Structure and tension in public and private sector governance: Observations from the UK and Australian experience

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Abstract:

The past decade has produced significant change in how the public and private sectors operate and the public expectations of their role. This paper claims that the pressures that have challenged the governance structures of key public and private organisations in the UK and Australia are common to both sectors. It argues that the 'independent regulatory agencies' of the public sector and publicly listed companies in the private sector have evolved in ways that point to a common template of organisational governance and response to crisis. The dynamic of both organisations was forged through the large-scale privatisations of the past decade and the reaction to the loss of collective public ownership.

The paper assesses similarities in the governance of regulatory agencies and listed companies according to four broad criteria: performance, conformance, credibility and trust. It highlights the initial establishment of a principal-agent framework; the politicisation and placement of unrealistic expectations on CEO performance; the subsequent onset of forms of regulatory crisis; a process of restoring trust through a mix of tighter regulation and corporate governance standards; and greater participative consultation among stakeholders. Comparisons between public and private sector governance also identify similarities in the British and Australian experience.

Glossary

CAC	Commonwealth Authorities and Companies Act
CEO	Chief Executive Officer
CSR	Corporate Social Responsibility
FMA	Financial Management and Accountability Act
IRA	independent regulatory agency
PLC	publicly listed company

Introduction

This article examines two key consequences of the modern era of privatisation and financial deregulation in the British and Australian experience. The first relates to the role of the public sector and the shift from the state as a provider of services to that of a regulator of commercial contractors, with devolved independent regulatory agencies (IRAs) given responsibility for enforcing specific laws in the public interest. The second relates to the operation of privatised (publicly listed) companies and their focus on 'shareholder value' as a guiding philosophy. Together, the regulatory emphasis of IRAs and the goal of higher share prices of publicly listed companies (PLCs) have shifted the responsibilities between the public and private sectors. Rather than public agencies being accountable to citizens for the direct provision of rail, postal, electricity, water, telecommunications and employment services, they became responsible for regulating the private providers, primarily to ensure low prices for consumers. Rather than company directors enjoying autonomy to manage in the company's interests, privatisation and the revolution in financial markets meant that boards and Chief Executive Officers (CEOs) became stringently judged according to share market value. These changes reflect the public sector's endorsement of corporate values and market signals, the private sector's adoption of these signals as a systemic guide to performance, and the resultant need for both public and private organisations to devolve their operations.

Parts 1 and 2 of this article sketch these two trends in the British and Australian experience.[1] Part 3 examines the reasons for subsequent crisis. Part 4 identifies the issues of corporate governance and stakeholder relations as the key challenges facing both IRAs and PLCs into the 21st century. After 20 years of privatisation and financial liberalisation, both the regulatory state and the philosophy of shareholder value have suffered major institutional failures. In response, regulatory agencies have required a sharper focus on issues of governance - rather than law - which improves coordination between state agencies (vertical governance) as well as these agencies' relations with their societal stakeholders (horizontal governance). Similarly, publicly listed companies have needed to provide greater accountability and transparency for their shareholders while at the same time broadening their responsibilities to stakeholders (consumers, suppliers, community groups, environmental interests).

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[1] These countries are chosen for their common policy of privatisation and financial deregulation, the development of independent regulatory agencies, their private sectors' endorsement of 'shareholder value' and the resultant 'principal-agent' framework in both sectors. The American regulatory state is somewhat different in that it was not based on privatisation but a cultural preference for private economic activity and a concomitant requirement for the state to steer that activity (see Scott 2001).

The article is interested in the shifts of public and private sector organisation flowing from privatisation and financial liberalisation, and in their similar responses to institutional crisis as a result of these shifts. It is not immediately concerned with the influence of regulatory agencies and publicly listed companies upon each other. There have been obvious strong linkages between the two with the regulation of financial markets, codes of corporate governance and public agencies' adoption of the private sector corporations' legislation. While these connections are duly noted, the focus is on plotting the patterns of the governing philosophy and institutional development of each sector.

1. The Regulatory State

Privatisation and an increasingly competitive financial sector have changed the institutional structure of governments. As key public services have shifted to private providers and markets have become more susceptible to anti-competitive behaviour, generalist bureaucracies and hierarchical control have been usurped by 'independent regulatory agencies' (IRAs). These specialised agencies focus on specific regulatory objectives, often prescribed by an Act of Parliament, and are thereby independent from executive government and elected politicians (Majone 1997, pp152-55; Hood, Rothstein and Baldwin 2001, p24). The creation of IRAs has led to new classifications of administrative organization, defined by their distance from Parliament and executive government and their regulatory powers (see Hood 1978, 2000). 'New public management' made a distinction between the executive core, the semi-corporate service delivery agencies and the regulatory agencies. Both Britain and Australia have delegated extensively, establishing independent agencies for the regulation of utility competition and in financial, social and environmental fields (See Table 1). Australian government agencies with explicit regulatory functions employed around 30,000 staff and spent $4.5 billion in 2001-2002 (Banks 2004).

TABLE 1

	Britain	*Australia*
General competition	Competition Commission 1998 Office of Fair Trading 1973	Australian Competition and Consumer Commission (ACCC)*
Telecommunications	Office of Telecommunications 1984	Australian Communications Authority 1997#
Energy	Office of Gas & Electricity Markets 2000	Office of the Renewable Energy Regulator 2001*, ACCC
Aviation	Civil Aviation Authority	Civil Aviation Safety Authority 1995#!
Water	Office of Water Services 1989	State Environmental Protection Agencies*
Railways	Office of Rail Regulator 1999	State franchises (eg RailCorp in NSW) regulated by State governments and federally by ACCC
Postal Services	Postal Services Commission 1999	ACCC, Self-regulation by Australia Post
Media	Independent Television Commission 1990	Australian Broadcasting Authority 1992#
Stock exchange	Financial Services Authority 1997	Australian Prudential Regulatory Authority (APRA) 2002# Australian Securities and Investments Commission (ASIC) 1991#
Environment	Environment Agency 1996	Australian Greenhouse Office 1998-2004*
Food Safety	Food Standards Agency 1999	Food Standards Australia New Zealand#

Source: Thatcher 2002, p143, DoFA 2003. The date relates to the year the agency was established.

* As of 1997, these Australian regulatory agencies are subject to the *Financial Management and Accountability Act*, where the CEO is accountable to the Minister and ultimately accountable for the performance of the agency.
# As of 1997, these Australian regulators are subject to the *Commonwealth Authorities and Companies Act* which requires a board to which the CEO and management are accountable. The relevant Minister elects the board of directors who are responsible for developing a corporate plan and informing the Minister of major events. The ACCC and ASIC are also subject to the *Financial Management and Accountability Act* (1997).
! In October 2003, legislation was introduced proposing the abolition of the CASA Board.

