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‘The Institutions and Governance of Economic Reform’1: Theoretical Extensions and Applications

Abstract

This article uses the reform of New Zealand's state-owned enterprises from 1984–1995 to highlight two lessons for public sector reform from New Institutional Economics. First, failure to apply agency, property rights and transaction cost theory in tandem can lead to time-consuming pauses and policy shifts in a reform programme. Second, a discriminating alignment between the institutional environment and the regulatory governance structure chosen is crucial for successful privatization in industries characterized by economies of scale, large non-redeployable investments and extremely political output such as telecommunications and electricity.

Keywords

new institutional economics, New Zealand, public sector reform, regulation

Disciplines

Business Administration, Management, and Operations

**‘The Institutions and Governance of Economic Reform¹’:
Theoretical Extensions and Applications**

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Abstract:

This paper uses the reform of New Zealand’s state-owned enterprises from 1984-1995 to highlight two lessons for public sector reform from New Institutional Economics. First, failure to apply agency, property rights and transaction cost theory in tandem can lead to time consuming pauses and policy shifts in a reform program. Second, a discriminating alignment between the institutional environment and the regulatory governance structure chosen is crucial for successful privatization in industries characterized by large economies of scale, high sunk costs and extremely political output such as telecommunications and electricity.

Keywords:

public sector reform, utility regulation, new institutional economics, New Zealand

JEL Classification:

L33, L32, L43

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I. Introduction

Policymakers contemplating large scale restructuring of politically sensitive sectors of the economy typically have only a limited window of political opportunity in which to implement their reforms (Keeler, 1993). This paper presents a theoretical framework that aims to assist policymakers in maximizing the returns from such opportunities. While a growing body of theoretical evidence (Megginson et. al., 1994) supports the claim that privatization can yield substantial productivity gains, the difficulties inherent in privatizing monopolies have also been repeatedly uncovered (Ramamurti, 1996 and Levy & Spiller, 1996). Policymakers committed to enhancing the efficiency of state-owned enterprises but wary of public recrimination for failed privatizations have myriads of often contradictory theoretical approaches and arguments to consider in their policy design. This paper highlights the potential for combining three such frameworks that share their origins in The New Institutional Economics. It argues that a nuanced combination of agency, property rights and transaction cost theory helps explain the successes and failures of New Zealand's experience with state owned enterprise reform with special reference to the utility sector.²

This new institutional approach to public sector reform is consistent with a large body of recent theoretical and empirical work from the 'public management' perspective. However, it may also be feasible to extend the framework presented here to address the added concerns voiced within the 'public governance' perspective (Kooiman, 1993; Kickert, 1997). First, the new institutional approach can encompass the need to guard legality and legitimacy as suggested by the inclusion of probity (Williamson, 1999). Public networks or interrelated transactions may

be used as the unit of analysis as demonstrated in the private sector by Nickerson and Silverman (1997). Such extensions are beyond the scope of this article that seeks to summarize an emerging underlying theoretical framework for the 'public management' perspective on public sector reform.

Successful reform efforts must get the incentives and property rights right but they must also tackle the difficult contracting issues surrounding the reform of many state sector activities. In short, they must get the regulatory governance structure right as well. While this analytical framework was proposed by Williamson (1996), recent theoretical and empirical contributions by Levy and Spiller (1996) and Heller and McCubbins (1996) and others have allowed for an operationalization of this next stage of reform design. The central tenet is that government's must take advantage of whatever mechanisms they have at their disposal -- either an independent judiciary **or** regulatory rules and procedures -- which can best provide a credible commitment against interference in the day-to-day operations of an enterprise. In Section III, evidence will be presented that New Zealand's institutional environment offered limited credibility for regulatory rules and procedures but was relatively more efficient at providing commitment to privatized firms through contract. However, their privatization program foundered when the government failed to sufficiently consider the hazards involved in transferring highly politicized transactions produced using technologies characterized by substantial economies of scale and scope and requiring large quantities of sunk assets from the public to the private sector. Section IV concludes and argues that the theoretical framework has resonance beyond the case study of New Zealand by surveying recent empirical work on utility privatization.

II. A New Institutional Approach to Regulatory Design

Background: 'The Institutions and Governance of Economic Reform'

Williamson (1996) claims that the macro approach of centralized planning and targeting of accounting aggregates has been largely discredited. In its place, has emerged a more microeconomic approach based on liberalization, deregulation and privatization. More recently the importance of the precondition of an institutional environment that supports the market forms of organization implicit in this viewpoint has reigned ascendant. Williamson argues for a more microanalytic approach in which the concern over property rights is supplemented by an analysis of the optimal governance mechanisms for private sector transactions. In the context of utility privatization, the choice between contract and legislation based regulation may be as important for the long-term performance of the enterprise as the choice to privatize.

Neoclassical/Neoliberal Policy Reform: Getting the Prices Right

The neoclassical or neoliberal recipe for economic reform includes a hard budget constraint, alignment of spending priorities with economic returns, tax efficiency, financial and trade liberalization including a lifting of any restrictions on foreign direct investment, deregulation and privatization and the establishment of secure private property rights. Of these six recommendations, five can be summarized in the prescription: 'get the prices right.' By eliminating politically imposed constraints on development and improving transparency and accountability, the government frees economic actors to seek economic returns. Tremendous gains have been realized from stabilization and reform programs across Latin America and

around the world that have followed this simple dictum (Little et. al., 1993; Williamson, 1994; and World Bank, 1995). Rampant inflation has been controlled, substantial one-time efficiency gains have been made in state-owned, regulated and privatized enterprises, new markets have been created and investor confidence restored. Earlier interest in alternative forms of business-government relations characterized by closer and more informal personal ties (Amsden, 1989; Wade, 1990; World Bank, 1993 and Nelson, 1996) have waned in the onset of the Mexican debt crisis of 1995 and the East Asian crisis of 1997-98.

