus of transaction cost theory. In designing a transaction governance structure, one key economic concern is whether it is minimising the related costs.

of regulation. Firstly, there is an assumption that political control of regulatory bureaucracies is possible. It means that a matter of set up the extent and the means by which politicians can guide and control regulatory bureaucracies. Secondly, there recognises political parties' central roles in the regulatory process and focuses on the problems of establishment of the appropriate level of delegation. They try to research when politicians will delegate the policy making process to regulators, and when regulators will choose to exercise that delegated power. The central statement is determining the appropriate governance mechanisms and level of rules that should be set for regulatory agencies as opposed to discretion processed by regulators to enforce those rules and governance mechanisms(Levy & Spiller, 1996).

Agency theory is always utilised to study regulatory governance, argued that principals contract agencies to perform certain duties. However because of information asymmetries between the principal and the agent, the agent has the incentive to act in his/her own interest rather than the interest of the principal. In the regulatory environment, bureaucratic regulatory agencies shall obey democratically-elected politicians, but the interests of the politicians and bureaucrats diverge over time because of changes in the political environment (Baldwin & Cave, 1999). Majone (1996) also highlights one significant limitation in the employment of agency theory into regulatory governance. Agency theory is most applicable to hierarchical relations between one subordinate and one superior. It is of limited utilisation in the regulatory environment where the regulator faces multiple principals, each with possibly different and conflicting objectives. The theoretical arguments and empirical evidence on this issue has produced mixed results and these results are dependent on several conditions. One suggestion is that whether better result is produced under government ownership or through regulation of private monopoly depend on whether contracts are complete or incomplete (Williamson, 1981, 1996). Shirley and Walsh (2000) argue that if

contracts are complete, governmental ownership and regulation of private firms will produce the same results. However, if contracts are incomplete, the results of these choices (public ownership/private regulation) will be different.

Using a cost of information framework, Shapiro and Willig (1990) analyse this issue, under conditions that: information about profits is revealed only after investment are made, or when government is indifferent to the amount of money spent to acquire that information *ex ante*. They find that when agents (GOE manager or regulator) have greater autonomy, governmental ownership and private ownership with regulation produce the same results. However, in the absence of these conditions, governmental ownership produce better result as political markets becomes more efficient. On the other hand it will produce poor result when the agents' private interests become more important. Shapiro and Willig (1990) also conclude that when agents have little autonomy, regulation will produce better results provided that information on the market failure is publicly known.

It must be clearly indicated that privatisation and related policies could be viewed as ideological matters, therefore, it would be unrealistic and naïve to assume a system which is totally independent of politics, so-called 'self-regulation'. However, the actual process of regulation should be taken out of politics and placed in the hands of professionals who have the expertise. It is apparently that the governance approach implies examination and analysis not only of the institutions, policies and process, but also of the politics of regulation and competition. As a result, there are some requirements for regulatory governance for public utilities; it is quite possible to separate day-to-day management of regulatory bodies from the broader politics of policy making; 'transparency' is significant in its own right, particularly for DCs which usually lack an atmosphere of open debate, since a requirement on regulators to explain and publish their decisions and processes should reduce the likelihood of unfairness or

incompetence. The public should be made aware of implementations of regulatory policies; ‘information issues’ are also crucial in the regulatory context, particularly between government and regulators, should enhance to make regulation more effective, by removing any possible confusion about which functions are carried out by regulators and which are carried out by Ministers or others. Regulators should have a clear statement of both their functions and their objectives in carrying out those functions. Regulatory agency should have access to detailed information on related matters to operate properly (Stern & Holder, 1999). It should be noted that governance mechanisms for regulation should be properly designed in accordance with the country’s economic and culture structures as well.

