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## **Managing Deregulation: Balancing between public and private goals**

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## 1 Introduction

During the eighties, western liberal democratic countries have shown a public and scientific debate on 'reinventing government' initiating processes of re-organising the public sector. In Europe the debate marked the end of an area of the welfare state in which the public sector could hold responsible for economic, societal and cultural well-being of the citizens. One's innovative concepts of public regulation have been outpaced by societal changes, leaving policy evaluators with unsatisfying conclusions on public organisation and public regulation. Hard core liberals believe that markets should dominate public regulation. Based on this idea, new public management styles have been proposed ranging from de-regulation, public-private partnership to a full liberalisation of one's hierarchical regulated societal domains. Indeed, times have changed, asking for adaptive public management to account for, flexible and effective regulatory forms.

But how should deregulation be understood in this context? Is it just as Mitnick puts it, the opposite of regulation which he defines as 'the intentional restriction of a subject's choice of activity by an entity not directly involved in performance of the activity. Consequently, a broad definition of *deregulation* may simply be the removal of such a choice restriction'.<sup>1</sup> In its basic form, deregulation can be understood simply as Mitnick puts it, as a decrease or removal of the restrictions put on the choices of societal actors by a public authority. So deregulation is primarily an act of a public authority, an act consisting of a withdrawal by the public authority from regulated societal domains. However, this view on deregulation immediately puts a new question on the agenda: Why should a public authority withdraw? Is it because the rationale for public regulation changed? Is regulation no longer necessary, because the regulatee can do without regulation? Is society no longer interested in achieving certain public goals?

In my view, deregulation is not simply the withdrawal of a public authority from a societal domain. In this paper I take the view that deregulation should be perceived as a change in the regulatory position of a public authority within the institutional structure of a societal domain. In this view, deregulation is a change in, what Williamson calls, the governance structure of a societal sector.<sup>2</sup> Within these structure, a public authority possesses a regulatory position that can change, due to several factors. Regulation and *deregulation* can only be understood adequately, by taking the broader institutional setting of societal domains into account. Whatever the reasons for deregulation might be, in my view, deregulation is not caused by a redefinition of public goals and the attainment of these goals. In other words, the motives to regulate did not change, only the kind and range of regulation is in discussion.

For example, electricity supply is still a matter of public interest, but the conditions to produce and to distribute electricity have changed. Due to technological innovations, the institutional setting of the electricity supply industry came under pressure, resulting in processes of institutional transformation which have consequences for the governance structure of the sector. The same holds for environmental regulation. Environmental protection as a public goal did not lose its actuality, but industrial companies no longer accept lengthy and inflexible licensing procedures to regulate their activities. Companies need a day to day flexibility in order to cope

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<sup>1</sup> Mitnick, Barry, M., *The Political Economy of Regulation*, Columbia University Press, New York, 1980, p. 418.

<sup>2</sup> Williamson, O.E., *The Economic Institutions of Capitalism*, New York, 1985, p. 68 ff.

with their highly dynamic environments. Extensive regulation processes do not fit in these business conditions. Both examples illustrate the need to search for new modes of public regulation, to be able to attain public goals under changing institutional conditions. One of the effects of these institutional changes is, the necessity for a public authority to account for private goals in the attainment of public goals.

This goal balancing perspective on deregulation combines two different normative conceptions of regulation: the market failure approach and the social engineering approach. The economists stress the market failure of economic sectors, i.e., governmental intervention is necessary to correct the market mechanism to induce a social performance that is as close as possible to the neo-classical model of complete competition. In this case regulation is aiming at enhancing the performance of the system in terms of cost efficiency, allocative efficiency, innovation and economic growth. The political science approach of regulation goes back to the social engineering idea of achieving collective goals. In this view regulation is legitimised by achieving certain public goals that are based on democratic decision making. Here the notion of general interest is the normative point of reference and not the economic performance, as in case of the economic notion of regulation.<sup>3</sup>

So both the economist and political scientist view on regulation have their own standard for optimal regulation. For the economist, regulation is optimal when the market is in equilibrium, whereas for the political scientist, optimal regulation is the actual attainment of public goals. All regulation that goes beyond these normative points of reference has to be avoided and should be put on the agenda for deregulation. So both views provide for a normative standard to evaluate the need to regulate and to deregulate.