The Impossibility of Selective Intervention: Getting the Property Rights Right

However, a growing consensus is emerging around the hypothesis that getting the prices right is a necessary but not sufficient condition for successful state sector reform. Political institutions are increasingly accepted as crucial determinants of economic outcomes (North, 1991; Williamson, 1996; and Henisz, 1998). One institution that is commonly cited as having a tremendous economic impact is that of private property. Regardless of how carefully we design contracts and incentives, we should not expect state-owned enterprises to be able to replicate the performance of a privatized counterpart. The rationale follows Williamson's (1985) impossibility of selective ownership argument by claiming that public ownership is unable to control agency costs as effectively as the private sector model. While both governance structures face positive transaction costs, agency problems and complex internal contracts, the institutional arrangement for mitigating these problems varies widely across organizational form. In the private sector, the dilemma posed by the separation of ownership and control is dealt with through the discipline of the sharemarket, market for corporate control, monitoring by bondholders, expert board of

directors, managerial labor market, mutual monitoring by managers, threat of bankruptcy and competition in product markets (Jennings and Cameron, 1987).

In the public sector, each of these avenues is severely constrained. Outputs are often sold in non-competitive or tightly regulated markets. There often exists at least an implicit government bailout guarantee that eliminates or reduces the threat of bankruptcy. Most importantly, while both private sector shareholders and voters (the implicit shareholders of state-owned enterprises) have incentives to free ride and must bear some costs to become informed, the existence of a market for ownership provides a small number of entrepreneurial capitalists the incentive to overcome these costs and reap financial gain by trading until the share price reflects the net present value of expected future returns. Furthermore, board members can use the share price as a relatively low cost measure of managerial performance and, assuming they hold an equity stake in the firm, they have an incentive to replace managers in whom the markets place low confidence. Thus every management decision in a state-owned enterprise including pricing, production, marketing and diversification is subjected to reduced scrutiny giving managers greater discretion to pursue their own independent objective functions.

Despite any formal establishment of independent rights and responsibilities, incentive contracts, reporting requirements and operating independence, state owned enterprises remain subject to continued bureaucratic discretion and political intervention. As stressed by Weingast (1995), the establishment of formal property rights does not automatically create market incentives nor provide a credible commitment against expropriation or strategic action by the government. Those incentives are dependent on the incentives of individual economic actors and

those rights must be self-enforcing for a credible commitment to obtain. State owned enterprises, however independently constituted or separated from political control, remain the property of the state as represented by elected public officials. They will, as such, unavoidably be more conscious or made more conscious of political and social constraints crucial to the reelection of the party in power. This may include, but is not limited to, price restraint, hiring policies, or cultural values. Policymakers who fail to impose these political or social objectives on the enterprises face the possible recrimination of the voters.

The Institutional Environment and Regulatory Governance: A Microanalytic Approach

The distinction between public and private ownership neglects important categories of intermediate governance mechanisms. The new institutional approach to regulatory governance enriches the framework offered by the property rights school in isolation by arguing that each regulatory governance structure offers distinct costs and competencies under various combinations of the institutional environment and transactional characteristics.

Before setting out the theoretical framework some clarification of terms is in order. First, following Levy and Spiller (1994) the institutional environment is characterized by

- (1) The existence of an independent, non-corrupt and respected judiciary.
- (2) The number of checks and balances on executive power including a Constitution, democratic elections, multiple chambers of Parliament, multiple levels of government, and international constraints.

Second, regulatory governance may either be administrative (ranging from reliance on competition law to various forms of extended regulatory contracts based on easily observable indicators such as RPI-X); legislative (legislated rules and procedures based on more difficult to observe constructs such as cost or allowable returns); or the enterprise may remain state-owned

organized as either a state-owned enterprise (with de jure operating independence) or government department (under explicit political control).

In order to create incentives for private agents to invest, Levy and Spiller (1994) argue that governments must craft discriminating alignments of their regulatory mechanisms and the institutional environment. They warn that if regulatory mechanisms (specific/flexible rules/legislation) are incorrectly aligned, a credible commitment will not obtain and "efforts at privatization may end in disappointment, recrimination, and in resurgent demands for renationalization."

In the absence of an independent judiciary (one whose authority over contracts between private or private and public entities is not subject to political intervention), governments are unable to credibly commit without external assistance. Any promise, legislation, contract or rule can be reneged upon without recourse of an appeal to an independent party. Such societies which include absolutist monarchies, centrally planned economies and single party totalitarian states can be characterized by Louis XIV's famous dictum "L'Etat c'est moi" (I am the state). The existence of an independent judiciary gives citizens and firms an independent forum to which they can appeal arbitrary, capricious or self-serving rulings by the state and whose rulings they can have confidence will be enforced by that state. Levy and Spiller posit that, in the absence of judicial independence, efforts at establishing judicial reform should precede efforts at privatization or, if privatization must be enacted for political reasons, governments should rely on third party commitment mechanisms such as provided by international institutions.