The principal-agent framework and functional focus

Much of the academic literature on the regulatory state has been devoted to the reasons for its emergence (Thatcher 2001; Moran 2002; Majone 1994; Moran 2002). *Prima facie*, it is puzzling that governments should cede power to agencies at arms-length from the executive. It would seem only logical that executive agencies oversee regulation of privatised utilities to ensure close Ministerial involvement. Yet IRAs were favoured precisely because they were free from elected political influence. The argument is that delegation improves electoral legitimacy and is essentially a response to general public cynicism with traditional modes of governance (Davis and Keating 2000, p10). In the absence of political flexibility, citizens and investors are likely to be more assured of optimal policy outcomes than if the process was left to politicians' discretion. While the public may not care which government agencies deliver the needed goods and services (Kettl 2000, p488), governments have guarded against the perception that privatised public assets have become their political pawns. This is the basis of the 'credibility hypothesis', which argues that fixing policy settings or delegating to external powers actually increases a government's credibility (Kydland and Prescott 1977; Shepsle 1991; Majone 1997). Delegation to regulatory authorities overcomes the 'short-term horizons imposed by the democratic process' (Gilardi 2002) often through a legal mandate. The regulatory state was formed to instill trust among citizens that the privatised asset would be properly managed and that competition rules would be administered equitably for existing and potential private providers. It has been argued, for instance, that regulation without political influence is a better guarantor that safety standards will be upheld, that service obligations will be met, and that multi-national investors will be lured (Levy and Spiller 1996; Henisz 2000; Gilardi 2002).

A second rationale for delegating regulation is more practical but it too deals with the issue of credibility. The basic argument is that delegated agencies have more knowledge and expertise in dealing with private providers than a generalised bureaucracy (Rose and Miller 1992). For regulators to be effective and to be taken seriously, they must be focused in their goal and well positioned to influence the social responsibility of those they regulate (Braithwaite 1999). Majone (1994, p81) defines effective regulation in terms of 'detailed knowledge of and intimate involvement with the regulated activity. [This will] necessitate the creation of specialised agencies entrusted with fact-finding, rule making and enforcement'. The devolution of governance associated with the regulatory state is a product of the technocratic demands of specific public objectives (McGowan and Wallace 1996, p562). Effective regulation requires specialisation, which requires closer contact with stakeholders than the traditional Westminster model allows. This proximity establishes institutional autonomy or 'negative coordination' (Scarpf 1994, p39; Jayasuria 2001, p104) as a key feature of the regulatory state. Rather than a process of bargaining between ministerial units (positive coordination), the devolution of agencies is designed to minimise conflicts between the objectives of these independent regulatory institutions.

The regulatory state has been developed upon a principal-agent framework, which separates ownership from management. The reasons for delegation have mainly been functional, reflecting a desire by the executive to shift blame, to develop greater trust among citizens, and to build the technical expertise necessary to cope in an increasingly complex and international regulatory environment. Circumstantial factors have also contributed. In Britain, delegation has been an institutional response to policy problems (Thatcher 2002b, p143). Underpinning both these explanations, the principal-agent framework of the regulatory state reflected the climate created by privatisation and deregulated financial markets.

Politicisation and outcomes

Despite these arguments supporting the credibility and autonomy of independent regulators, their role has not been depoliticised. The privatisation of key public assets has ensured a high level of partisan and media scrutiny. In the UK and Australia, regulatory authorities have become quasi republics with a prominent, entrepreneurial leader often pursuing his / her own regulatory agenda (Hall, Scott and Hood 1998; Goggin 2000; Thatcher 2002, p140; Brenchley 2003). Many regulatory agencies in Australia and the UK have adopted a corporate structure with the CEO appointed by the relevant Minister, answerable to a board and responsible for the operation of a budget (see Table 1). While an Act of Parliament guides regulators, the style and targets of enforcement are often indicators of the vigilance of the chief regulator. Legislative changes have reinforced the CEO-style image of regulatory chiefs (Osborne and Gaebler 1992). Devolution has meant that the responsibilities of public sector CEOs have 'probably never been greater', while changes to the legislative framework have aligned their duties more closely with those of private sector CEOs (Barrett 2002).

Still, Parliament sets the framework for regulation and thereby provides governments and opposition parties with avenues for involvement. IRAs may have diluted the practice of ministerial responsibility, but partisan politics ensures that the performance of these agencies is not neglected. The British Labor government, for example, strongly supported the initiative of the rail regulator to reform its regulatory institutions to oversee more effectively the privatised franchises (Moran 2001, p27). Similarly, the issue of service provision has been of strong partisan concern in regulating the Australian public Telco. In addition to scrutiny from independent telecommunications and competition regulators, the case for placing majority ownership of Telstra in private hands has been the subject of intense parliamentary debate and of inquiry as to whether the company currently meets universal service standards. While devolved regulation may give credibility to the regulatory process, the importance of the services provided by the privatised companies, coupled with the eagerness of governments to ensure the success of privatisation, has inevitably politicised the regulatory state. Credibility of process led to the rise of IRAs; credibility of outcomes has ensured political participation (and coercion) in the regulatory process. I will look at the harm caused by outcome-based party-political influence in the regulatory state in Part 3.

Transparency and trust

In operational terms, this basic tension between devolving regulation to IRAs while maintaining executive oversight has been bridged by the use of audits (Power 1994, p15). An important sub-theme of this article is the influence of private sector administration on the regulatory state. The exemplar is the use of auditing, both government audits of its own agencies and these agencies' audits of private sector corporations. Within the British and Australian governments, National Audit Offices scrutinize the financial statements and administration of public sector entities on behalf of Parliament, the executive, Boards, Chief Executive Officers, and the public. They report on the efficiency and effectiveness with which government bodies have used public money (National Audit Office 2000). The internal audit process of government agencies is established by legislation. Many Australian IRAs are governed by the *Commonwealth Authorities and Companies Act* (CAC Act 1997), which requires the directors of the Authority to inform the relevant Minister of its operations (Edwards et al. 2003, p30).[2] The CAC Act contains duties of care, business judgement and individual liability that correspond closely to the provisions of the (private sector) Corporations Act (2001). Table 1 shows that Australia's key corporate regulators (ACCC and ASIC) are also governed by the *Financial Management and Accountability Act* (1997) which makes the agency's CEO ultimately responsible for the performance of the company, the implementation of a fraud plan (s45) and the creation of an audit committee (s46). British utilities have traditionally been governed by an FMA-style single person structure in the form of a non-ministerial government department although this is slowly changing toward the European-style multi-person board (see Thatcher 2002, p130).

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[2] Many 'CAC Agencies' are also prominent regulators including the Australian Prudential Regulation Authority, the Civil Aviation Safety Authority and the Health Insurance Commission.

The regulatory state is defined by the use of audits and controls by IRAs themselves, notwithstanding the increasing influence of elected officials over their operation. Similarly to the Audit Office, IRAs use the tools and language of the audit process to give assurance to Parliament and the executive that the bodies that they oversee — whether universities, the medical profession, airlines or private corporations — are complying with an industry or consumer standard. Moreover, the power of the newly privatised business sector has heightened pressures for audits to control monopoly, enforce competition and manage social damage caused by externalities (Prosser 1997, pp10-11). The upshot is a system in which the regulation of the private sector and professional bodies is devolved to independent public agencies in order to ensure credibility. And these agencies, through legally defined responsibilities and the independent checks of an Audit Office, inform the executive and the legislature of their own financial records and regulatory activities to ensure transparency and accountability.