In addition, Fukuyama<sup>7</sup>, at a broader level, regards ‘trust’ as necessary to the efficient operation of markets (1995). At the level of regulatory institutions, “trust is at the heart of regulation” (McGregor, Prosser, & Villiers, 2000). The spread of PMR has led to both opportunities and problems in relation to the establishment of trust-based relationship. Fukuyama has sought to distinguish between ‘high-trust’ and ‘low-trust’ societies (1995). High-trust societies offer more effective regulatory systems while low-trust societies (characterised by fewer civil society associations, formalistic relationships, and primary social loyalties e.g. to family) exhibit an ‘implementation deficit’ (Minogue, 2001, pp.18-19).

It can be concluded that regulatory policies in general, and regulatory governance in particular, have substantial roles to play in the privatisation process. Regulatory mechanism in the U.K. presents an instance for DCs where have

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7 Francis Fukuyama takes the matter of trust beyond the boundaries of the organisation. He states that, the prosperity of societies depends on relationships of trust which reach beyond the family and organisation. He believes that, because Italy’s and China’s familial societies are hard to put their confidence in anyone outside the family, this situation has prevented these countries creating truly global organisations (1995). However, it is important to note that, each state has its own ‘culture’ and that means ‘policy transfer’ should be more carefully and suitable for its own state’s condition instead of fully copying.

adopted privatisation and liberalisation in the public utilities. However, two statements should be made clear: at first, the British regulatory system is not a perfect model, it has a number of shortcomings as was indicated in previous section. Secondly, what is feasible for the U.K. may not be feasible for DCs, therefore it would be unsuitable just to adopt the same mechanism. The tendency to transfer the idealised model of advanced economies is not surprising, but likely to yield the ‘implementation deficit’ characteristic in DCs (Minogue, 2001). Moreover, it is difficult to set up a regulatory mechanism especially in the context of DCs, however, it needs to be kept in mind as a means of limiting the adverse effects of privatisation, not to constraint the operations of companies.

#### **4. Regulatory Governance for Privatisation**

The introduction of liberalisation and PMR have arguably resulted in a shift from ‘the entrepreneurial state’ towards ‘the regulatory state’<sup>8</sup> (Cook & Minogue, 2002; Majone, 1994, 1999; Minogue, 2001, 2002; Moran, 2001, 2002) which is said to involve a shift from governmental to private ownership of public utilities and other social service infrastructures, an increasing emphasis on pro-competition regulation by quasi-autonomy independent bodies (Loughlin & Scott, 1997; Stirton & Lodge, 2001).

In the UK, these interests are enshrined in the principles of good regulation

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8 For some, the regulatory state represents a retreat from commitment for development and a decline in state autonomy. For others, the regulatory state can be as interventionist as the developmental state. Another view proposes that in the nineteenth century ‘Nightwatchman State’, most of the steering and rowing was done by civil society, whereas the Keynesian/Developmental/Welfare State has tried to do both steering and rowing. The new Regulatory State reached some balance: state steering and civil society rowing is its ideal. As will become apparently shortly, the variations in the advance of the regulatory state across the different sectors are greater than those across countries. This strengthens an understanding of the advance of the regulatory reforms as a sector-level phenomenon and the conviction that research aimed at the study of the reforms should combine comparisons between sectors and nations.

formulated by the Cabinet Office. These are to protect and enhance the rights and liberty of citizens; to promote a safe and peaceful society; to collect taxes and ensure that they are spent in accordance with policy objectives; to safeguard health and safety or protect citizens from 'learning' themselves; to protect consumers, employers and vulnerable groups from abuse, to promote the efficient working of markets and to protect the environment. However, in relation to the economy, Kirkpatrick (2001) defines regulation as measures that focus on correcting market failures, and strengthening the enabling business environment. In clarifying the concept, Yarrow (1986) defines regulation as any activity of government or its agencies that seeks to influence behaviour via the establishment of rules to guide to constrain economic decisions. He stressed that in the context of market power, regulation aims to reduce the economic inefficiencies associated with monopolistic positions.