Given the presence of an independent judiciary, the next relevant variable is the extent to

which the government in power is unified across various branches (unicameral vs. bicameral legislature, federalist vs. centralized, parliamentary vs. presidential, etc.). Governments that face limited internal constraints can quickly overturn past legislation making that mechanism insufficient for the provision of a credible commitment. Instead they should adopt an administrative or rules based approach that can produce commitment through contract. Divided governments may, by contrast, rely more on more flexible enabling legislation rather than administrative procedures. The authors go on to demonstrate that the evidence of the performance of privatized telecommunications companies in Argentina, Chile, Jamaica, the Philippines, the United Kingdom is consistent with the above theory.

By contrast, Heller and McCubbins (1996) claim that judicial independence is not a prerequisite for successful privatization but that institutional environments which provide regime stability (through unity of purpose or, more commonly, separation of powers) and regulatory predictability (through regulatory rules and procedures) can foster private sector investment with stable prices and sustainable profits in the utility sector. The authors successfully apply this framework to the cases of the privatization of electric utilities in Chile and Argentina.

The two frameworks are broadly consistent. As regime stability weakens, which both authors define as a function of some constraints on executive discretion, credible commitments are increasingly difficult to fashion. The contribution of the Heller and McCubbins paper is noting that increasing the specificity of rules or legislation can compensate for increased uncertainty in judicial outcomes. Spiller and Vogelsang (1996) and the case study of New Zealand's utility privatization presented in this paper present the complementary argument:

increasing the independence of the judiciary can compensate for a paucity of formal constraints on executive discretion by relying on contract and competition law.

The two institutional environments under consideration present different hazards to contracting parties. These hazards are best mitigated using alternative regulatory governance mechanisms. Countries in which one government can unilaterally overturn the policies of its predecessor, such as Westminster Parliamentary systems, should rely as heavily as possible on the institutional framework of contract law in which the private property rights of the utility are as carefully specified as possible even at the risk of lost flexibility. These rights may then be protected by the courts without concern over regulatory uncertainty. By contrast, in institutional environments in which the judiciary is less likely to rule against the government in a politically sensitive dispute or one in which uncertainty is high due to corruption or lack of competence, judicial discretion should be narrowly delimited through the use of a highly specific rules-based approach to regulation with multiple checks and balances.³ In each case regulatory design maximizes the extent to which the government, given its constellation of institutional environment parameters, can provide a credible commitment not to intervene in the day-to-day operations of the privatized utility.

Countries unable to provide credible commitment through either judicial enforcement or credible regulatory rules and procedures will likely benefit from retaining state ownership of these enterprises until such commitments may be fashioned. Countries able to draw upon both types of commitment mechanisms require an extension of this analytic framework.

In these cases, one must also consider variation in the transaction to be regulated.

Following Williamson (1996), contracting hazards vary depending on the value of the asset in its next best use or asset specificity, the frequency with which the transaction occurs, the uncertainty surrounding the transaction, and the demand for probity (Williamson, 1999) in supply. Limiting analysis to the first and last considerations, when asset specificity is high, given the incomplete nature of contracts presumed by the behavioral assumptions of bounded rationality (“*intendedly* rational, but only *limitedly* so” (Simon, 1961)) and opportunism (“self-interest seeking with guile” (Williamson, 1996)), the potential for hold-up in market exchange increases. Above some threshold, the hazards to simple spot market exchange will be too large to bear and the transaction will be brought under a more formal governance mechanism such as a long-term contract, joint venture, or common ownership. The demand for probity imposes a cost disadvantage on private forms of provision due to the perception of illicit profits or conflicting objectives.

As contracting costs increase based on transactional characteristics, the implicit regulatory contract necessary to sustain the transaction in the private sector becomes increasingly costly to support. Levy and Spiller (1994) convincingly argue that utilities are the prototypical high cost transaction. They provide highly political services (high demand for probity), using technologies characterized by economies of scale and scope (small number bargaining reducing value of asset in next best use), and requiring large sunk investments (high asset specificity). However, within the utility industry there remain a wide range of differentiated transactions which vary in their transactional characteristics. Thus in countries in which the institutional environment provided little clear guidance as to the optimal regulatory framework or for

transactions in which the hazards are especially high, a more microanalytic analysis of the specific transaction, the hazard it poses and the regulatory governance mechanisms available to mitigate that hazard is called for. The following section provides an example of the application of the above outlined New Institutional Approach to state sector reform including such a microanalytic analysis of the New Zealand utility sector.

III. A Case Study of New Zealand State Owned Enterprises.

Institutional Background

Before turning to the history of New Zealand's state owned enterprise reform program, one must understand the institutional context in which these reforms took place and the constraints that this placed on the government. At first glance, New Zealand's institutional environment stands out as a polar case of a government unconstrained by institutions (Palmer, 1987). "New Zealand is the most streamlined example of a Westminster Parliamentary democracy in the world" (Palmer, 1993). As a British colony, it inherited much of its institutional framework from the United Kingdom and has modified it to enhance Parliamentary power. Despite seemingly limited checks on government discretion in such a system, New Zealand's tradition of judicial competence and independence still offered substantial guarantees for the sanctity of contract. Furthermore, the long history of respect for civil service had drawn a highly talented pool of economists and policymakers into government.