It seems somewhat peculiar that much of the advance in IRA's auditing powers has been in response not to executive and Parliamentary demands for transparency *per se* but to the impact of scandal. It is often observed that the powers of IRAs have increased commensurately with regulatory failure. However, this is not that surprising given that the nature of regulation is both reactive and preventative and, in the case of Britain, that command law has often been usurped by a reliance on cooperation and trust (Hawkins 1984, pp191-4; Vogel 1996, pp146-92). As Ulrich Beck (1992) famously recognised, modern industrial societies have created new kinds of risks: they are catastrophic in effect, unknowable in advance and collective in their incidence (see also Moran 2001, p29). Scandal – whether corporate fraud or environmental crisis – inevitably leads to regulators' expanding their controls and intensifying audit activity. Power (1997, pp134-8) has argued that, in many cases, regulations and audits have replaced trust as the mechanism through which the British Parliament and public receive assurances on financial administration. Privatisation and the power now vested in business by both governments and the general public has strengthened the underpinning idea that the regulatory state can and should manage the associated risks. This is a theme that recurs in the context of private sector corporate governance, to which we now turn.

2. Privatisation and shareholder value

This second section looks at *the* key change that has occurred in the governance of the private sector as a result of the modern era of privatisation and financial deregulation. The intent is to recognise that many of the features identified in the operation of the regulatory state – focus, credibility, politicisation, outcomes, audits, risk and scandal – have also been prominent in the management and governance[3] of publicly listed corporations.

Beginning in the early 1980s, the revolution in private sector governance was based on the idea of 'shareholder value'. The primacy of delivering the highest possible dividends to a company's shareholders was based on the new effectiveness of the stock market in disciplining companies, attracting investment and democratising access to information about stocks. Several factors underpinned these changes. First, deregulation and innovation in the money markets worldwide produced a highly liquid and competitive system of corporate finance and performance (see Friedman 2000, pp53-60). The 1980s marked a sharp increase in both the availability of venture capital and the possibility of takeover as foreign entrants were allowed into the recently privatised markets of telecommunications, banking and airlines (Owen 2003). Second, privatisation led to a massive surge in the number of institutional[4] and 'retail'[5] investors in the share market[6], an increase in the liquidity of the share market and growth in governments' coffers[7]. Kay (2002, p22) notes that the sale of even half share in British Telecom was six times larger than any previous issue on the London Stock Exchange and the demand from private investment exceeded expectations such that the maximum allocation in the open offer was scaled back. The first two rounds of the Australian Telco float produced similar enthusiasm.[8] The overall level of share ownership in Australia increased from 15% of adults in 1992 to 54% in 1999 (ASX 2002). Third, government regulations also contributed to the high level of indirect share ownership and the rise of the funds management industry as a key institutional investor. In Australia, for example, the 1992 Superannuation Guarantee Levy made salary contributions to a

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[3] I draw a distinction between management and governance as recognised by Tricker (1984). 'The purpose of governance is not to manage but to gain an assurance that an organisation is well managed.'

[4] Institutional investors are mainly pensions funds and mutual funds.

[5] By retail shareholders I mean investments by private citizens.

[6] The 2002 ASX study into share ownership found that half of all Australians owned shares – 37% directly, 13% indirectly.

[7] In the UK between 1984 and 1996, the largest public flotations raised revenue of around 50 billion (at 2000 prices) (Kay 2002, p22). In Australia over the 1990s, over $95 billion was raised by Commonwealth and State Governments through privatisation, $45 billion of which was by public float (Walker 2000, p17).

[8] The first third of Telstra was sold for $14,330 billion at a first installment price of $1.95 per share. Within months, the share price had peaked in excess of $9 a share.

pension fund compulsory. The funds have offered various investment options for policy holders, which has made them indirect shareholders and enabled the funds to gain a major stake in other financial institutions.

The principal-agent framework and functional focus

Just as privatisation induced change to the Westminster style of governance by creating discrete agencies with competence in policy-making, regulation and service provision, it also focused the activities of the managers of publicly quoted companies. The ethos of 'shareholder value' was a significant break with the past. During Britain's nineteenth-century experiment with privatisation, Conservative governments' commitment to *laissez-faire* and company directors' interests in preserving their own autonomy overrode shareholders' interests. The joint-stock company was characterized by a large number of inactive shareholders, by increasingly specialist managers, and by increasingly transferable shares (Ireland 1999, pp38-9). Unfettered private enterprise was supported through limited liability legislation to attract more shareholder capital (Gamble and Kelly 2001, p111). There emerged agreement that business should not remain for specific purposes as endorsed by the state, but was the right of private citizens. Corporate property was private individual property which left British companies to operate without a legal framework. Even as the state grew in the 20th century, the political interest in the growth of corporations and the absence of mass shareholding meant that shareholders' interests were left largely to the whim of directors. The enduring influence of these early developments ensured that corporations' responsibilities were an internal matter, free from state or civil influence. The 1844 and 1856 Companies Acts established the limited liability corporation in Britain and implied that the company was not made of its shareholders but made by them (Ireland 1999, p39).

Beginning in the 1960s, the idea of company profits in the name of the company and its directors began to fade. In the UK, 1962 legislation established that only *shareholders* have exclusive claim to the companies' residual assets in the event of liquidation. Easterbrook and Fischel (1991) have argued that shareholders own the company given that they bear the residual risk of the enterprise, because their funds can be seized by liquidators. These legal arguments have been strongly backed by ideological opposition to the idea of businesses' having social responsibilities to those other than shareholders. Friedman famously simplified the goal of the corporation as 'to make as much money for stockholders as possible' (Friedman 1962, see also Hayek 1969). For auditors, company directors and shareholders alike, this argument is highly appealing for it serves the dual purpose of accountability and efficiency (Gamble and Kelly 2001, p110). It creates a credible system that overcomes the principal-agent problem[9] by connecting the interests of directors, managers and shareholders. If the share price rises, the board and shareholders are financially rewarded and the stock becomes more attractive to potential investors and less attractive to corporate raiders. If the share price falls, managers and shareholders lose financially and some shareholders may leave or they may remain if a takeover bid offers a higher price than the existing value of shares. As with the regulatory state, the logic of 'shareholder value' is to specialise and deliver outcomes.

Politicisation and outcomes

The private sector's response to the challenge of 'shareholder value' has been to develop its own incentive and reward structure. The CEO of private corporations has assumed unprecedented responsibilities and has personified the activities and culture of the company. The accompanying scrutiny of the CEO's performance by the Board, shareholders, the media and IRAs reflects the transformation of the office from a managerial to a political appointment. The US in particular has nurtured the 'cult of the CEO' and similar trends are apparent in Australia and the UK (see Haigh 2003). The 'cult' has essentially been a response to the new commercial environment. The increased threat of takeover in the 1980s was based on the innovation of 'leveraged buy-out' whereby the funds for takeover were promised by investment banks selling bonds secured on the company's future earnings (Chancellor 2002, p29). In response, companies aligned CEOs' remuneration with future performance on the sharemarket through stock options and long-term incentive plans (see Pass 2003, p21). This alignment made direct the CEO's incentive for acting in shareholders' interests and achieving contractual outcomes. CEOs were no longer empire-building managers but risk-taking entrepreneurs investing in shareholders' and their own pecuniary gain.