In Minogue's view (2001), regulation is based on strict rules or broadly formulated guidelines, which allow further negotiations and discretion over their implementation. However, regulation can carry many different meanings depending on the context it is used. He identifies various types of regulations such as regulation of business, (the control exerted over private, non-state activities), regulation inside government (the control exerted within and between government agencies, and between levels of national government), international regulation (regulation of national governments by supranational mechanism), self-regulation (less formal alternatives than legislative or administrative rule-making), metaregulation (overarching system for reviewing regulatory mechanisms within government policymaking processes), and deregulation. In light of Majone (1996), Minogue noted that regulation may be defined as a sustained and focused control exercised by a public agency, on the basis of legislative mandate, over activities that are generally regarded as desirable to society. He notes that many definitions of regulation are based on formal and legalistic definition, which focus on the

construction and application of rules and views government as a command and control regime operating on behalf of public interest. Regulation, therefore, has several connotations and is more complex than originally thought.

Governments the world over are calling for privatisation and regulatory reform as the solution to the problem of the poor performance by public utilities, and as the means to the improvement of their delivery of service (Levy & Spiller, 1996). Notwithstanding, privatisation and regulatory reform need to be analysed in a broader context of PMR and governance approaches which have been initiating across both developed and developing governments (Minogue, 2001, 2002). There are some reasons for the shift towards the 'regulatory governance' or so-called 'the rise of the regulatory state' (Loughlin & Scott, 1997): firstly, it is the displacement of the welfare state or of fiscal-difficult government and separates operations from policy making; secondly, it tends to establish free-standing regulators and to institute mechanisms of oversight; finally, it is the increasing use of greater formality (UK case) as policy instrument in the public utilities.

Regulation is as old as the existence of societies and governments. Majone states three principal types of regulation, namely, regulation through public ownership (nationalisation), statutory regulation by independent agencies (delegated regulation), and self-regulation. According to a comparative study of regulatory developments between the USA and Europe, Majone found that the form of regulation was dependent on prevailing political systems, ideas, ideologies, and interpretation of economic life. Majone argues that the traditional (early) public interest theories and the later economic theories of regulation (forward by Stigler/Peltzman) were complimentary to each other rather than mutually exclusive. Both theories assume that market failure results in the demand for regulation. Majone (1996) also notes that the normative and positive theories are criticised for being silent on the crucial factors of the regulatory process. These factors include: the limits on political control over regulatory discretion, the requirements of public

accountability of regulatory actions, the entrepreneurial skills of key individuals within the regulatory bureaucracy, and the importance of reputation and credibility to regulators.

Narrowing down the definition, Minogue (2001) stressed that for the economist, regulation is primarily the means by which private firms are constrained from anti-competitive behaviour. It focuses on the way in which regulation creates conditions for efficient market. Minogue however, adopted a simple and broad definition of regulation by Hood et al (1999), who define regulation as the use of public authority to set and apply rules and standards. According to Minogue, regulation is an important tool to foster competition. Referring to the element of competition, Ogus (2001; 2002) states that economic regulation applies to markets which are insufficiently competitive. Ogus asserts that regulation or competition law is the primary instrument for restraining anti-competitive practices since they preserve or enhance the competitiveness of market. He stressed that where a natural monopoly exists, legal measures must be introduced to control price and quality of products and services.

Based on these discussions, regulation is a complex concept, which involves many facets. However, regulation can be characterised by a number of important elements. First, it is based on rules formulated and enforced by a public authority. Second, it aims to promote competition, ensure efficient market, restraint anti-competitive behaviour and control monopoly power and abuse. Third, it acts as a mechanism to reconcile the interests of various stakeholders. For the purpose of this study which is defined as a set of rules or policies, which enable the government to control and sustain the economy by managing activities and interest of various groups, especially private enterprises.