Incentives and Corporatization

In the 1981/82 fiscal year, New Zealand's state owned enterprises produced 11.5% of that

country's Gross Domestic Product, accounted for 20.9% of gross fixed capital formation and represented a consistent drain on government resources. In 1984, a new Labour Government entered office in the midst of a foreign exchange crisis that highlighted the century long relative decline of the New Zealand economy.⁴ Despite this long-term decline of the macroeconomy and the mounting evidence of micro-inefficiency (Palmer, 1986; Jennings and Cameron, 1987; Spicer et. al., 1991; and Birchfield and Grant, 1993), wholesale reform of state owned enterprises was by no means foreshadowed by the incoming Labour government whose platform pledged only the introduction of more market forces into government operations to improve efficiency (Boston, 1987).

The Labour government's early efforts (1984-1986) were true to their platform. They reconstituted the trading operations of government departments as state owned enterprises with commercial objectives and incentives. The government's aim, in the words of one interviewee, was to create "companies in drag." This meant giving managers a target rate of return and full autonomy on input, pricing and marketing decision. Managers could thus be evaluated on commercial performance compared with a corporate plan. Any noncommercial objectives would be achieved through a government contract with an "independent" though government owned entity rather than internally by fiat. Financing would have to be obtained on the financial markets and dividends would have to be paid to the government shareholder (Minister of Finance, 1985). Regulations were streamlined (Auditor General of Canada, 1994) and free entry and competition were to be introduced where possible (Duncan and Bollard, 1992).

The final step in the corporatization process involved the passage of the State Owned

Enterprise Act in September 1986. It defined the principal objective of 15 newly created state owned enterprises as "a successful business" itself defined by:

being (a) as profitable and efficient as comparable businesses that are not owned by the Crown; and (b) a good employer; and (c) an organization that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavoring to accommodate or encourage these when able to do so (New Zealand Government, 1995).

being a good employer was itself defined by operating

a personnel policy containing provisions generally accepted as necessary for the fair and proper treatment of employees in all aspects of their employment, including provisions requiring -- (a) good and safe working conditions; and (b) an equal opportunities employment program; and (c) the impartial selection of suitably qualified persons for appointment; and (d) opportunities for enhancement of the abilities of individual employees (New Zealand Government, 1995).

The State Owned Enterprise Act also attempted to work around the ownership problem by crafting an alternate monitoring scheme to proxy for the absence of a sharemarket. The typical private sector scheme was modified under the recognition that private sector firms face very different incentives than state owned enterprises. First, private firms have an incentive to provide information and set dividends to attract private investment while state owned enterprises can also rely on government funding. Second, private firms are more profit oriented while publicly owned firms likely have broader objectives. Third, the Board of Directors and senior management of private firms typically have remuneration packages that are more correlated with firm performance than is possible in the public sector. The resulting four part incentive scheme attempted to correct for these differences by mandating information flows, insuring action by Ministers when performance fell below targeted levels and insuring that these performance levels

were not set too low. It included annual negotiations between Boards and Ministers on Statements of Corporate Intent that included performance targets, dividend policy and capital requirements; regular reporting requirements by state owned enterprises that included formal business plans, operating budgets, board papers, accounts, balance sheets and performance measures; procedures for evaluating alternate courses of action to be taken by Ministers when performance lags including the hiring of independent consultants; and periodic review of state owned enterprises to revalue assets thus insuring optimal asset management.

The Impossibility of Selective Intervention

Despite remarkable initial performance improvements causing it to be heralded as a design breakthrough, "the solution for state owned enterprise" (McKinlay, 1987), and a credible third-way between government department and privatization, corporatization was not a long term solution capable of providing private sector levels of efficiency in the public sector. The State Owned Enterprise Act itself encapsulates the tensions in this goal predicted by property rights theory and by the Treasury (Cameron and Duignan, 1984).

In a court case decided by the UK Privy Council, the requirement that state owned enterprises be good employers and behave socially responsibly were held to be of equal weight as the profitability and efficiency objective heralded by the government. While shareholders or stakeholders may place pressures on private sector firms to work towards these general principles, no private sector firm would receive a court mandate forcing them to give equal weight to these objectives and a profit motive. Similarly, no private sector firm faces mandatory reporting requirements as strenuous as those imposed on state owned enterprises and, more

importantly, no such firm has to negotiate anything as onerous as a statement of corporate intent. This allows the shareholding Minister to impose dividend levels, the nature and scope of operations, the objectives of the enterprise, accounting policies, performance targets, and additional information requirements. While these divergences from private sector practice are necessitated by the divergences in incentives outlined above, they necessarily disadvantage state owned enterprises in competition with their private sector competitors.

At this point, the debate refocused on the question of ownership that had earlier been set aside. There was an increasing recognition by various government actors that corporatization was a second best policy solution that could improve upon the performance of government departments but would be unlikely to approach levels of efficiency seen in the private sector. In fact, opportunistic behavior by state owned enterprise managers and government Ministers conspired to keep this system from operating at peak efficiency.

The Controller and Auditor General found that the corporatized firms did not meet the accountability requirements established by the State Owned Enterprise Act (Controller and Auditor General, 1988 and 1990 and State Owned Enterprises Committee, 1990). Managers not surprisingly withheld that information that would be useful in developing sanctions against them. Statements of corporate intent were seen as superficial: corporate objectives were defined in philosophical rather than measurable terms; the scope of activity to be undertaken was vaguely specified; and performance measures were generally viewed as inadequate. Reporting requirements were often ignored and data was withheld due to "commercial sensitivity." Furthermore, this second best proxy would continue to deteriorate in performance relative to the

private sector, unless its assets were reevaluated periodically by externally contracted consultants to insure against degradation or excessive risk exposure.