Some have argued that the rigour of financial markets, coupled with the alignment of managerial and shareholder interests is a sufficient framework for corporate governance (Sternberg 1996). The option that shareholders have to exit if their stock devalues is a better guarantor of company performance than their collective voice at meetings. Market governance also has appeal 'as a practical matter [...] the corporation cannot be managed by shareholder referendum [because] of the complexity of managing [its] affairs in fast-moving and ever-changing markets' (OECD 1999). But these options of withdrawing ownership or ceding all decisions to management are at odds with the rise of shareholder activism and the development of corporate codes over the past

9 This problem arises when the owners of an asset are not the managers.

decade. Privatisation and the rise in the number of retail shareholders have been significant in shaping demands and avenues for shareholder participation. With half its adult population owning shares[10] and the average size of portfolios over $A40,000 (ASX 2003), Australia is fast becoming the prototype of a strong shareholder democracy, underlining the need for managerial accountability. The number of citizens investing in the share market has intensified the forum of the annual general meeting and put pressure on governments to ensure that companies are regulated as much in the interests of healthy shareholder returns as they are for meeting the demands of other stakeholders.

Transparency and trust

Given the unprecedented interest in shareholding among retail and institutional investors, it is not surprising that the accountability standards governing publicly listed companies have increased. The codes of corporate governance devised by regulatory agencies and sharemarkets over the past fifteen years reflect the fact that market governance through shareholder activism is insufficient to control management. As discussed earlier, shareholder value is essentially about outcomes, not processes. As Section 3 will explain, the intense pressure to achieve short-term outcomes can corrupt the proper processes which are essential for the long-term health of companies. Shareholders' activism is often inadequate to provide a proper check on companies' activities. Companies cannot be run through shareholder plebiscite. Although legislation provides an opportunity to put questions to directors or make comment about the management of the company, small investors in large public companies are generally apathetic, while large institutional investments are more likely to leave a company that experiences management difficulties than they are to become involved (Dine 2000, p31). While dividends are accruing, both retail and institutional investors will unquestioningly trust a large public company's internal controls and processes. Even if shareholder concern is aroused, the information asymmetries caused by the separation of ownership from control makes a thorough process of management accountability difficult. Shareholder ownership does not allow for an auditing role.

The UK has had three major codes on corporate governance – the Cadbury[11] (1992), Greenbury[12] (1995) and Hampel[13] (1998) Reports. All three emphasized the importance of appointing the right

[10] - either directly or indirectly -
[11] *Report on the Financial Aspects of Corporate Governance*, Gee, London, 1992.
[12] *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury*, London, 1995.
[13] *Committee on Corporate Governance Final Report*, Gee, London, 1998.

people to board positions and ensuring sound structures for making decisions. Cadbury began the reform process by focusing on board cohesion and the auditing role of non-executive directors in reviewing the performance of the Board and directors. The Cadbury Report also recognised the importance of institutional investors for providing outside accountability. The Greenbury Committee sought to depoliticise the issue of remuneration by requiring the directors of a listed company to establish a remuneration committee, consisting of non-executive directors, that would determine company policy on executive payments. The criticism made of these first two reports focused on their two-tier approach to resolving the issue of board governance. The internal checks of non-executive Directors seemed to grate with the Report's basic tenet that board effectiveness hinged on the ability of boards to work together (Cadbury 1992, p20 para 4.2; Dine 2000, p135). There was also negative reaction to the prescriptive nature of the Cadbury and Greenbury Reports which has recast corporate governance less in terms of compliance and more in terms of standards that will enhance business performance (Hampel 1998).

These government-imposed internal checks on British companies were complemented by formal resolve among institutional investors to exercise greater pressure on corporate governance. As early as 1991, a report from the Institutional Shareholders' Committee emphasized shareholders' obligations 'to exercise their commitment in a responsible manner' and a responsibility 'to actively intervene where necessary' (Institutional Shareholders' Committee 1991). It argued that institutional shareholders had a duty to check the power of executive Directors through ensuring the appointment of non-executives of appropriate calibre, experience and independence. A decade later, the Committee released its principles of best practice, governing the responsibilities of institutional shareholders and investment managers. These included: the publication of policies with respect to institutional shareholders' active engagement with companies; monitoring the performance of companies; intervening where necessary; evaluating the impact of companies' policies; and, in the case of investment managers, reporting back to the clients on whose behalf they invest (Institutional Shareholders' Committee 2002). If companies persistently fail to respond to concerns, the Committee's members will vote against the Board at General Meetings.

There have been similar attempts at the internal reform of corporate governance in Australia. Reports and reform processes have focused on achieving auditing independence within company structures in the broader interests of transparency, accountability and shareholder activism. In 2003, Guidelines produced by the *Australian Council of Super Investors* strongly supported the role of a two-tiered board through 'skilled Independent Non-Executive Directors' (ACSI 2003, p.4).

It listed specific attributes for this independence. In 2002, the *Investment and Financial Services Association* reviewed its corporate governance guidelines for fund managers and corporations covering issues of independence and competency of the Board of Directors, executive remuneration policy and disclosure guidelines. The Guidelines insist that 'the Board should review its performance and the performance of individual directors, the company and management regularly. As a key part of that process, independent directors should meet on their own at least once annually to review performance' (IFSA: Blue Book 2002, p6). As with UK corporate governance guidelines, the Australian approach has been to require compliance or explanation of non-compliance (IFSA Blue Book 9.4.2, p10; Hampel p10; Ayres and Braithwaite 1992). This is supported by stringent disclosure requirements so that shareholders can form a view to either support the approach or advocate change. These issues of establishing transparency and trust in publicly listed companies are revisited in Part 4.

Diagram 1 summarises the context so far. It identifies:

- the common impetus of privatisation and financial deregulation
- the establishment of a principal-agent framework as a credible governing structure
- the politicisation of the role of agents (regulatory chief / CEO) due to pressure from principals to achieve outcomes
- the adoption of private sector-style boards by regulatory agencies and legislation with a private sector emphasis
- a greater role for internal auditors with National Audit Offices and Offices of Regulatory Review for regulatory agencies and institutional shareholder committees for corporations