In combination, both normative perspectives on regulation reflect the idea that public regulation no longer addresses only public goals. Achieving these goals has to account for the consequences of the economic functioning and economic performance of societal sectors. Economic efficiency and flexibility have become themes of general interest, resulting in a need for public and private actors to co-operate more actively. For a public authority as the principal, the information of the agents has become a necessary condition for effective and efficient regulation. From a perspective of new public management, public regulation then becomes primary a matter of structuring the relationship between public and private actors, in order to combine the joint achievement of public and private goals. In this view, regulation and *deregulation* address the idea of finding an optimal division of tasks between public and private actors and effective and efficient means of co-ordination.

In this paper I elaborate on this organisational perspective of regulation. Regulation and deregulation are presumed to be a question of orientation on the position of a public authority within institutional structures. Due to several factors, these structures change, affecting the position of a public authority within these structures. Regulation and deregulation account for these structural changes by finding an optimal fit between institutional structure and regulatory position of the public authority. Public governance then becomes a question of finding optimal governance structures, based on a division of tasks and competence's between public and private actors and an orientation on the joint achievement of public and private goals by co-ordination between these tasks and competence's.<sup>4</sup>

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<sup>3</sup> Mitnick, op.cit., p.111 ff

<sup>4</sup> Van Vught, *Governance Structures in Higher Education*, Enschede, 1995, p. 4

It is obvious that a changing regulatory position of a public authority within an institutional context and a changing ability to regulate, has consequences for evaluation research. Most important, evaluation research has to face a new set of evaluation criteria, consisting of a combination of public and private goals.

Section two goes into the institutional context of a governance structure. Section three elaborates on the theoretical relationship between structure and public regulation in order to define the concept of deregulation. Section four deals with the regulation of structural change. Section five draws some conclusions.

## 2 Institutional Context of Governance Structure

Social life is organised in institutions. According to Ostrom, institutions are systems of rules that are reflected in human behaviour.<sup>5</sup> As the economist North puts it: 'Institutions include any form of constraint that human beings devise to shape interaction. (...) Institutional constraints include both what individuals are prohibited from doing and, sometimes, under what conditions some individuals are permitted to undertake certain activities'.<sup>6</sup> Institutions are not visible by themselves, but they are manifested in human activities and human interaction. This puts an intellectual burden on the construction of legal theory.<sup>7</sup> In this paper I ignore this intellectual debate on the legal nature of institutions, by presuming their existence and functioning.

The idea of institutions as systems of rules has been elaborated by Ostrom. He suggests that 'Rules are the result of implicit or explicit efforts by a set of individuals to achieve order and predictability within defined situations by: (1) creating positions; (2) stating how participants enter or leave positions; (3) stating which actions participants in these positions are required, permitted, or forbidden to take; and (4) stating which outcome participants are required, permitted, or forbidden to affect' (Ostrom, 1986, p. 5). This logic of institutions has been operationalised by Ostrom in a set of rules. These rules are position rules, boundary rules, scope rules, authority rules, aggregation rules, information rules and pay off rules (Ibid, p. 19).

Following Van Vught, I would suggest that 'every governance structure consists of a combination of these types of rules with respect to a certain number of tasks performed by a certain group of corporate actors' (Van Vught, 1995, p. 5). From this point of view, the regulatory changes as manifested in concepts like deregulation and liberalisation, can be perceived as a reshuffle of institutional rules. A reshuffle that might be induced for example, by technological innovations, strategic behaviour of certain actors, a change in legal rules or simply by agreement between actors.

In the context of this paper I would elaborate on two types of rules: the aggregation rules and the authority rules. The aggregation rules specify 'the decision function to be used at a

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<sup>5</sup> Ostrom, E, *An Agenda for the Study of Institutions*, Public Choice, vol. 48, 1986, p.7-8.

<sup>6</sup> North, D.C, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, New York, 1990, p. 4.

<sup>7</sup> See for instance, Ruiters, D.W.P., *Institutional Legal Facts. Legal Powers and their effects*, Kluwer Academic Publishers, Dordrecht, 1993.

particular node to map actions into intermediate or final outcomes'. Authority rules, specify 'the set of actions assigned to a position at a particular node'. The first set of rules addresses the basic mechanism to co-ordinate human activities and the second set of rules defines the position of a public authority within an institutional structure. The next section elaborates on a theoretical content of both set of rules.

### 3 Institutional Organisation and Public Regulation

In this section I take the co-ordination of economic activities to illustrate the content of the aggregation rule and the dynamic this rule might take. The idea of basic mechanisms to co-ordinate human activities, is combined with Williamson's concept of governance structure<sup>8</sup>, in order to cope with the interrelation between organisation and public regulation.