Ministerial opportunism also occurred taking the form of de facto expropriation. One of the first instances of political interference in the operation of a state owned enterprise occurred in the establishment of Television New Zealand's Statement of Corporate Intent. Attempts to force the inclusion of the objective "promote New Zealand's culture and identity" were derided by Treasury in the strongest possible language:

[this would] reduce profits, reduce revenues to the Crown, reduce new asset value, and thus contravene the State Owned Enterprise Act. Even more fundamentally, this policy would so confuse the company's goals that it would be impossible to assess its performance objectively - effectively a return to the situation which prevailed under the former Broadcasting Company of New Zealand when there was confusion between social and commercial objectives and continuing arguments about financial structure and performance (Treasury analysis, cited in Spicer, Emanuel and Powell, 1993).

Similar controversy surrounded the Labour Party's 1989 campaign announcement lowering mortgage interest rates (a power supposedly held by the corporatized Housing Corporation) so as "to help to reinforce the general decline in interest rates" (New Zealand Herald, 8/25/89 cited in New Zealand Business Roundtable, 1992).

The most egregious political intervention occurred in 1991 when the Government disapproved a rate increase of 2.9% contravening an earlier agreement with Electricity Corporation of New Zealand. In the words of CEO John Fernyough

there is in my view no possibility that any future ECNZ Board will attempt to increase prices without full Cabinet approval and backing. Effectively, this means that electricity prices are now politically controlled (Spicer, Emmanuel and Powell, 1993).

This opinion was confirmed when in 1992, two shareholding Ministers told the board of the

corporation that the government would accept lower rates of return to accommodate a pricing strategy that would not defer economic recovery and that was consistent with economic growth (New Zealand Business Roundtable: NZBR, 1992).

The Government's commitment to provide no financial bailouts was also tested and found wanting. New Zealand Rail, Radio New Zealand, Government Property Services, the Bank of New Zealand and the Development Finance Corporation all received substantial cash infusions from the Government (NZBR, 1992). Similar bailouts and restructurings were implemented on New Zealand Steel, Shipping Corporation and Petroleum Corporation (NZBR, 1988).

The corporatization experiment rested on the assumption that state owned enterprises could mimic the high powered incentive scheme of the private sector while remaining under state ownership. The State Owned Enterprise Act attempted to construct a new organizational form that would include the monitoring and incentive gains provided by a sharemarket without selling shares. It set the benchmark for comparison for performance at the level of private sector corporations and expected simultaneous adherence to good employer rules, social responsibility requirements, more stringent reporting requirements and equity concerns. This conflict between these private and public objectives placed inherent stress on the corporatized firms. Given that the state retained ownership and that contracts are necessarily incomplete (Williamson, 1985), it was impossible to fully recreate private sector incentives for residual ownership rights remained in the hands of the public sector.

While, these faults would prevent corporatized enterprises from attaining private sector levels of performance, they may have facilitated the process of privatization. While government

pronouncements cast serious doubt on the accusations that privatization was the intended goal from the start, corporatization did ease the process of asset valuation and separation of commercial from non-commercial activities.

Privatization

In the end, the argument that apparently swayed the politicians and, possibly, the electorate in favor of privatization was one that had been voiced earlier but viewed as a benefit from though not a cause for privatization: debt reduction. By couching the argument in these terms, the inherent weaknesses of state ownership were obscured. Some combination of the increasing evidence of flaws in the state owned enterprise model and this newly highlighted benefit of transfer to the private sector⁵ allowed Douglas to cross the political watershed in 1987 (Treasury, 1987; Minister of Finance, 1987) and expand the scope of the privatization program in 1988.

The National Party returned to power in 1990 after six years in opposition and further accelerated the pace of the privatization program (see Table 1) while also expanding upon the theoretical framework in one important regard. Based either on the lessons of previous government bailouts or a richer appreciation of the hazards involved, the Government analyzed the potential for ex post opportunism by managers of privatized firms that retained some social or political objectives. The government now recognized that even the transfer of residual ownership rights could not remove all government obligations so long as the privatized corporation retained some public obligations. It pledged to create “a clear-cut regulatory framework” to “allow the new owners to plan with certainty” and to transfer the responsibility for

“any Government policy objectives that might have been set for the businesses” to the core public sector (Treasury, 1990). While this was an important step forwards, it failed to develop a framework that would signal when such hazards are likely to be especially important implying that a return to political control or the crafting of an alternate institutional framework should be preferred to privatization for some subset of transactions.

The Special Problem of Utilities

The reform of two state owned enterprises in particular bedeviled the National Government. The experiences of New Zealand Telecommunications and Electricity Corporation of New Zealand illustrate the types of transactions that, as argued by Levy and Spiller (1996), are most apt to create opportunistic hazards when organized through the market. While most state owned enterprises were primarily engaged in transactions of low/moderate asset specificity (printing, property management, construction, media, airlines, energy, and banking), telecommunications and electricity were characterized by substantially greater transaction costs due to the politicized nature of the market, likelihood of small numbers bargaining given economies of scale and scope and the need for large non-redeployable investments.

