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The Contemporary Political Economy Approach to Bureaucracy

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Bureaucracy: The support staff that is responsible for developing plans, collecting and processing information, operationalizing and implementing executive decisions, auditing performance, and, more generally, providing direction to the operating parts of a hierarchical enterprise. Bureaucracy is attended by low powered incentives (due to the impossibility of *selective interventions*) and is given to *subgoal* pursuit (which is a manifestation of opportunism).

Oliver Williamson (1994, 102)

The government may chose to engage in public production, though a preponderance of evidence suggests that public bureau's production costs are higher than private firm's (Bennett and Johnson 1980; Borcherding, Pommerehne, and Schneider 1982). By critically analyzing the theories developed to explain the connection between the behavior of bureaucrats and the costs of producing public sector output, we attempt to elucidate two reasons why this is so. There may be comparative advantages to public supply depending on the nature of the output being produced, and the ease of bargaining, monitoring and enforcing production quality and quantity. In addition, given the goal of politicians is not just to arrange for the production of government goods and services, but also to generate political transfers, the government may, in fact, be choosing the lowest cost producer of

public sector output when it chooses the public bureaucracy over contracting out with private firms.

Past theories or "paradigms" formulate several explanations for the divergence between private and public enterprises in production costs. Broadly speaking, three of these key paradigms are Niskanen's budget-maximizing bureaucrat, Alchian and the UCLA School's property rights approach, and Stigler and the Chicago School's regulatory capture theory. The current political economy paradigm integrates these important behavioral approaches with newer political insights into a comprehensive theory of government bureaucracy. Further, the latter also enriches them with notions from sociological economics such as commitment, culture, social capital, and trust. With this in mind, a good theory of public bureaucracy, in our opinion, must account for three elements: bureaucratic self-interest, the effect of competition on bureaucratic behavior, and the role of political institutions. Past paradigms have captured one or even two elements; none of these theories has satisfactorily combined all three into a coherent explanation of bureaucratic behavior. We hope to show that contemporary theory has successfully combined these elements into a coherent approach, though it is still short of complete.

1. The Three Traditional Approaches

Niskanen (1971) identifies a classic principal-agent problem and describes the conditions leading to its existence. His hypothesis asserts that bureaucrats are interested in more of the "3 Ps"—pay, power, and prestige. By maximizing their agencies' budgets, bureaucrats raise their 3 Ps, since each P is positively related to budget size. Niskanen's theory of budget

maximization describes the bureaucrat as a self-interested, rational actor whose action is to benefit himself at the expense of voters and taxpayers. This approach captures the element of self-interest, but does not account for observed competition or the institutional oversight structure. Niskanen assumes that the bureaucracy is an effective all–or-nothing monopolist, possessing full knowledge of the legislature's preferences. There is no control of bureaucratic behavior by the legislature through the application of its potential monpsonistic power. Extensions of Niskanen's model attempt to rectify the exclusion of competition and bureaucratic control, but they never develop this element as strongly as they do the idea of unfettered bureaucratic self-interest.

Armen Alchian, his students and followers—loosely termed the UCLA School (Khursheed and Borcherding, 1998)—in the 1960s and 1970s argued that the distinction between public and private firms lies in the structure of property rights, and attribute the higher costs of publicly produced output to the lack of ownership transferability. Because voters, the "owners" of the public firm, are so diffuse and unable to buy and sell public firm shares, they have little incentives to monitor the behavior of self-interested bureaucrats. Further, since output is generally not sold in the marketplace, competitive pressures from very close substitutes are absent. This property rights approach concentrates heavily on the effect of institutions, but pays little attention to the actual behavior of bureaucrats and leaves unexplained why such an institution would ever be selected to produce public sector goods and services. Extensions of the work of Alchian et al. account for competition that bureaucrats face. Both Wittman (1989, 1995) and Wintrobe (1987, 1997) published highly optimistic studies that view political instruments, particularly free elections, as able to discipline bureaucrats as effectively as takeover bids discipline private firm managers.

DeAlessi (1976) and Demsetz (1982) disagreed with these sanguinary views, stating that political elections only discipline behavior close to election time, and then only imperfectly.