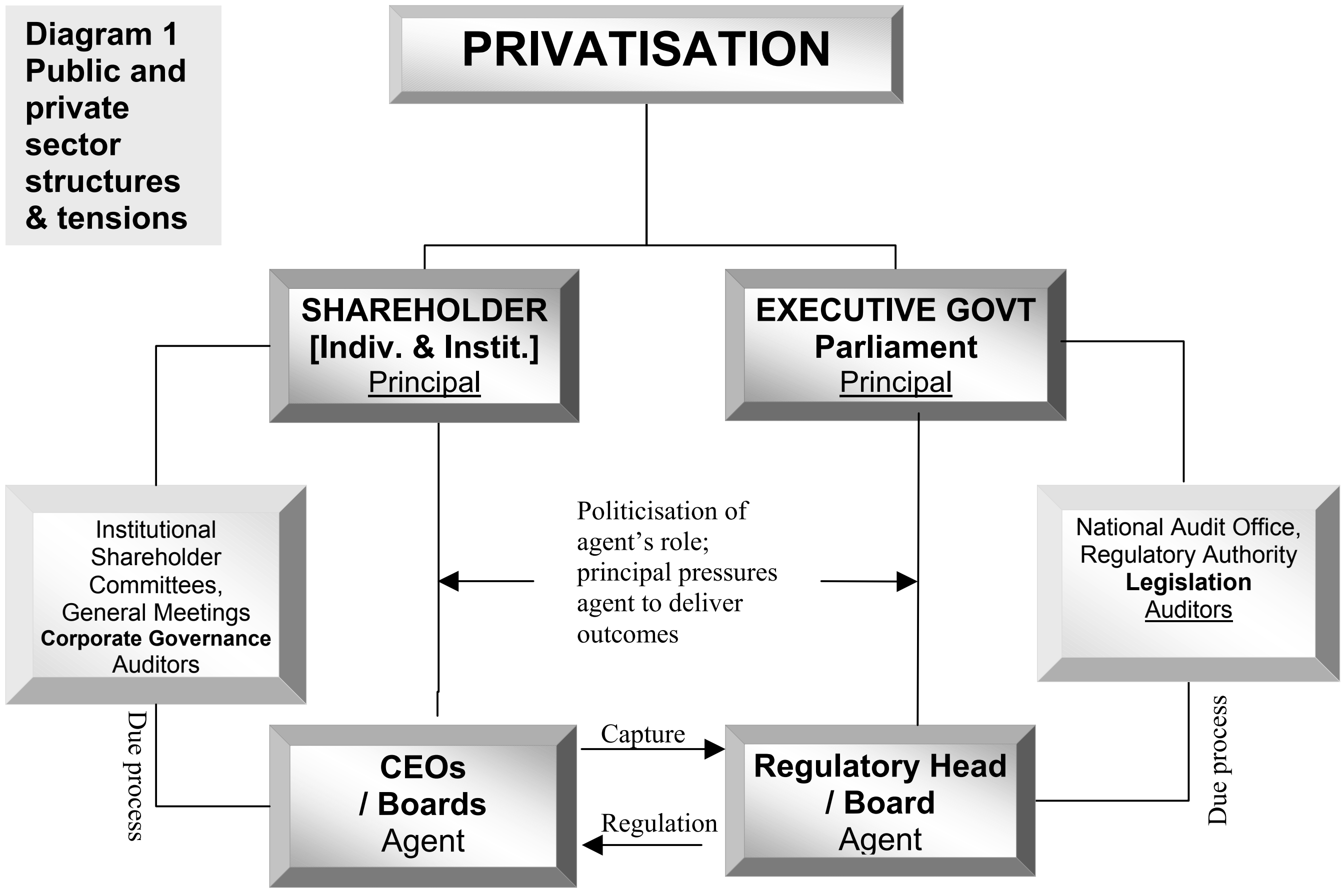
Diagram 1
Public and private sector structures & tensions
PRIVATISATION
SHAREHOLDER
[Indiv. & Instit.]
Principal
EXECUTIVE GOVT
Parliament
Principal
Institutional Shareholder Committees, General Meetings
Corporate Governance
Auditors
Politicisation of agent's role; principal pressures agent to deliver outcomes
National Audit Office, Regulatory Authority
Legislation
Auditors
Due process
CEOs / Boards
Agent
Capture
Regulation
Regulatory Head / Board
Agent
Due process

3. Credibility crises in the regulatory state and PLCs

I foreshadowed at the outset of this paper that the regulatory state and the model of shareholder value have both suffered institutional crises. There has not been a reversion to previous forms of public and private sector governance as a result. Nonetheless, the publicity generated by specific incidents has produced widespread debate and public concern about the reliability of the changes wrought by privatisation and market liberalisation and corresponding pressure for action. The purpose of this section is to emphasise that the frameworks of governance and reasons for crisis are common to both systems.

Parts 1 and 2 of the paper recognised that executive governments' delegation to regulatory agencies and board and shareholder delegation of managerial responsibilities to CEOs are both principal-agent frameworks whereby ownership is separated from control. In both cases, the rationale is the agent's greater efficiency and possibility for the principal to externally audit. Importantly, while the agent is accountable to the principal, the principal is precluded from direct involvement in the agent's day-to-day functions. As mentioned above, these conditions have been important for the credibility of the changes to both sectors over the past twenty or so years. Regulated industries require a credible independent watchdog to build trust among consumers and investors. Publicly listed companies, in addition to these external checks, have gained credibility through its internal controls and, in particular, the focus on delivering share value and disclosing information to shareholders. What has caused this credibility to decline?

Overload and oversight

A leading explanation is that the regulatory state has itself become overloaded. The demands placed on IRAs, through their charter and through wider government and community expectations, have been unrealistic. There are various dimensions to this idea of 'overload'. The first is a fundamental paradox between delegation to IRAs in the interests of greater regulatory efficiency and the tendency of these agencies to over-police competition and expand social and environmental regulations to protect against perceived and actual risk (Moran 2001b, p30). Deregulation has clearly overcome the inefficiencies of nationalised monopolies, but delegation to agencies charged with specific regulatory duties has produced a strong executive mandate for IRAs to be vigilant in their audits. More pointedly, agency directors have recognised the importance of the power and legitimacy that comes from a reputation of regulatory vigilance. The laws and standards which support this power are notoriously slow to adapt to new risks. Second, in setting these regulatory standards, IRAs are increasingly captive to public expectations. The modern electorate has responded to regulatory precedents and now demands a high level of protection across a far wider spectrum of economic activity. IRAs themselves have shaped these expectations about public and commercial services and in so doing have focused attention on their performance. Third, at the same time as political pressures have expanded IRAs' scope and ambitions, scientific and financial innovations have stretched their resources to regulate effectively. Regulatory agencies have come to power in the UK and Australia at a time of increasing complexity, which has required greater sophistication to gauge and monitor risks and to enforce the necessary standards of compliance. Fourth, despite this accumulation of power, questions linger over whether IRAs are accountable and legitimate institutions, given that they clash with the Westminster tradition of ministerial responsibility (Moran 2001b, p31) and that there is no legal doctrine of independent agencies (Thatcher 2002, p127). The purely economic objectives defined in utility regulators' charters often spill over into the social domain, which is properly the preserve of elected government (Prosser 1999, p199).