Given the New Zealand government's inability to commit not to intervene in any traditional regulatory governance structure for the utilities (a potential de facto expropriation by the state), private monopolies would either have to be offered rates or return that would yield political acrimony or be so tightly regulated as to offer little efficiency gain over their continuation as government departments. Debate continued for years after the passage of the State Owned Enterprise Act 1986 on a breakup of the previously state owned monopolies that

would create a competitive market that would discipline these firms under a light-handed regulatory approach. Partly because of New Zealand's small size (long distance and local calls were routed through the same switches resident in Telecom headquarters (Treasury, 1989c and 1989d)) and unique dependence on hydroelectric power (requiring coordination across different dams, levies and river systems (Electricity Distribution Reform Unit, 1991)), there was the perception that no breakup of Telecom or Electricorp could be designed that accomplished these ends.

Telecom was eventually privatized as a monopoly regulated primarily by the threat of competition which, in fact, did emerge quite rapidly. However, overcapacity in electrical generation made the initial threat of potential competition quite remote for Electricorp stymieing government efforts at privatization. In both cases, the difficulties encountered by the government were centered on the polar case of the utilities problem outlined above, the problem of access to essential facilities or interconnection.

Competition for telecommunication services is greatly facilitated when competing networks are able to interconnect so that users of one service have access to all other users. However, Telecom had a strong advantage in any negotiations for interconnection as it owned the only local network that reached 100% of customers. The first major entrant into the telecommunications market, Clear Communications Ltd., claimed that Telecom's pricing of interconnection was neither "fair" nor "reasonable" and violated Section 36 of the Commerce Act of 1986 because Telecom used its market power in an anticompetitive manner to maintain its dominant position and protect monopoly rents. In a case that reached the Privy Council of the

House of Lords in London, Clear's argument was largely dismissed. In December 1995, after over five years of negotiation, an interconnection agreement was finally reached. The terms of that agreement have not been publicly released and Clear continues to protest claiming it had no choice but to sign a biased accord. BellSouth has not yet reached an accord with Telecom and has made clear its reluctance to sign a similar agreement.

Policymakers faced a difficult decision. Telecom demanded reimbursement for the politically necessary Kiwi share and allowance for a competitive rate of return on a highly specific fixed investment.⁶ Clear's arguments seem equally persuasive. Telecom can be expected to behave opportunistically and thus threaten the competitive returns on investment in competing infrastructure and new services made by entrants.

The Government did warn that failure to balance these claims in private negotiation could lead to a reconsideration of the light-handed regulatory approach initially favored. In 1989, Treasury noted that as Telecom's management favored privatization, they were currently on their best behavior. However, while current interconnection proposals seemed "fair and reasonable", they were "untested by actual operating experience." (Treasury, 1989c emphasis in original) Though initially hopeful that further action would be unnecessary, the Government, frustrated by the lengthy, acrimonious and politically damaging negotiation process, published a barely veiled warning to Telecom in August 1995 to expedite the process. That document failed to reach a conclusion regarding the merits of a revision to the existing regulatory structure but did call for public comment on the matter and promised to evaluate its options surrounding "price restraints on access or interconnection to the natural monopoly facility" (Treasury and Ministry of

Commerce, 1995). Despite the signing of an interconnection agreement by Clear, the final outcome of this debate is still uncertain. The political controversy surrounding the negotiations demonstrates the hazard of opportunistic manipulation of the political process by both entrants and incumbents even in a light-handed regulatory regime.

Despite the long-standing interconnection battle, New Zealand Telecommunications was privatized and does now compete with Clear and BellSouth in long distance and some local markets. The reform of the former Electricity Division of the Ministry of Energy took an almost entirely converse course. While reforms in the sectors of electricity supply and distribution have been impressive, proposals to create a competitive generation sector in private hands remain, as of yet, unfulfilled.

The center of the controversy was, again, interconnection to the transmission network. Given the lack of potential private competition, the government attempted to at least avoid the concentration of monopoly power of generation and transmission in a single entity by establishing a private club ownership for the national power grid divided between generators, distributors and, under some proposals, private investors. However, due to concern surrounding the market power held by the dominant state owned generating company, the distributors resisted and ultimately succeeded in defeating this reform proposal. Reform efforts did not begin again in earnest until supply shortages in the summer of 1992.

Since then, substantial progress has been made in the retailing or local supply sector and in the creation for a spot market for electricity. The 48 local Electrical Supply Authorities (ESA) were corporatized in 1993 with the intent that they would be privatized. In 1994, ECNZ's high

voltage transmission business was separated into an independent state-owned enterprise with the intention of creating a common carrier for a competitive generation sector. As of 1996, despite the fact that only 9 ESAs have sold even a minority of their shares to customers with control remaining with the local council or a community trust and that generation remains a state-owned oligopoly (30% of ECNZ's generating capacity having been split off to form the independent state owned enterprise CONTACT that may be privatized in 1999), the desired competition has begun to emerge.

Since 1994, all customers have had the right to purchase electricity from any supply company. In that same year, the Electricity Marketing Company (EMCO) was set up as a joint venture between ECNZ, Trans Power and the national association of ESAs with the task of creating a wholesale market for electricity. The institutional design of EMCO incorporated many lessons from the failed attempt to set up a club ownership of the transmission grid. Voting rights are divided equally between buyers and sellers to reflect the fact that, unlike financial markets, market participants tend to play one or the other role but rarely both. No one entity is permitted more than 45% of within class voting shares so although ECNZ has 72% of the generating capacity it has 45% of producer votes equal to the share of CONTACT which has 22% of national generating capacity. Furthermore, a majority of both buyers and sellers is required to pass any changes in the rules regulating the market.