The Chicago School approach, initially described by Stigler (1971) and later modeled by Peltzman (1976) and Becker (1983, 1985), describes bureaucratic behavior as wholly controlled by outside interests, and examines political outcomes as emerging from competition between opposing political forces. Politically influential interest groups exert considerable control over public agency policies in an attempt to redistribute income toward themselves, though diminishing returns and transactions costs insure that no one interest group entirely dominates. Although a theory of political pluralism, the Chicago School ignores not only the role of political institutions, but also the role bureaucratic influences on competition. First, the Chicago group treats political institutions as a detail of no theoretical concern to the analyst (Moe 1990, 1997). Second, they do not look at bureaucracies as either alternative source of public supply or as control devices used by the legislature. Third, they disregard the power bureaucrats (and public employee unions) have as an interest group to influence the demand for public goods. Among public choice scholars, the Becker-Peltzman-Stigler model is jocularly known as "the theory of politics without the politics."

2. The Current Political Economy Approach

Current theory argues that public bureaucracy has particular advantages and disadvantages relative to market contract-out alternatives, based on various economic, political, and social factors which enhance productivity and/or the redistribution of income. The decision to "make-or-buy" goods and services involves evaluating costs, transactions as well as production costs. The former are associated with bargaining, monitoring, and enforcing

contracts. The existence of public firms provides evidence that the government finds it less costly to produce certain goods and services itself instead of contracting out production to private firms. Given this insight, the "so-called inefficient" public firm may actually be the least-cost alternative when all motivations, including income transfers, are considered (Borcherding 1983, 1988; Borcherding, Pommerehne, Schneider 1982). McCubbins, Noll, and Weingast (1987, 1989), Milgrom and Roberts (1992), Moe (1990, 1997), and Weingast and Moran (1983), have developed a current paradigm that integrated the three aspects of bureaucratic behavior mentioned above.

Unlike the previous approaches, today's political economy modeling of bureaucracy focuses on the legislature as the monitor of bureaucratic behavior and on the various control techniques it imposes to prevent bureaucratic misconduct and to minimize transactions costs. The key scholars here take as given bureaucratic self-interest, as well as non-minimizing production cost behavior due to the costliness of governance mechanisms. The legislature recognizes this agency problem, however, and attempts to redirect bureaucratic behavior toward desired legislative goals. Two approaches within this current political economy paradigm have attempted to model the legislature as an authoritative monitor of bureaucratic behavior. The first, using legislative supremacy assumptions, accepts bureaucratic self-interest, but does not explicitly include the strategic interaction between principal and agent. The second includes all sorts of strategic interaction between the legislature and bureaucrats, including bureaucratic resistance to legislative control.

The agency literature examines the development of incentive structures in private firms to control the behavior of private firm managers. The Alchian and Demsetz (1972) revision of

Coase (1937) and the seminal article of Jensen and Meckling (1976) sees control devices—profit sharing, monitoring, reputational effects and other enforcement techniques incorporated into the governance structure—as specifically designed (or evolved) to align managers self-interest with the interests of the firm. Carrying this idea into the public sector, Milgrom and Roberts (1992) devote their paper to this neo-institutional view of government. The legislature uses control devices such as sunset legislation, agenda control, encouragement of "professionalism" in the bureaucracy, and its own oversight to ensure compliance with implicit contracts and to put itself in a dominant position over the bureaucracy in an effort to reduce waste associated with realizing its policies.

While Weingast and Moran (1983) demonstrated that direct monitoring of bureaucratic action is not necessarily the most economic or effective system of control, indirect methods such as political control of bureaucratic appointments are often less costly and at least as effective. By controlling key appointments at the upper ranks of bureaucracy, Weingast and Moran argued, Congress is able to exert effective indirect control over agency discretion. As a result, the costlier methods of direct oversight and congressional investigations of bureaucratic behavior are less frequently employed. In effect, Congress implicitly steers the bureaucracy from straying off the path it has set, regardless of its seemingly lax monitoring. The public agency behaves as the legislature chooses, since the legislature appoints individuals with similar political motivations to run the bureaucracy, a modern equivalent of the "spoils system," which Wilson (1961) found to be quite effective. In this modern view of bureaucracy, higher public firm costs are not remedial, but reflect political transfers desired by members of the legislature. Weingast and Moran concur that the legislature

makes bureaucratic appointments that crucially affect the form and direction these transfers take.

Reversing Niskanen's conclusions, legislative supremacy models maintain an extreme view of congressional dominance where bureaucrats are treated as passive actors. Legislative supremacy models do not wholly answer, however, why bureaucracies produce inefficient public output, since they assume legislature controls them (Weingast and Moran 1983). Paying little attention to whether and how bureaucrats respond to the actions taken by legislators, these models imply that legislators' control with certainty bureaucratic behavior. A more sophisticated principle-agent model of government supply predicts, however, that self-seeking bureaucrats will search for "loopholes" in the common rules and control devices adopted by the legislature, even if those interests are aligned through key bureaucratic appointments.