Against this backdrop of 'overload', the credibility of the regulatory state has also suffered the well-known problems of 'regulatory capture' (Stigler 1971), in which a symbiotic relationship evolves between the specialist sectoral regulator and the regulated firm seeking concessions. The frequency of their dealings engenders trust which progressively loosens regulatory demands. The relationship may be coercive with the regulated firm offering future jobs to regulatory staff, limiting the information available to the regulator or even offering bribes (Prosser 1999, p203). The UK and Australia have both had major regulatory lapses, characterised by misplaced trust in elite financial institutions. The July 1995 collapse of Barings was the culmination of several financial disasters made possible by the Bank of England's informal regulatory culture (Moran 2001a, p421). The 2001 collapse of Australia's second largest insurer HIH, and major currency trading losses incurred by the National Australia Bank in 2003-4 raised strong criticism that the regulator, the Australian Prudential Regulatory Authority (APRA), was slow to act on warning signs, preferring to take a consultative approach. Subsequent inquiries found that APRA was under-resourced both in terms of the number of personnel and the experience and training of staff (Mealey 2002; Garnaut & Hughes 2004).

The collapse of publicly listed companies has also been a product of overload and interference with companies' internal governance frameworks. As with the rationale for devolution to IRAs, there is an obvious paradox in the role of the internal auditor within a publicly listed company. On one hand, these auditors are charged with disclosing the correct information about the company's financial position to guide board decision-making. On the other, the general dynamic of company decision-making and performance criteria is to act in accordance with 'shareholder value'. This trade-off became particularly sharp with the rapid enlargement of stock market capitalizations in the 1990s. The Chairman of the US Federal Reserve Alan Greenspan (2002) noted that this enlargement:

> engendered an outsized increase in opportunities for avarice. An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed. Too many corporate executives sought ways to "harvest" some of those stock market gains. As a result, the highly desirable spread of shareholding and options among business managers perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising.

Australian and UK PLCs were similarly influenced by high risk strategies that calibrated shareholder and executive remuneration on a steep upwards path without due regard for internal auditors' cautions. The financial innovations of futures and derivatives enabled companies to spend tomorrow's money today. The hubris surrounding these opportunities, their obfuscation on balance sheets, and the need for Australian PLCs to establish international footholds silenced auditors. CEOs, in their privileged position as a conduit of company information to the board, were given strong incentives to filter only positive information to the board (see Arbouw 2003, p7). The barometer of share price was substituted for the objectivity of auditors and risk management experts. 'Regulatory capture' may have been fuelled by the speculative frenzy on the sharemarket, but the conditions were generated by passive boards, unbalanced fiduciary incentives for CEOs and auditors' distance from boards. Public criticism in the UK and Australia has inevitably centred on the incongruence of large payments to CEOs of underperforming PLCs.

Risk management and averting crisis

It is somewhat ironic that the financial crises of privatised utilities and large PLCs has tended to demote the role of IRAs in favour of political intervention. Regulators may well have day-to-day control of utilities, but financial crisis inevitably shifts power back to executive government. The political imperative of ensuring the success of privatisation has forced governments to take over from regulators by offering financial carrots. Take the case of Victoria's privatised rail and tram systems. When privatised in 1999, the British National Express Group won a 15-year contract. In February 2002, the State Labor government offered a $100 million rescue package to operators but this was insufficient to prevent National Express leaving later that year. In February 2004, a package inexcess of $1 billion was offered to the remaining private carriers (Skulley 2004, p8). Not only has the State government by-passed the specialist regulator and interfered with the role of wider competition regulators, but its direct financial assistance to privatised utilities reflects that risk has not been passed on to private buyers. The British experience identifies similar trends. The privatised UK rail utility RailTrack collapsed due to poor management and a lack of public confidence. The government had foreseen this possibility upon privatisation and had established administrative rules to ensure a smooth handover to a new operator. In the event, the rules failed to work as effectively as for failed private companies in competitive markets and the government was forced to make a payout to RailTrack shareholders (Kay 2002, p27).

These elements of public risk and regulatory inadequacy also seem present in the reaction of executive government to the collapse of PLCs in competitive markets. The collapse of a key commercial service (eg: an airline) has often forced government to compensate staff and to conduct protracted public inquiries at taxpayer expense. Thereafter, British and Australian governments have responded by reforming the audit requirements of PLCs. This unrealistically inflates society's expectations of auditors. Lansley (2002) has argued that the auditor's role is not to guarantee the accuracy of financial information but to ensure that financial reports give a fair and true view of the company's financial position and performance. While recent Government proposals in Australia give the impression that proper auditing can avert financial crises (see CLERP9 2002), auditors' power only extends to biannual snapshots of financial records and not to continuous disclosure. In truth, the bulwark for better disclosure and compliance lies with the role of the board and CEO incentives schemes. Chancellor (2002, p32) is one of many who blames short-term options packages offered to CEOs, which 'create an overwhelming incentive to manipulate earnings in order to inflate share prices'. Within the business community itself, debate has focused on the need to change relationships by promoting the role of non-executive independent directors and their access to internal auditors' information through a pro-active board. Part 4 addresses this issue.

4. The challenges of corporate governance & stakeholder responsiveness

At the same time as regulatory crises have prompted tighter standards and higher public expectations of auditors in IRAs and PLCs, there has also been an emphasis on the need for improved governance through better communication with a wider range of stakeholders and a wider range of policy tools. The argument is that improved transparency, accountability and integration is a panacea for any organisational type, but in particular those that are challenged by pressures causing overload, oversight and heightened risk. The impact of new corporate governance arrangements is potentially significant for IRAs and PLCs. In broad terms, the effect will be to narrow the spectrum between the contractarian shareholder and communitarian stakeholder models (see Schipani 2000). Regulation will still remain the key concern of IRA among pressures to implement soft law and use taxpayer money more strategically. Shareholder profits will still remain the prime concern of PLCs, among pressures to increase board involvement and respond to the corporate social responsibility agenda.

The post-regulatory state

Take the idea of the 'post-regulatory state'. Recent scholarship in the UK and the US has noted the pervasiveness of non-state law, non-hierarchical control processes and the wider use of tools of public action (see Scott 2004, Salamon 2001). The argument is that command-based legal control is increasingly accompanied by unwritten standards flowing from extensive consultation between regulators, the regulated and the wider community. This consultation is particularly evident in the area of environmental regulation where there are many stakeholders in a newly created regulatory setting with frequent disagreement on scientific evidence and best practice (see Grant 2004). The complexity of public problems has progressively undermined the precision and detail of regulatory law (Cohn 2001) and required a greater involvement of non-state actors in regulatory governance. Braithwaite's pyramid of regulatory compliance, with a suite of responses from self-regulation through education to prosecution, neatly represents the new environment of the post-regulatory state (1992, p35; see diagram 2). Regulatory compliance as an end in itself has been tempered by the financial expense of regulation and by challenges to the interpretation of the Act governing IRAs. In 2003, the Australian competition and consumer watchdog, the ACCC, suffered legal costs which blew its annual budget by A$10 million. The commitment by the regulator's Chairman in 2004 was to be more selective and strategic in its prosecutions while 'working more closely with small business so they have a better understanding of the sort of issues that we have to deal with in enforcing the Act' (Samuel 2004). The British Office of Fair Trading is similarly emphasising the importance of deterrence, informal resolution and raising business awareness as part of a non-regulatory approach (Bloom 2003). The challenge for IRAs generally is to reduce the burden of their regulatory responsibilities by promoting community engagement and participation in governance processes.