Initially, EMCO focussed on transparency in price setting by publishing weekly updates on the process used by ECNZ to determine prices. In 1995, the cap was removed on the spot market for electricity and government support for a light-handed regulatory approach was

reiterated. Since October 1, 1996, prices have been set by a computer-based trading and information system developed from the foreign exchange room system used by major banks around the world based on bids between buyers and sellers for 30 minute blocks of electricity at 200 entry or exit points along the national grid (Bollard and Pickford, 1996). A recent study by Bergara and Spiller (1997) using data disclosed under the light-handed regulatory system finds that relatively high-cost suppliers in urban or industrial areas tend to distribute the electricity of others suggesting that market forces are having an important impact relatively rapidly.

The distinct reform paths taken by these two utility sectors under comparable institutional regimes of light-handed regulation highlight the importance of transactional characteristics to the determination of an optimal regulatory governance mechanism. In the case of electricity, despite the difficulty in transferring the generating sector to private control, interconnection was achieved with little acrimony and a functioning spot market for power has developed. By contrast, despite the emergence of a competitive telecommunications service sector, interconnection remains highly contentious. Electricity may have proceeded further due to the homogeneous nature of the product that creates more reciprocity between different network owners and eases the burden of information disclosure requirements. Additionally, after corporatization and deregulation of the 48 Electricity Supply Authorities, there existed a competitive downstream market. By contrast, telecommunication services are heterogeneous, bundled and sold directly to the consumer across a participant-owned and currently monopolistic infrastructure.

In both cases, after substantial delay, trial and error and acrimony, prices were reduced,

service reliability improved and competition enhanced. Progress in competition was greatest where contracting costs were minimized. For transactions in which, due to technological or political constraints, small numbers bargaining over the returns on non-redeployable assets was subject to political intervention, progress was limited. By contrast, where competitive suppliers could emerge and safeguard the hazards in their exchange through contract or reciprocal arrangements, gains were the greatest. It is not possible, in hindsight, to assess whether more or better reforms were theoretically possible but only to compare feasible alternative institutional structures. Given gains to consumer and producer surplus in both sectors (Boles de Boer and Evans, 1994 and Culy, Read and Wright, 1996) since 1984 and likely gains of dynamic efficiency, there is little doubt that New Zealand succeeded on this score.

IV. Conclusions and Further Applications in the International Context

The New Institutional Approach to state sector reform presented in Section II allows for a better understanding of the successes and failures of New Zealand's state-owned enterprise reforms as well as the construction of a set of recommendations for future reform efforts. Until the 1993 electoral reform, New Zealand's government was constrained from arbitrary or opportunistic behavior only by the independence and professionalism of the judiciary, the strong administrative capabilities of the civil service, and informal societal norms that constrained excessive behavior. While such a framework offered substantial guarantees against arbitrary administrative or judicial expropriation of private assets, legislated reforms lacked credibility due to the ease with which the present or any future government could overturn past law.⁷

The extended agency theory based experiment with corporatization of state owned enterprises, despite initial efficiency gains, failed to yield private sector levels of efficiency or produce the sustained dynamic efficiency gains hoped for. Political intervention became increasingly common and disclosure standards frequently evaded. In response to these shortcomings and new theoretical insights from the property rights school, state-owned enterprises that were seen as operating in competitive, or at least contestable, markets were privatized while the remainder were brought back under increasingly direct state control (see Table 1). In those cases such as public utilities where contracting costs were extremely high, regulatory governance was structured around light-handed regimes that took advantage of New Zealand's independent judiciary and minimized the dangers of regulatory uncertainty posed by its Westminster Parliamentary regime.

However, consistent with the lessons of transaction cost economics, the type of regulatory apparatus that was adopted differed substantially between the telecommunications and electricity sectors based on the unique technological, market and political characteristics of the two industries. An important lesson from this application of the new institutional approach to public sector reform is the need for a careful microanalytic analysis of the hazards to market exchange and from political intervention that characterize a specific regulated industry prior to the proposal of a specific sectoral reform program. Not only will the regulatory governance mechanism differ substantially across countries based on the institutional environment but it will also vary within a country across industries based on the specific hazards faced in market exchange.

In a broader international context, the new institutional approach to public sector reform

developed here predicts that countries with relatively independent judiciaries but relatively few formal constraints on executive authority will rely on light handed regulation. Several recent case studies on the privatization of electricity and telecommunications firms support this claim. Spiller and Sampson (1996) and Spiller and Vogelsang (1996) document the use of contract law as a regulatory mechanism for the telecommunications sector in Jamaica and the United Kingdom which, like New Zealand, possess Westminster style Parliamentary democracies with relatively independent and autonomous, if circumscribed, judiciaries. Similar results are reported by Newbery and Green (1996) for electricity in the United Kingdom and by Hjalmarsson (1996) in Norway, Sweden and Finland. Countries with less developed judicial systems but a stronger set of checks and balances against executive discretion will tend to rely on highly specific regulatory rules and procedures. Such is the case for telecommunications (Galal, 1996 and Hill and Abdala, 1996) and electricity (Heller and McCubbins, 1997) in Chile and Argentina respectively.

Countries lacking both commitment mechanisms are not expected to secure successful privatizations in high transaction cost industries unless they offer rates of returns which so high as to themselves raise concerns regarding the political sustainability of reforms. Most East and South Asian economies fall in this category and have tended to be characterized by acrimonious renegotiation of contracts with private sector providers earning what are perceived as supernormal profits (Enron in India), the use of build-own-transfer contracts that leave most of the non-commercial risk in the hands of the government (Philippines and Malaysia) or continued state ownership (Korea and Taiwan).