The significance of regulatory policies in the privatisation process has been emphasised so far. It is of evidence that the economics of privatisation cannot be analysed in the absence of the economics of competition and regulation (Cook,



2001; Minogue, 2001; Newbery, 2001; Vickers & Yarrow, 1988a). It should be highlighted that regulatory mechanisms are just one element in the overall combination of public policies and that regulatory governance<sup>9</sup> is crucial to the exploration of the strengths and weaknesses of utility regulation.

The fundamental idea of regulation is to design an incentive mechanism which will lead firms to act in accordance with the public interest, that will rely on the state of technology and demand, and the market conditions. It is apparently that GOEs have been criticised on the grounds of inefficiency most of the time. Privatisation policies, therefore, have been considered as a remedy of inefficiency. However, the achievement of efficiency improvements crucially depends upon the institutional framework of regulation in which the privatised firm is to operate.

In 1997, OECD stated that, “the emergence of the regulatory state in this century was a necessary step in the development of the modern industrialised democracy... Regulation has helped governments make impressive gains in protecting a wide range of economic and social values” (1997). The increasing use of regulation as a government instrument may thus arise due to the growing demand to ‘steer not row’ the involvement of a variety of public and private sectors which operate at some remove from the central government (Osborne & Gaebler, 1993). In other words, government is likely to retain greater responsibilities and accountabilities for economic and social regulation, especially in DCs.

Majone (1999) concludes that in developing an effective regulatory state the key variables are: the extent to which decisions are delegated to an independent agent rather than taken by the political principal; the nature of the structure of

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9 Rhodes declares that, “governance has too many meanings to be useful, but the concept can be rescued by stipulating one meaning and showing it contributes to the analysis of change” (Rhodes, 1997: 52-53). According to Rhodes, governance refers to processes of regulation, coordination, and control (Rhodes, 1997).

governance itself particular in determining the agent's degree of independence from the political process; the rules that specify the procedural framework e.g. reason giving requirements, consultative processes; the scope for political principals to overrule agency decisions; the relative autonomy of financial resources; the extent of ex post monitoring, e.g. legislative oversight, judicial review, citizen's; complaints procedure. It shall be recognised to move between the narrower conception of regulatory instruments and procedures, and the broader conception of politics. Therefore it may be useful to bring these two approaches together under the label of 'governance' (Minogue, 2001).

However, the establishment of a regulatory system is more difficult in the context of DCs. There are deep-rooted problems arising from the less developed structure of these economies, especially building up good governance capacities. As Polidano (2001) highlighted, embeddedness of governmental institutions within public space has been a relatively under-emphasised aspect of institutional capacity. Although privatisation has been considered as an effective policy the regulatory aspect has been neglected. It should be stressed that privatisation does not mean the retreat of the government from the economy. It should also be viewed that privatisation is not a means to get rid of the problems of GOEs, because it is not the case. Kooiman suggests that it is "generally more appropriate to speak of shifting roles of government than of shrinking roles of government" (Kooiman, 1993: 73). As a result, privatisation must be accompanied by a set of properly designed regulatory policies in order to be successful.

Governments do have several important roles to play in the governance process. First of all, governments must actively participate in the planning, financing, delivery, and evaluation of public services. Secondly, they must creatively and innovatively deal with changes and initiate public choices, programmes, and projects, which contribute to solving emerging problems, meeting society's changing needs, and achieving a sustainable future. Thirdly, they

must do this efficiently, effectively, equitably, and also humanely. Fourthly, governments must act transparently so that citizens have the necessary information, access, and involvement to hold them accountable for the outcomes they produce. Fifthly, and perhaps most importantly, governments must actively participate in the process of creating the conditions under which governance take place. They must assure that civil order prevails and democracy thrives, so that collectively we are able to undertake actions designed to solve problems, meet society's needs, and achieve a sustainable future (Osborne & Plastrik, 1998).