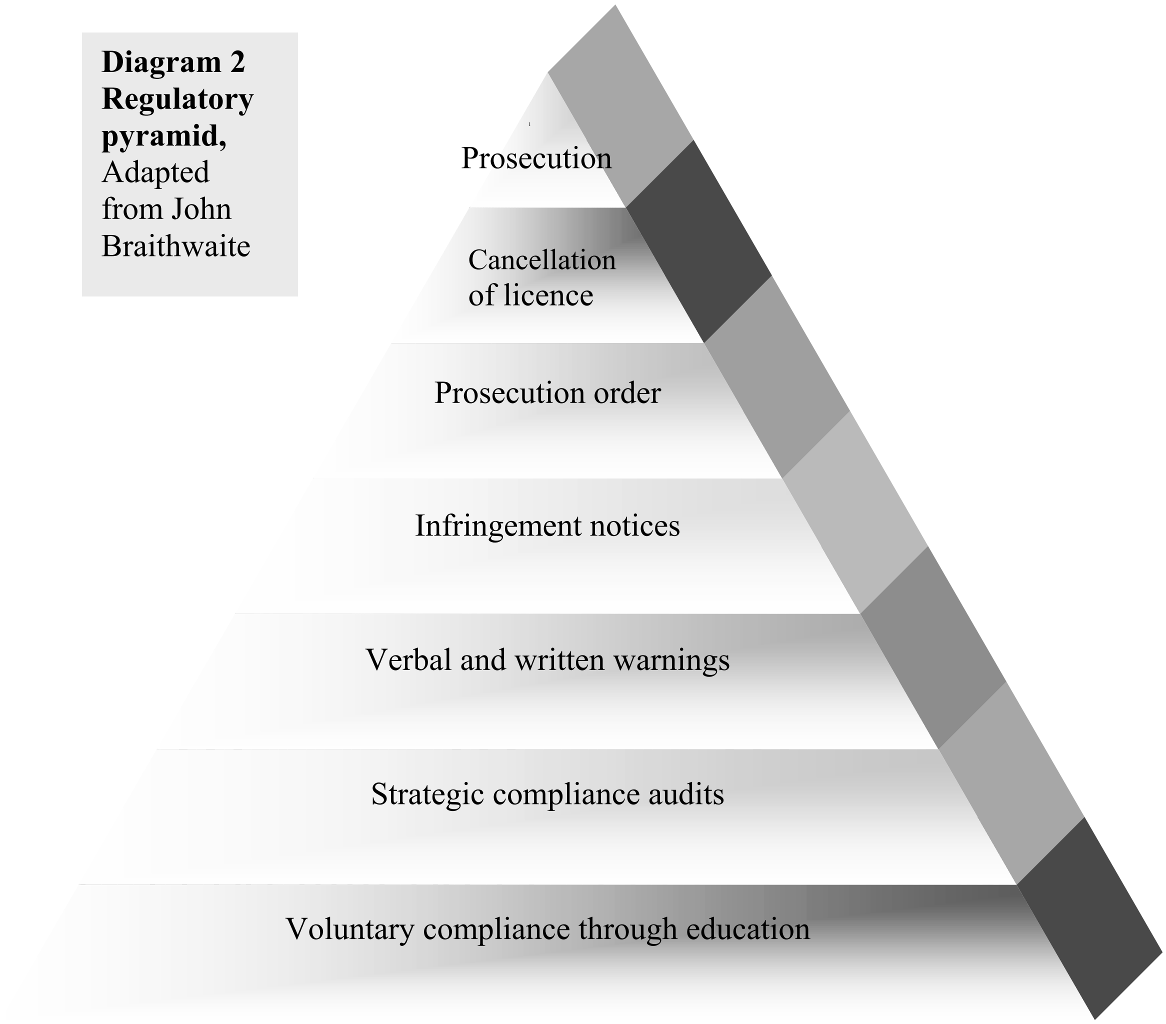

Diagram 2 Regulatory pyramid, Adapted from John Braithwaite

This challenge is often presented as balancing performance with conformance. This is potentially very difficult for regulators. The failure to promptly regulate where companies subsequently collapse or where companies' actions injure the public interest will inevitably raise questions about the value of a regulatory body. On the other hand, regulators that spend large amounts of their budget to enforce compliance will often be questioned about whether their strategy best delivers value for public money. A judgement needs to be made as to whether resources are better spent on preventing a problem rather than on undertaking costly prosecutory action. The literature on responsive regulation recommends empowering public interest groups 'to oversee the regulator/regulated relationship and step in where there is undue evidence of capture of corruption (Dine 2000, p132; Ayres and Braithwaite 1992, Ch.3). To this end, there is a clear role for facilitating technologies to inform industry, other government agencies, and the public at large of the regulator's mindset.[14]

The practical limitations of regulatory law and the trend of wider community engagement have also been reflected in challenges to the organisation of IRAs and the structure of government agencies at large. The OECD (2002, p21, p27) comments that, while the creation of bodies with various degrees of separateness has 'been a largely positive experience', 'one of the main challenges for central government is to maintain government and policy coherence across an increasing variety of organisational bodies'. Whereas regulatory agencies' independence was once prized due to its associated impartiality, the emphasis of governance into the 21st century is on 'joined-up' (UK) or 'integrated government' (Australia; see Management Advisory Committee 2004). The negative coordination of the regulatory state is under challenge. Government departments in the UK and Australia are required to develop policy according to economic, social and environmental criteria which requires close collaboration with other agencies. Regulatory agencies are required to develop 'whole of government' strategies. The Australian Greenhouse Office, for example, was established as a separate agency within the environment portfolio to provide a whole of government approach to greenhouse matters. Bodies have also been established to monitor and coordinate regulatory impact across government. Both the UK and Australian governments have Offices that conduct regulatory impact assessments to oversee the reduction in regulatory measures which reduce competition.[15]

These 'post-regulatory' developments have received tacit support in stakeholder approaches to regulation. The argument is that if regulators were to look beyond the bi-lateral relationship between themselves and the firm and see their role in terms of a wider network of relations involving competitors, consumers, employees and suppliers, the problems of regulatory capture and public skepticism of regulators would be overcome (Prosser 1999, p206). Souter (1995, p45) has argued that regulators should 'adjust their regulatory instruments to ensure that outcomes

[14] See *The Commonwealth Centre for Electronic Governance*, http://www.electronicgov.net/about/index.shtml . See also 'Modernising Government: How the NAO are responding', *National Audit Office*, November 2000.
[15] The Australian body is *The Office of Regulatory Review*.

are not inconsistent with a desirable balance between the interests of different stakeholder groups'. To this end, government should be involved in identifying broad sectoral issues that regulators must heed.