At the basic analytical level there are three mechanisms to co-ordinate economic activities: markets, networks and hierarchies.<sup>9</sup> These mechanisms differ in basic allocation mechanism, unit of decision making and goal orientation. See table 1.

Table 1: Characteristics of basic co-ordinating systems

Co-ordinating mechanism	Unit of decisionmaking	Mechanism of allocation	Dominant economic goal
Market	individual	price setting	individual profitability & continuation
Network	group	agreement	collective profitability & continuation
Hierarchy	public authority	directive	national public interest

In a market allocation is based on prices, in networks on general agreement and in hierarchies on public rules.<sup>10</sup> In theory each of the three mechanisms can be used to co-ordinate economic activities. In practice these basic mechanisms have little relevance, because mixed systems prevail.

The relevance of the basic mechanisms is not their empirical validity. They are very helpful in understanding processes of structural change. At a basic analytical level these processes can be understood as a change in co-ordination mechanism. Full hierarchical systems are e.g.,

<sup>8</sup> Williamson, Op. Cit.

<sup>9</sup> Arentsen and Kunneke, Economic Organisation and Liberalisation of the electricity sector: In search for conceptualisation, Energy Policy, 1996, forthcoming. See also Thompson, G., J. Frances, R. Levacic and J. Michel (eds.), Markets, Hierarchies and Networks. The Co-ordination of Social Life, Sage Publications, London, 1994. Mitnick, distinguishes four co-ordination mechanisms: market, hierarchy, voting and bargaining. Mitnick, op. cit., pp 340-341. The idea of different co-ordination mechanisms was already suggested by Dahl and Lindblom in their Politics, Economics and Welfare.

<sup>10</sup> For an elaboration of the economic logic underlying these co-ordination mechanisms, see Williamson, 1985, op. cit.

combined with a limited price mechanism or with some form of self regulation by agreement. So transitions of economic sectors can be understood analytically as a change of mechanism to co-ordinate economic activities. These changes can be understood as adding one or two mechanisms to the dominant mechanism. In order to avoid theoretical complexity, we distinguished six mixed models of economic organisation based on the notion dominant and added co-ordination mechanism. See table 2.

Table 2: Pure and mixture systems to co-ordinate economic activities

Added co-ordinating mechanism	Dominant co-ordinating mechanism		
	Price	Agreement	
Price	<i>Full free market</i>	Liberalised co-ordination	Liberalised hierarchy
Agreement	Co-ordinated free market	<i>Full co-ordination</i>	Co-ordinated hierarchy
Public rule	Controlled free market	Controlled co-ordination	<i>Full hierarchy</i>

So institutional change can be understood analytically as a change in basic mechanism to co-ordinate economic activities. The change in co-ordination is perceived as a manifestation of a change in the institutional aggregation rule.<sup>11</sup> A change in basic co-ordination mechanism lays at the heart of transformation processes visible in many sectors of modern economies. In the introduction of this paper, the energy sector was mentioned as an example.

Telecommunication, air traffic, railways are other examples of sectors in transition. These transition processes raise two relevant regulatory issues:

1. the attainment of public goals, taking private goals of other actors into account; and
2. to cope with institutional transition as a public regulator?

Both issues address the general problem of regulation under uncertainty. The first issue is about the uncertainty how to optimise public and private goals under given structural conditions. The second issue is about the same uncertainty, but under dynamic structural conditions. Both issues can be dealt with by taking the institutional position of the public authority into account, which reflex the authority rule of institutions. I first go into the goal balancing problem.

Taking the three pure models of co-ordination as a starting point, it can be presumed that each mechanism determines specific opportunities to regulate. Only in the pure hierarchical model, the structure, functioning and performance of an economic sector are completely determined and controlled by a public authority. In both other pure models the public dominance is restricted, conditioning the style of public regulation.

<sup>11</sup> The causes of these changes are beyond the scope of this paper. Geelhoed, the secretary general of the Dutch Ministry of Economic Affairs, suggests three causes: internationalisation, societal dynamic and heterogeneity and technological changes, Geelhoed, Deregulating, herregulering and zelf regulering, in: Eijlander, Ph, Gilhuis and Peters (eds.), Overheid en zelfregulering, Tjeenk Willink 1993.

The logic underlying the conditional functioning of structure (co-ordination mechanism) is given by the principal agent model in neo-institutional economics. The basic question of the principal agent approach is why individuals refuse to co-operate even under circumstances where co-operation results in welfare gains for some, without welfare losses for others.<sup>12</sup> The solution to this problem lays in the information asymmetry between individuals, resulting in information costs. Decentralised decisions will only result in optimal allocation, if non of the participants posses particular information. Under circumstances of particular information, the Pareto optimal allocation is not achieved.