“ Regulatory governance as a concept is firmly grounded in the wider theme of democratic governance”. It should go beyond the design and implementation of instruments, or their co-ordination, and also incorporate broader issues that “are integral to democratic governance, such as transparency, accountability, efficiency, adaptability and coherence” (OECD, 2002: 16). Therefore, it is significantly important to explore the implications of the relationship between PMR (privatisation) and regulatory governance (see, Minogue, 2002: 6):

I. the analysis of regulation goes beyond examination of the formal rules which govern relationships between the public and private sectors to the broader framework of government-market relations (Minogue, 2001).

II. regulation is then seen as part of the whole range of neo-liberal market reforms, which include privatisation and reshaped government-market mechanisms such as contracting and public-private partnerships (PPPs) (Lane, 2000; Savas, 2000).

III. since much regulation is carried out inside government (Hood et al., 1999), it is appropriate to consider the effects on regulatory policy and practice of PMRs that introduce the government the entrepreneurial disciplines of the market.

IV. since regulation can be categorised as a distinctive mode of policy making (Majone, 1999), it is appropriate to examine its relation to the general public policy process.

V. finally, the significance effects on regulatory systems and processes of political ideas, institutions and relationships of power require analysis of governance frameworks and an understanding of such concepts as ‘the regulatory state’ (Loughlin & Scott, 1997; Majone, 1994, 1999; Moran, 2001, 2002), ‘regulatory capture’<sup>10</sup> (Bernstein, 1955; Stigler, 1971) and ‘regulatory space’<sup>11</sup> (Hancher & Moran, 1989).

Notwithstanding regulation should not be viewed as the opposition of market. It depends upon the nature and task of regulation. Markets and regulation are complementary rather than opposed and both of them can be viewed as means of delivering public interests (McGregor et al., 2000), so that regulatory governance can be viewed as the process in which economics, politics, and law are inextricably intertwined. Furthermore, regulatory governance shall be viewed to cover: the whole range of government institutions involved in rulemaking and implementation; the public policy processes which involve this set of institutions; the interactions of public actors with private actors; the significance of political will and leadership; the interactions of political and economic elites; political

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10 In his famous paper, George Stigler shifted attention away from the public interest approach, and named the public choice approach. He observed how the struggle over economic rents by regulatory actors would affect regulatory policy. The main actors in his study, enterprises and politicians are assumed to be self-interested income-maximisers and not at all concerned with the public interest. Enterprises utilised their all resources to bargain with politicians to bring about policies that benefit them. They will favour regulation that reduces competition, and maximises economic rents. On the other hand, Bernstein develops the idea of a ‘regulatory life-cycle’. Bernstein declares that regulatory bodies go through four stages: gestation; youth; maturity; old age.

11 The importance to extend the analysis of regulation to the wider environment and the interaction between potentially multiple parties has been summarised in the notion of regulatory space. “The notion of regulatory space focuses attention not only on who the actors involved in regulation are, but on structural factors which facilitate the emergence and development of networks and which contribute to the institutionalisation of linkages” (Hancher & Moran, 1989: 292). Moreover, OECD (2002) states that regulatory governance refers to a large domain encompassing the complex interplay of other regulatory actors such as the legislature, the judiciary and the sub-and supranational levels of government action.

interventions in rule adjudication (especially in the actions of judicial or other regulatory actors); and the use of political relationships either to achieve regulatory capture or to build trust relationships which underpin effective informal regulation; the system of public values which provides the setting for privatisation, regulation and competition. It is at once evident, then, that a governance approach implies examination and analysis not only of the institutions and policies, but of the politics of privatisation, regulation and competition (see Minogue, 2001). This study defines 'regulatory governance' as encompassing the whole system by which competition and regulation are exercised in the management of achieving the economic and social goals for development. Regulation also needs to be analysed in the broader context of PMR and governance-based approach which has been spreading across both developed and developing countries. The focus of this research refers to the creation of new regulatory institutions in the wake of privatisation and liberalisation reforms, the term is so-called 're-regulation' for public utilities. Most importantly, it uses a dynamic and forward looking view, focussing on the key priorities for moving forward with the privatisation and regulatory policies agenda.