It is perhaps a symptom of the need (and often the inability) for IRAs' to pay closer attention to stakeholder issues that governments have interfered in their regulatory role. Not surprisingly, political interference has often preceded regulatory failure. As Table 1 shows, many Australian regulatory agencies are governed by an Act requiring a corporate plan, a two-tiered board, compliance with financial and risk management standards, accountability of the CEO to the board and of the board to the Minister, and the expectation of communication with stakeholders and shareholders (see Horrigan 2001). The desire for more direct Ministerial control over boards can significantly affect corporate governance arrangements. The Australian Civil Aviation Safety Authority (CASA) is a case in point. In November 2002, the Federal Transport Minister announced reforms to corporate governance 'intended to provide more direct control over CASA in relation to setting policy directions and priorities, performance standards, reporting and consultation processes, and stakeholder and industry advisory machinery' (CASA Annual Report, 2002-03). The CASA board was abolished accordingly.

Corporate Social Responsibility in PLCs

Publicly listed companies have also faced pressures to integrate and widen their corporate agenda and to reform their governing structures. Over the past 5 years in particular, there has been acute interest in developing and codifying PLCs' duties to their stakeholders – customers, employees, suppliers, the physical environment and the community at large. These stakeholder interests – broadly grouped under the rubric of Corporate Social Responsibility (CSR) – have gained greater academic and media attention in the wake of major corporate collapses. Some have argued 'the death of shareholder value', citing corporate scandals as evidence that corporate decision-making is guided by executive self-interest, not the interest of shareholders (Gittins 2002)[16]. Others urge a shift away from the American business model toward the stakeholder-based models of Germany and Japan (Kay 2003). Then there are those who acknowledge recent corporate failures but reject the intrusion of stakeholder interests as disorienting to corporate governance and potentially harmful to shareholders and stakeholders alike (Owen 2003).

[16] Generic claims of incongruence between shareholder and company interests are found in 19th century English court judgements (see Dine 2000, p.31).

What initiatives have advanced the CSR agenda in Australia and the UK? There have been various standards and indices proposed by a combination of government, stock market and civil society interests aimed at promoting corporate social and environmental responsibility. The UK has a government Minister for CSR, a stock market with CSR indices (FTSE4GOOD) and 700 corporations (many of them FTSE Top 100) volunteering to help community groups (Ryan 2003, p26). Australia has produced measurements of CSR through the firm 'Reputation Measurement', which has enlisted the support of two national broadsheets to focus public and business attention on how companies rank according to community expectations. At the same time, Australian PLCs are being urged to improve their corporate governance standards with the Australian Stock Exchange (ASX) and Standards Australia International (SAI) producing rival corporate governance codes. The SAI's is voluntary; the ASX's is a condition of public listing. In both cases, their appeal is the conferral of company reputability although the business community is wary of codes that go beyond basic principles (see Lahey 2002; Arbouw 2003, p7).

This raises an important issue. The practicality of enhancing CSR must consider how standards of corporate governance accommodate these notions (see Horrigan 2002, p516 & p525). Herein lies a dilemma. On the one hand, corporate governance reform may focus purely on realigning shareholder with executive interests and reject prescriptive standards promoting wider stakeholder involvement. The British Hampel Report (1998, p10) described the objective of company control as 'the preservation and greatest practicable enhancement over time of their shareholders' investment'. In similar vein, Nick Grenier, former New South Wales Premier and board director of various companies, has argued that corporate governance guidelines should not interfere with the need for board directors to take a more active interest in managing shareholder relations (Arbouw 2003, pp7-8). There is a sense to these arguments that improvements in CSR will informally follow from deliberate efforts to promote better lines of internal corporate communication in the interests of the company and (therefore) shareholders. Meddling with the internal mechanics of PLCs to accommodate social and environmental interests can corrupt the capacity to deliver profit making, stock values and shareholder returns (see Sullivan and Conlon 1977).

On the other hand, there are no guarantees that corporate law and corporate governance reform will incorporate stakeholder interests. This does not satisfy those who insist on the interdependence of shareholder *and* stakeholder interests and the need for corporate governance frameworks to recognise the importance of a wider range of stakeholders to the ongoing health of companies (Leader 1995). There is merit to the argument that recent corporate collapses reflect the inadequacy of shareholders alone to exercise proper checks on the CEO and board management. As with independent regulatory agencies, there have been attempts to reconceptualise the principal-agent framework of PLCs. Blair and Stout (1999, pp250-2) propose a 'mediating hierarchy' of stakeholders and shareholders, whose negotiations with the corporations are subsequently passed on to the board for consideration. Instead of boards receiving their information from the CEO and shareholders individually, this team approach is designed to reflect and develop the holistic interests of corporations. Similarly, Turnbull (2003, pp36-7) proposes the use of Internet-based stakeholder panels that elect stakeholder councils to promote corporate legitimacy and guard against single interest capture.[17] Here, there are clear parallels with the use of technologies to connect independent agencies to 'whole of government' issues and structures.

Formal recognition of wider stakeholder interests in PLCs' corporate governance frameworks seems unlikely even in the medium term. Australian and UK companies can expect more detailed standards for auditing and disclosure and higher penalties for failure to comply. Voluntary self-regulation is also more likely as companies learn better strategies of communication between boards and CEOs. As for social and environmental standards, there is likely to be significant challenge to codified fusion of shareholder and stakeholder interests, reflected initially in continuing disagreement over the most appropriate system of rating and ranking (Ryan 2003). There is also the argument that joint public-private companies (eg: Telstra) should be fully privatised to protect shareholder interests, leaving government agencies to regulate their social obligations (Chaudri & Kerin 2004). Stakeholder issues within PLCs may pass the test of corporate accountability, but their pretense of greater legitimacy will always suffer from arguments that they undermine the role of the market environment.

5. Conclusion

This paper has been interested in evolving patterns and rationales for governance in specific types of public and private sector organization that arose from the British and Australian experience with privatisation. On the evidence presented, there seems a case of 'parallel evolution' - where two related species or lineages have made similar evolutionary changes after their divergence

[17] Turnbull does concede that Directors must be primarily accountable to shareholders. p36.

from a common ancestor (ISCID Encyclopedia). The two 'related species' - the agencies of the regulatory state and listed companies driven by shareholder value - both originated from the 'common ancestor' of executive government following large-scale privatisation, financial deregulation and a surge in the number of institutional and individual shareholders.

The similar 'evolutionary changes' may be sub-divided into three parts – structure, tension and current mindsets. In terms of structure, both have a principal-agent framework whereby the principal funds the agent and the agent works in the best interests of the principal. The agent is best placed to be efficient and responsive in meeting these interests; the principal is best placed to set broad parameters, monitor performance and intervene where necessary. In terms of tension, both public and private sector agents have suffered from pressures of overload caused by the demands of their respective principals and the demands of the other agent. CEOs and boards have been pressured by shareholder demands and highly competitive markets. Regulatory agencies have been pressured by executive government to achieve results. In turn, regulators have been pressured by a rapidly changing corporate world and companies have been pressured by the tighter requirements placed on them by regulatory agencies. In terms of current mindsets, there are striking similarities in the demands on public and private agents, with both pressured to be more communicative and receptive to a wider range of stakeholders. Regulatory agencies will be pressured by ministerial and departmental involvement in their operations and the diverse and more competitive claims of 'the public interest'. Publicly listed companies will be tested by stricter standards of disclosure, the prospect of more proactive boards and the great unknown of corporate social responsibility.

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