I. Introduction: Legislation, Agency Problems, and Execution

A. We often treat "governance" as a "black box," in much the same way that we look at production in most economic model of the "firm." That is, we assume that the implementation of policy takes place mechanically and automatically.

i.   If the electorate votes for a referendum, a legislature enacts a policy, or a court makes a decision, we often assume that those policy decisions are actually implemented.

ii. This is one of the assumptions, for example, of the median voter model., and it has also been assumed in most of our mixed and dictatorship models.

iii. However, nearly all policy decisions are implemented by the executive branch of government --that is to say by the bureaucracy.

    a. Governmental bureacracies are **staffed by unelected** and largely invisible people working within government agencies, **bureaucrats**.

    b. They are given discretion over some goverment policies--at least at the margin--because of their expertise or knowledge of the particular circumstances in which policies are implementd.

B. Do bureaucrats simply implement the directives given them by the "median voter" and her elected representatives or do bureaucrats promote their own interests?

i.   If bureaucrats were positively interested in implementing legislation or were at least indifferent between policies, there might be no agency problems other than that observed in the private sector.

    a. This would tend to be the case if voters were very well informed about public policy and able to perfectly monitor bureaucrats, which would allow voters to punish elected politicians for not perfectly monitoring the bureaucracy.

    b. In that case, representatives would have strong incentives to "oversee" the bureaucracy and punish errant bureaucrats.

    c. However, such perfect monitoring is obviously too costly for typical voters to manage, which also reducees the incentives of elected representatives to carefully monitor the bureaucracy..

ii. Instead voters use what some theorists call a "fire alarm" system of monitoring.

    a. Under a fire alarm system of monitoring, some major problems are discovered by the press, and reported to voters, who then can punish officials for failing to do a proper job of monitoring.

    b. However, since not all problems are found or punished, the bureaucracy can advance its agenda to some extent.

- Namely they can deviate from policy mandates up to the point where their expected gains from doing so equal their expected costs.
- Depict this decision using MB and MC^e curves.

    c. The extent to which **"agency problems"** exists is, thus, partly a matter of the marginal benefits that bureaucrats can obtain by "violating policy mandates" and partly a matter of the expected costs of doing so--which are determined in part by the probability of being caught and in part by the punishment meted out.

iii. Were bureaucrats entirely disinterested in policy and effectively monitored, and were the policy decisions reached by political decision makers always crystal clear, the bureaucracy could be considered a rather uninteresting area of public choice research.

iv. However, imperfect monitoring by voters implies that agency problems may exist..

    a. And, because such problems are known to exist, the legislature may delegate additional tasks to the bureaucracy as a method of shifting responsibility.

    b. After all if they cannot perfectly monitor the bureaucracy, when "policy mistakes" arise it is clearly the fault of the implementing agency rather than the legislature when mistakes are made. [Consider blame that is attached to FEMA after a major hurricane. such as Katrina.]

C. Bureaucrats have at least some **discretion over the implementation of policies, because monitoring is always imperfect, and because of their policy expertise and usefulness as a scapegoat.**

i.   Bureaucrats will always possess some discretion over the implementation of policy simply because it is impossible to punish them for every possible error in implementation.

- (For example, some laws may go unenforced, at least on occasion, because no law enforcing agent has an incentive to enforce such laws. No one else knows who the guilty parties are or whether any such parties exist. Consequently there are neither specific rewards for performing one's duties nor penalties for malfeasance in many cases.)

ii. Bureaus are often granted explicit discretion to *interpret and implement* "the policy," because of their expertise in a policy area of interest (law enforcement, highway safety, etc.), although limits on discretion are also normally part of the delegation of authority to the agency.

iii. Politicians may also explicitly delegate decisions to the bureaucracy to avoid responsibility for the policies that are ultimately adopted.

- Such efforts to "de-politicize" some areas of policy (as with EU fiscal and monetary policies) may have beneficial effects.
- But this is clearly cannot always be the case, if agency problems exist..

II. Agency Problems

A. In cases in which the aims of bureaucrats differ from those of the legislature or electorate, an *agency problem* may be said to exist.

i. That is to say, bureaucrats may exercise their discretion in ways that fail to maximize the net advantage of their "sponsors" (the legislators or the electorate).

ii. [Figure: Simple Work-Shirk Illustration of a Principal-Agent problem.]

iii. [Figure: Shirking with monitoring example: Max $U^e = P(L)U(Y, L) + (1-P(L)) U(Y-C,L)$]

iv. [Figure: Agency problems with policy preferences]

B. The modern literature on contracts (which emerged well after the modern literature on bureaucracy) suggests that there are a wide range of contractual means by which agency problems may be addressed.

   a. For example, bureaucrats may be required to post a performance bond which they may redeem upon successful completion of an assigned task.

   b. Wages and salaries might be based on output (bridges built, cases handled, money's dispensed appropriately) rather than the quantity of an input (time spent on the job) or straight salaries.

C. However, surprisingly few such incentive systems are used, beyond prospects for promotions, in public bureaucracies.

   a. Most bureaucrats are paid a straight salary that is largely independent of day to day performance.

   b. [Given this, you could argue that agency problems are surprisingly small, even if they are not trivial.]

III. A Simple Model of Bureaucratic Agency Problems: the Budget Maximizing Bureaucrat

A. About thirty years ago, a government efficiency expert named William Niskanen (1971, 1975) proposed a Budget Maximizing model of bureaucratic behavior.