## **5. Conclusion: Upholding Regulatory Capacity**

Based on the analysis, regulation is a complex concept, which involves many facets. There is little attention or research on regulatory capacity so far. Regulation, however, can be characterised by a number of important factors. Firstly, it is based on rules formulated and enforced by a public body. Secondly, it aims to promote competition, ensure efficient market, restraint anti-competitive behaviour and control monopoly power and abuse. Thirdly, it can be operated as a governance mechanism to reconcile the interests of various actors. For the purpose of this paper, we shall focus on regulation governance, which is referred to a set of rules

or policies, which enable the government to control and sustain the economy by managing activities and interest of regulatory actors, especially private firms.

The relationship between privatisation and regulation has analysed a number of issues associated with competition or the lack of competition, monopoly, market power, market entry, market structures and market failures in the public utilities. These issues are generally interrelated and concerned with the functioning of market and extent of competition. Where there is market failure and supply of goods and services is provided by a monopoly or where competition is limited, the need for regulation becomes necessary (Newbery, 2001; Shirley & Walsh, 2000). These works noted that the literature posed the issues whether governmental ownership or regulation of a private monopoly produces better results. In other words, the issue is whether public ownership under monopoly conditions, with some forms of internal regulation is preferable to private ownership with only the market or some kind of agency as the regulator.

If privatising the monopoly and regulation does not contribute to increased efficiency and performance, then privatisation, will only transfer a government monopoly to a private monopoly. As Cook and Kirkpatrick (1988) highlighted that extensive market failures in less developed countries may not bring about the intended benefits of privatisation in these countries. This may imply that it would be better to retain public utilities under public ownership.

The theoretical arguments and empirical evidence on this issue has produced mixed results and these results are dependent on several conditions. According to Vickers and Yarrow (1988a) regulation can lead to a number of inefficiencies, namely overcapitalisation (Averch-Johnson effect), asymmetric information, complexities of regulating multi-product enterprise and regulatory capture. Shirley and Walsh (2000) suggest two methods of resolving these regulatory failures. First, is to foster competition through bidding for the right to operate as a monopoly. For Kay and Thompson (1986), this measure will address the natural monopoly

problem by introducing a form of competition into non-competitive markets. The second method of resolving regulatory failure is to use regulatory mechanism to promote competition among parallel firms. This means that the regulated prices for one firm would depend on cost savings of other firms. This will promote internal efficiency and allocative efficiency since this process creates the conditions of a competitive industry (Vickers & Yarrow, 1988a). In other words, the regulator can get better results by rewarding effort of each firm relative to all other agents. However, in practice this method is difficult to achieve because it applies if all the firms face similar circumstances or that differences can be measured and accounted for, and that they do not collude.

It is of evidence that the government's regulatory capacity is crucial in ensuring the success in the privatisation of the monopoly. However, difficulties of privatising public utilities have raised the issue of addressing the choice between retaining ownership under the government or privatising and regulating it. Shirley and Walsh (2000) suggest that middle-income countries with more developed regulatory capacities tend to benefit more by privatising and regulating the monopoly than retaining it under governmental ownership compared to those lower-income countries with weak regulatory capacities. However, since lower-income countries may lack capabilities in managing the GOEs, they would benefit more from privatisation despite holding weak regulatory capacities. According to Shirley and Walsh (2000), in most empirical studies, private regulated firms perform the same as or better than GOEs. However, in competitive markets, five out of 16 studies show that monopoly GOEs outperformed private monopolies.

The analysis on regulation shows that the choice between retaining a monopoly under governmental ownership or privatising and regulating the private monopoly is not a simple and straightforward issue. Theoretical arguments and empirical evidence have provided mixed results. Regulation may lead to

inefficiencies and measures to address regulatory failures depend on the conditions of contracts, autonomy of regulators, availability of information and the government's regulatory capacities. Weakness in regulatory capacity is one of the key factors that determine whether privatisation and regulation of monopoly will bring the intended benefit.