The notion of information asymmetry can be used to understand the conditional effect of structure on regulatory position of a public authority. If a public authority is aiming at certain public goals, taking private goals into account, than the following assumptions can be formulated.

- In a full free market the information asymmetry is in favour of the private market actors. They posses the information how to achieve economic and public goals. Under these structural conditions, the position of a public authority is *subordinate* to the other players in the sector. The full free market is dominated by individual exchange relations between equivalent players. These relations should be affected as less as possible by public regulation, to avoid as much as possible market disturbances. The achievement of public goals depends on vital information about the functioning of the market of the private actors.
- In a full hierarchical system the information asymmetry about goal achievement is dominated by the public authority, resulting in hierarchical structures. In a system of full hierarchy a public authority is in a *dominant* position to the other players; enabling a public authority to enforce its will.
- In a system of full co-ordination, the information asymmetry on goal achievement is equivalent for public and private actors. Private actors take an information advantage on private goals, whereas a public authority takes the advantage on public goals. Under these conditions a public authority is in an *equivalent* position to the private actors.

The position of a public authority under different structural conditions is presumed to have consequences for the style of regulation. Three styles of public regulation can be identified in order to define theoretically the scope of regulation in each model of co-ordination:

1. The facilitating style; the public authority only lays down conditions for the functioning of a sector to integrate the attainment of public goals with the private goals of the economic actors.
2. The initiating style; the public authority encourages a sector to develop in a certain direction. Here the attainment of public goals has to be integrated by information exchange.
3. The enforcing style; the public authority enforces a sector to develop in a certain direction. Here the attainment of public and private goals is enforced.<sup>13</sup>

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<sup>12</sup> The notions on principal agent relationships I took from De Vries, P., *De lastige verhouding tussen departement en agent*, (diss.), Enschede, 1992, p. 60 ff.

<sup>13</sup> In theory, a public authority does not have to take its role within a sector of the economy into account when setting regulations. In all three roles, facilitating, initiating and enforcing styles are possible. However, to achieve effective regulation the public authority must chose a

These styles of public regulation can be identified by the *object of regulation*. Taking the neo-classical structure-conduct-performance paradigm as a starting point, structure, conduct and performance can be perceived to be the objects of public regulation. In order to be effective, the regulator not only should account for its style of regulation, but also be aware of what to regulate. In a full hierarchical organisation, nor style, nor object seem to matter, the public authority can do what it likes, always being able to enforce its will. In hierarchical models, structure, conduct and performance can be objects of regulation. In network-based models, the position of the public authority is more equivalent to the other players. A public authority primary has to initiate the information exchange with private actors. Besides the structure to prepare for this information exchange, also the exchange behaviour of actors might be the object of regulation. In sectors dominated by the price mechanism, public regulation can be restricted to the structural preconditions for the integration of public and private goals. The presumed relationship between structure on the one hand and the style and object of public regulation on the other hand is illustrated in table 3.

*Table 3 Sectoral organisation and regulation*

Sectoral organisation	Dominant regulation style	Dominant object of regulation
full free market	facilitating dominates initiating and enforcing	structure
co-ordinated market		
controlled market		
liberalized co-ordination	Initiating dominates facilitating and enforcing	conduct
full co-ordination		
controlled co-ordination		
liberalized hierarchy	Enforcing dominates facilitating and initiating enforcing	structure and conduct
co-ordinated hierarchy		
strict hierarchy		

It should be noted that in table 3 the structural models are related to the dominant style of regulation and dominant object of regulation. The relationship is a hypothetical, rather than an empirical one.

style of regulation which matches its actual role; so, the relationship between its role and its style of regulation is characterised more by probability than by inevitability.



It can be concluded that the goal balancing problem (first issue raised above) can be dealt by taking the broader institutional context of societal domains into account. It was argued that the pure models of co-ordination condition the joint achievement of public and private goals. A change of co-ordination mechanism, both from dominant or from added co-ordination mechanism, affects the regulatory position of a public authority. In order to be effective and efficient, a public regulator should account for its position within the institutional and structural context. Due to structural dynamics, this position might change, affecting the type and outcomes of regulation. The change in position might take two main directions:

1. Deregulation, from enforcing to facilitating.
2. Reregulation, from facilitating to enforcing.

So within a context of structural change, the opportunities for effective and efficient public regulation can be assessed by accounting for the effects of these changes for the regulatory position of a public regulator. But how about regulating a change of the institutional structure. This theme is addressed in the next section.