   ▪ It is a clever model, and although it does not capture all possible types of agency problems, it provides an understandable model of one of the principle types of agency problems.

B. Why maximize a budget?

i. Niskanen argues that bureaucrats have a direct personal interest in the size of their organization's budget because:

   a. Opportunities for promotion tend to increase, and thereby expected salaries, as their bureau's budget increases

   b. Working conditions also tend to improve--computers, office furniture, secretarial support, etc.-- as budgets increase.

   c. Non-pecuniary compensation tends to increase as resources become available for travel or projects of particular interest to a given bureaucrat.

ii. Moreover, to the extent that public employees are public spirited, they may be personally interested in the mission of their agency or bureau.

   a. Such bureaucrats will gain additional satisfaction by being better able to advance the agency's mission as their budget increase.

   b. (Thus, perhaps surprisingly, even very public spirited bureaucrats generally have an interest in larger budgets.)

C. Informational Asymmetries.

i. The bureaucratic interest in larger budgets would not be significant, if they had no methods by which they might achieve higher budgets.

ii. Niskanen argues that the bureaucrat's superior knowledge of production methods, policy alternatives, (statistical) public demand for specific services, provides them the ability to make "all or nothing" offers to their sponsors (cabinet ministers or legislative oversight committees).

iii. In most cases, budgetary requests originate with the bureaucracy.

   a. In effect the President (prime minister) asks the bureaucracy what it "needs" next year, checks to make sure that program suggestions are more or less consistent with its goals, and sends it to Congress.

   b. (In the US system, OMB (the office of management and budget) does most of this for the President.)

D. Implications.

i. To the extent that bureaus can use all or nothing offers to secure budget increases, they will tend to propose budgets that are larger than those which maximize net benefits for their sponsors (ultimately voters or interest groups).

ii. In the case where marginal cost and the demand for the public service under their agency's power are linear, **the maximum feasible budget is exactly twice as much** as would maximizethe principal's net benefits.

iii. [FIGURE from lecture]

E. There are, however, many critics of the Niskanen model. For example:

i. Critiques: Migue and Belanger, 1974: objective function is too narrow

ii. Critiques: Breton and Wintrobe, 1975: competition and monitoring possibilities reduce budgets below the Niskanen level.

iii. Critiques: Weingast and Moran, 1983: budget maximizing behavior allows budgets, themselves, to be used as a method of bureaucratic control (empirical results from FTC, $R^2 = .50$)

IV. Extensions of the Niskanen approach

A. Bureaucratic Inertia and Bias (Congleton, 1980) [Figure]

B. Full Line Forcing (Mackay and Weaver, 1983): bureaus may chose output mix to maximize their budgets rather than to maximize the interest of their "sponsors."

i. Mackay and Weaver extend the Niskanen type analysis to a setting where the bureau produces multiple outputs.

ii. Homogeneous citizens maximize $U_i = u(C_i, X_{1i}, X_{2i})$ where C_i is private consumption by individual i, X_{1i} is consumption of service X_1 by "i", and X_{2i} is consumption of X_2 by i. They are constrained by a budget constraint: $Y_i = C_i + T_i$, where tax payment Ti is a constant share of the total budget spent on government services. Here $T_i = t_i(B_1+B_2)$.

iii. Expenditures on government services can be restated in terms of budget share, k, so that $B_1 = kB$ and $B_2 = (1-k)B$ where B is the total budget.

iv. This allows the voter's choice to be written as: $U_i = u(Y_i-t_iB, kB, (1-k)B)$. (Note that we have implicitly assumed that both government outputs cost one dollar each.)

v. Differentiating with respect to B and k, we find that the ideal budget level and service mix will satisfy:

   a. $U_C(-t) + kU_{X1} +(1-k) U_{X2} = 0$ and $U_{X2} = U_{X1}$ simultaneously.

   b. [Illustration of first order conditions.]

   c. These first order conditions are the reference point for the M&W analysis.

vi. In their model, the bureau controls the budget mix and the "voter" controls the budget level.

   a. The Bureau is assumed to set k to maximize its budget.

   b. This is very unlikely to be the same point as required to maximize the "sponsor-voter's" welfare.

   c. [Illustrating figure with B* function and k* functions, based on "Va" above, contrasted with revenue maximizing B and k.]

vii. In any case, M & W demonstrate that the ability of bureaucrats to affect public policy clearly depends upon the range of authority that the institutional and economic environment allows it.

C. Predatory Pricing (Lott, 199x, J.Pub.E.): bureaus may under price their services to drive out competition.

D. Manipulating the Demand for Bureaucratic services (Congleton and Fabiano, 1997 manuscript): bureaus may attempt to increase the demand for their services.

V. Rational Ignorance, Framing, and the informational importance of the bureaucracy [Discussion]

i. Consider environmental, nuclear, medical, or defense policies? How important has information provided by the bureaucracies been to the public policy debates?

ii. How important have actual policy proposals been? [US policies in Iraq?]

VI. Political Oversight: How good can it be?   [Discussion]

i. How much time can a typical voter spend monitoring bureaucratic outputs?

ii. To what extent can interest groups provide useful fire alarms?

iii. Are there incentive compatible contractual solutions to this agency problem?

iv. Does the existence of **contractual solutions** (even if unused) imply that any problems that remain must be Pareto efficient, or even more moderately, efficient from the point of view of the typical voter or member of government?