Therefore, the success of the privatisation and regulation depends on the government's regulatory capacity (Adam, Cavendish, & Mistry, 1992; Vickers & Yarrow, 1988a). Two issues are particularly relevant in order to understand the capacity to regulate; first, what does the government regulate or in other words, the functions of the regulator; second, what does it takes to regulate effectively. This refers to the requirements that enable the regulator to discharge its functions.

Regulate capacity can be clarified in terms of a number of characteristics. It refers to the creation of a regulatory environment and an operational system of regulation undertaken by an effective regulatory institution (Cook, Kirkpatrick, & Nixon, 1998). This means that there must be guiding principles, rules and laws that enable decision or discretions concerning regulation to be taken. There must also be a system and mechanism to discharge regulatory functions taking into account the interests of the various regulatory actors; the regulator, the industry being regulated, the consumers, and public interest (Foster, 1992). There must also be an institution staffed with competent personnel to enable effective discharge of regulatory functions, which include monitoring and enforcement of contracts, takeovers and mergers that change market dominance of firms (Shirley & Walsh, 2000). The 'arbitrary' nature of regulatory process, which attempts to reconcile the interests of the various actors, point to the complexity of regulation and the nature of regulatory capacity that is needed. The capacity to regulate is determined by the level of expertise and is dependent on the degree of autonomy, system of accountability, the availability of information, the nature of other regulatory instruments in the economy and the clarity of regulatory objectives (Cook et al.,



1998; Vickers & Yarrow, 1985, 1988a, 1988b).

Regulatory capacity, therefore, varies between industries and countries depending on these attributes. The analysis suggests that generally, regulatory capacity is more developed in higher and middle-income countries than in lower income countries (Cook et al., 1998; Nellis, Shirley, & Kikeri, 1992; Vickers & Yarrow, 1988a). The level of regulatory capacity in an industry or country is an important factor in ensuring the success of privatisation programme and effective regulation. Depending on the capacity to regulate and market structure, governments will need to consider the appropriate strategy when considering privatisation and regulatory framework.

Weak regulatory capacity tend to lead to 'regulatory capture' a situation where the regulated companies can influence decision made by the regulator on issues concerning pricing, or acquisitions and mergers, control of market share and dominance, to work in their favour and interest (Foster, 1992). This is one of the major problems of regulation in DCs and the failure of regulatory authorities to function effectively is due to the weak legal and institutional framework. Furthermore, most regulatory agencies lacked adequate staffing and technical expertise to monitor the privatised firms. For example, expertises from many backgrounds are required to regulate technical, safety and environmental standards, pricing and economic assessment, legal matters and managing relationships between investors, consumers and political authorities. Managing the relationships between the various regulatory actors is a highly political and complicated process and subjected to availability of information. In other words, regulatory capacity has been constrained by design of rules, tier of government at which rules are administered, creating autonomous regulatory agencies, use of cross-sectoral regulatory agencies and contracting out. On the other hand, the capacity to resist improper pressure or inducements refers to the ability to administer the conflicting interests between regulatory actors. In dealing with these issues, there are a

number of measures needed to set up, increasing competition, increasing transparency, creating autonomous regulatory agencies, increasing salaries of regulatory officials, vesting decision-making authority in a commission rather than an individual and establishing anti-corruption bodies. Regulatory capacity could also be improved by twinning arrangements and international cooperation between regulators.

The possibility of 'regulatory capture' by regulated firms or other regulatory actors and the effects of regulatory uncertainties on the investment behaviour of regulated firms need to be taken into account in designing regulatory mechanisms and institutions in Taiwan. Political economy considerations suggest that implementing and regulatory agencies should be designed to ensure independence of implementing and regulatory agencies from the executive branch of the government; to impose constraints on the regulator's discretion; to enhance transparency of the privatisation and regulatory process so as to limit information asymmetries and reduce inappropriate discretion; and to ensure consistency of regulatory approaches across industries. Governance mechanisms should incorporate a degree of pre-commitment so as to reduce the risk to enterprises that investment will be made unprofitable by subsequent decision while also, possibly, preempting political pressures arising as regulatory outcomes become known. Pre-commitment and constraints to regulatory discretion should not prejudice, however, the effectiveness of regulatory enforcement and the ability of the regulator to adjust regulation to changing technological and market conditions.