While the benefits of privatization have been well chronicled in numerous qualitative and quantitative empirical works, the appropriate framework for regulatory governance of industries with high contracting costs remains relatively poorly understood. Levy and Spiller (1996) posit the centrality of judicial independence while Heller and McCubbins (1996) stress regulatory rules and procedures. The New Zealand case study offered here provides additional evidence that at least two alternative paths to regulatory commitment likely exist. Countries with relative advantages in judicial independence should rely more heavily on competition law while those institutional environments with more formal internal checks and balances on executive discretion may benefit from developing regulatory rules and procedures that carefully delimit the range of executive and judicial discretion. In either case, a microanalytic focus on the sources of hazards in market exchange is required prior to the crafting of a public sector reform program that gets the prices, incentives, property rights and governance mechanisms right.

Table 1: Reform of State-Owned Enterprises

| <u>State Owned Enterprise</u> | <u>Activity</u> | <u>Status and Comments</u> |
|--|--|--|
| <i>Corporate forms predating 1987</i> | | |
| New Zealand Steel | Steel production | Privatized (1988) |
| New Zealand Railways Corporation | Train, bus, ferry services | Privatized (1993), government retains ownership of land pending settlement of Waitangi claims |
| Housing Corporation | Concessional mortgages and rental properties | Approximately NZ\$1.2b mortgages privatized (1991-92) |
| Development Finance Corporation | Development bank | Sold, under statutory management (1988) |
| Bank of New Zealand | Trading bank | Privatized (1992) |
| Air New Zealand, Ltd. | Domestic and Int'l air services | Privatized (1989) |
| Petroleum Corporation of New Zealand | Oil and gas production | Privatized (1988) |
| Tourist Hotel Corporation of New Zealand | Hotels | Privatized (1990) |
| Shipping Corporation of New Zealand | Shipping Services | Privatized (1989-90) with partial payback (1993) |
| Rural Bank | Agricultural bank | Privatized (1989 and 1992) |
| <i>Corporations established under 1987 act</i> | | |
| Airways Corporation of New Zealand | Air traffic control | State owned enterprises (profits of \$6m in 1994) |
| Coal Corporation of New Zealand | Coal Mining | Settling ownership issues under Treaty of Waitangi |
| Electricity Corporation of New Zealand | Electricity generation | State owned enterprises |
| TransPower | Electricity transmission | State owned enterprise (created 1994) |
| Government Life Insurance Corporation | Life Insurance | Now owned by policyholders |
| Government Property Services | Government property holdings | State owned enterprise (profits of \$1.5m in 1994) |
| Land Corporation | Government rural landholdings | State owned enterprise (profits of \$36m in 1994) \$77m in mortgages sold in 1989-90 \$887m of cutting rights privatized |
| New Zealand Forestry Corporation | Forests and sawmills | rest remain along with land as state owned enterprise |
| New Zealand Post | Postal services | State owned enterprise (profits of \$67m in 1994) |
| Post Office Bank | Savings bank | Privatized (1989) |
| Telecom Corporation | Telephone services | Privatized (1990) |
| Works and Development Services Corp. | Civil engineering | State owned enterprise (profits of \$10m in 1994) |
| Government Computing Services | Computer systems | Privatized (1994) |
| Government Supply Brokerage Corp. | Government purchasing company | Privatized (1992) |
| Radio New Zealand | National radio services | State owned enterprise (profits of \$1.6m in 1994) |
| Television New Zealand | Two national TV channels | State owned enterprise (profits of \$33m in 1994) |
| <i>Uncorporatized bodies</i> | | |
| Health Computing Services | Health Computing | Privatized (1988) |
| Government Print | Printing | Privatized (1990) |
| National Film Unit | Film making | Sold to Television New Zealand |
| Communicate New Zealand | Publicity services | Privatized (1990) |

SOURCE: Bollard (1992) and Treasury (1995c).

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1. See Williamson (1996).

2. For a broader perspectives on the recent reforms Evans, Grimes, Teece and Wilkinson (1996).

3. Schwartz, Spiller and Urbiztondo (1994) make a closely related argument in claiming that legislatures would want to pass highly specific rules vs. more general formulations when their preferences are intense, judicial uncertainty is high or the cost of reversing the courts is high.

4. From 1870 to 1966, New Zealand ranked among the top five countries in the world in GDP per capita and was among the top three in most of those years. By 1984, they had fallen to fourteenth and would continue to drop to seventeenth in 1991 just ahead of Spain, Ireland and Portugal who, in 1870, had per capital income roughly half that of New Zealand. (Maddison, 1995).

5. Note that the state's balance sheet only improves after a privatization if the private sector is a more efficient manager of the assets than the public sector. Both an asset and liability are being removed from the government's accounts. Only if the sale price exceeds the discounted present value of the rents from continued state ownership will privatization aid in debt reduction.

6. Telecom has claimed that it continues to provide a \$NZ100-200m cross-subsidy to local access from business and international tolls. (Crook, 1995).

7. The shift to a mixed member proportional system eliminated the virtually guaranteed single party majority provided by the Westminster system. Ironically, the new Parliament, though likely unable to push through substantial new reforms, will also have great difficulty in undoing prior reforms leading to an enshrinement of the status quo.