#### 4 Regulating Structural Change

Institutional and structural change can be evaluated as a search for new equilibrium between political and economic goals. Obviously there is considerable uncertainty about how to obtain these mixtures of goals. It can be stated that this uncertainty is due to a lack of a normative point of reference for regulation. When a sector is in change, it could be argued that there are market failures, in the sense that the system is searching for new equilibrium under new but different conditions. Under this circumstances it is plausible to assume that there are uncertainties about the preferable structure, conduct and performance of the new-equilibrium state of the world. There is no explicit point of reference, because, due to the change, the institutional structure as a whole is uncertain about the performance to attain.

Because of the changing character of all three identified objects of regulation, specific outcomes of regulation become highly unpredictable. But in order to overcome this uncertainty, it is possible to take the preferred direction (not the specific content) of change of a sector as the normative point of reference for regulating sector change. Among all uncertainties of a sector in change, a general conception of the preferable direction of change, is probably the least uncertain.<sup>14</sup> Thus the rather vague notion of *preference in direction of sector change*, might be taken as the point of reference of regulating change. But what does this vague notion means other that preferable performance of a sector as a whole, e.g., more political goals, or more economic goals, or both? The notion preference in direction of sector change, can be specified as '*dominant normative preference in direction of performance*'. So, in regulating structural change of economic sectors, the performance of that sector becomes the main point of reference for regulation. Based on this notion, the following relationship between direction of change and regulatory instruments can be assumed:

1. When the dominant normative preference in performance inclines towards more political goals, *directives* seem to be the most effective regulation type.

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<sup>14</sup> Governments and other actors within an economic sector most often have notions about the future of a sector without actually knowing how to attain these preferences by regulation.

2. When the dominant normative preference in performance inclines towards economic goals, *incentives* seem to be the most effective regulation type.
3. When the dominant normative preference in performance inclines towards *finding* a trade-off between political and economic goals, *negotiation* seem to be the most effective regulation type. Here the Dutch regulation model suits well.

Here too, the logic of principal and agent underlies these hypothesis. The necessary information flows to realise these goals have to be structured by the institutional framework. In this context the regulatory body (the principal) tries to induce the regulatees (the agent) to perform in a certain way. In the case of politically determined public goals, public authority takes a dominant position in the principal-agent relationship, which leads towards a hierarchy oriented co-ordination system (see above). The vital information for the functioning of this system (attaining public goals) is generated by the public authority. In order to minimise goal divergence between regulatory body and regulatee, the later is made completely subordinated by the public authority. Directives seem to be most efficient and most effective for regulating sector change.

If there are social preferences to emphasis the economic performance of the system, the vital information for system performance is with the regulatees. As it is known from neo-classical theory, individual action leads under certain conditions to efficient allocations. In a market oriented system individual actors generate all relevant information to operate efficiently, according to their economic goals. Public authority is subordinated in this case. Here incentives seem to be most efficient and effective in regulating sector change

Negotiated regulation might be a solution to optimise between political and economic goals. Here principal and agent share the vital information. The regulator is best informed about the preferred political goals and the individual actors are best informed about the preferred economic goals. Under these circumstances information exchange seem to be most efficient and effective to find new equilibrium between political and economic goals.

## **5 Deregulation and Evaluation Research**

In this paper I have argued that deregulation is not simply the withdrawal of a public authority from hierarchical regulated societal domains. Deregulation should be perceived as part of the institutional structure of societal domains. Many of these structures have come into transition, affecting the regulatory position of a public authority. I have suggested a conceptualisation of these structural changes and how structure and change is related to regulatory position. Staying effective as a regulator, presumes accounting for the effects of structure on regulatory position. The exploration of the interrelation between institutional structure and regulatory position of a public regulator puts the first challenge on evaluation research from a perspective of new public management.

The second challenge for evaluation research is the goal balancing problem. Evaluation research is no longer restricted to only public goals and the achievement of these goals. The institutional transformations taking place everywhere in modern economies ask for evaluation criteria consisting of a mixture of public and private goals. This means that not only political decision making, but also economic performance should be taken as normative points of

reference in evaluation research. In evaluation research both political and economic theories on regulation have to be taken into account.

Last but not least, evaluation research is important for the guidance of the ongoing processes of institutional change. Here the challenge is to find optimal directions the change might take. As I have argued above, under dynamic circumstances, the primary focus of evaluation research should be on the normative direction the change should take. Certainty about the direction of change, enables a public regulator to use familiar regulatory instruments to bring about the desired change.