The complexity of performing the regulation function and the high level of skill and expertise required has been illustrated by a study by Schofield and Shaoul (1996). The research indicated that the West Yorkshire water supply system failed, five years after it was privatised. The regulatory agency, Office of Water Services (OFWAT) was caught in conflicting demands of ensuring industry viability and protecting consumer interest. Yorkshire Water has given in to pressure to from

their shareholder to declare larger dividends, which decreased financial resource for reinvestment.

This case has confirmed the fear, that profit maximisation would be pursued at the expense of consumer's welfare. Although the legal framework and regulatory responsibilities have been well defined (level of service, quality indicators and measure of performance) the regulator has not been effective. Schofield and Shaoul noted that the regulator has failed to perform its duties although the system of regulation has been firmly established by clearly defined regulatory and financial framework. The failure seemed to stress the political nature of regulation enforcement. However, the research has ignored the importance of regulatory capacity.

While regulatory capacity has been ignored in many studies on privatisation and regulation, Smith and Wallenius (1999) have acknowledged its significance in terms of the telecommunications industries. They argue that effectiveness of regulation depends on several conditions; strong administrative tradition, ability to undertake commitments that endure from one government to the next and a judiciary that is impartial, immune to government and political pressures and able to make enforceable decisions. Smith and Wallenius stress that regulatory agency needs substantial professional staff who can handle complex regulatory concepts and processes. If these conditions are not present, regulation will be ineffective and this will affect sector performance. These researches demonstrate that regulation is a complicated and multi-facet issue and require highly skilled staffs who have various expertises. There is a need to look more closely at regulatory capacity in terms of the organisation, management, administrative and staffing requirements. It is also necessary to recognise privatisation and regulation as a long-term and complex process of change, including changes in attitudes, values, perceptions, and mentality in governmental and corporate governance.

In the end, it is necessary to understand fully the 'regulatory governance' and

significant for network utility regulation. Moreover, we must go beyond description and analysis of the formal structures and institutions of PMR; furthermore, we also must examine the characteristics of the public policy process. This means looking beyond the institutional façade to grasp the ‘real world’ of public action. Employing insights drawn from institutional analysis, this study insists the importance of capacities for regulation in the public utilities. But we shall deal with them separately while emphasising the interconnections. Given the variety of statements in the field of PMR, it is argued that this differentiated approach to regulatory governance provides a more effective response than narrow ‘traditional’ notion of new public management. It should be emphasised that privatisation, competition, and regulation are closely intertwined with each other in accordance with economics, law, and organisation theory and significant essential elements in the complicated reform process of network industries.

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# 析論公用事業民營化之管制治理： 加強管制能力

鄭國泰<sup>12</sup>

## 摘要

自由化和公共管理革新的引介，已導致「企業型國家」的轉型，並朝向「管制型國家」。本文旨在探求新公共管理及民營化之關係，及邁向管制型國家的原因，特別是公用事業民營化政策之再管制議題。本文研究發現：民營化，管制和競爭之間無庸至疑地環環相扣，且各有其必要的特殊意涵；研究其間的變動關係，治理途徑的概念更顯著重要，吾人更應確立民營化絕非孤立的觀念或政策，也非唯一的萬靈丹。文末主張以制度途徑來探討公用事業之管制治理，更能凸顯「管制能力」建構之重要性，及其鮮少被研究的遺憾。

關鍵詞：公共管理革新、管制治理、管制、民營化、制度途徑、管制型國家、管制能力

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