In response to this criticism, McCubbins, Noll, and Weingast (1987, 1989) known collectively as McNollGast, formulated a second, rather descriptive, but exceeding useful model in which bureaucrats are treated as strategic actors in relation to legislators. Realizing the high transactions costs associated with the use of ex post controls such as monitoring and enforcement, the legislature opts instead to control the bureau ex ante. In order to reduce transactions costs from monitoring and asymmetric information, McNollGast argue that legislatures deliberately design administrative procedures to avoid ex ante agency problems, and to control bureaucratic action without constant legislative supervision. Instead, the legislature requires public agencies to disclose information following specific and often cumbersome procedures identifying the quantity, quality, and completeness of

bureaucratic information. This ex ante governance allows the legislature to learn the bureaucracy's plans before they are put into place. This structure and process also slows the speed of bureaucratic action, providing the legislature an opportunity to intervene.

The McNollGast paradigm captures all the important elements required for a complete theory of bureaucratic behavior—bureaucratic self-interest, the effect of competition on bureaucratic behavior, and the role of political institutions. Absent these indirect controls Niskanen's monopoly assumption has merit, but by using "structure and process," the legislature restrains the behavior and aligns the goals of the bureau with their own. According to the property rights view, competition for bureaucratic positions disciplines bureaucrats through fear of replacement and reduces the legislature need to exert control over them. The legislators' participation in the structure and process assures their influence on bureaucratic decision-making and supports the Chicago School focus on the potency of special interests. A signal that public firms could be the low-cost producer of certain goods and services, especially transfers, is seen in the evolution of these disciplinary devices. Therefore, synergies must exist between the legislature and the bureaucracy, which is not present between the legislature and the private industry suppliers.

Unlike McNollGast, Moe (1997) concentrated on the behavior of bureaucrats as opposed to legislators, including a more defined role for interest groups, since they add uncertainty to political outcomes. Since legislators do not own property rights to their current positions, they cannot be sure that the agencies, programs, and rules they created will survive the next political cycle. As Moe (1997, 469) puts it: "Political uncertainty leads legislators to lock in bias to protect the bureaucracy from changes in group power and public authority." He

argues that political authorities currently in office make decisions that favor certain special interest in exchange for their political support and ensure that targeted interests continue to benefit from the political system, then and in the future. Thus, biases are built into the system so they cannot be easily altered or dismantled by others in the future. This necessarily provides the bureaucracy with greater autonomy, but in highly constrained ways. Moe concludes that the bureaucracy is rationally conceived by the legislature as a semi-autonomous decision-making entity and political uncertainty leads to a structure of power sharing between legislature and bureaucracy. He attributes the relative high cost of public production to the legislature rationally granting bureaucratic independence, since it anticipates "wasteful" acts by its agents. While in Niskanen's model the legislature is duped by the asymmetric information, in Moe's model the legislature fully consents to the "inefficiencies" of asymmetric information, since it gains in control over other margins which its special-interest clients particularly value. Yet, unresolved is how the current legislature actually locks its biases into the decision-making structure of the bureaucracy.

3. What is to Be Done

Notions of agency costs and deadweight losses along with the neo-institutional methodology expose the logic of bureaucratic contractual forms that have developed within the constraints imposed by political structures. To many economists, society's control devices are only two—markets and polities—yet, there may be a third and possibly powerful constraint: social controls which emanate from customs and morals. The pressure of social values in enforcing contacts, which we will simply term norms, has been much discussed in recent years by economists and others, particularly Akerlof (1984), Coleman (1990), Elster

(1989), Frank (1988), Fukiyama (1995), Granovetter (1985), Kreps (1990), Williamson (1990), and Wilson (1993). These scholars hold that social capital—the fourth factor of production after the Ricardian triad of labor, land, and capital—reduces free-riding and opportunism and causes individuals to internalize at least some external costs in a Ronald Coase-cum-Talcott Parsons functionalist fashion. This shift towards a new "moral sentiments" analysis is due to the realization that formal markets, common law, statutes, and politically driven policy would not work nearly as well as they do given self-interest fettered only by market and political constraints. Social capital theory with its concentration on customs, morals, reputation, and trust, makes sense of what otherwise would be mysterious deviations from strict self-interest within public agencies (as well as for-profit firms).

Breton and Wintrobe (1982) treated trust relationships as key in understanding the logic of public bureaucracy. They noted that human relationships of a vertical nature within an organization—between superiors and subordinates—when fortified with trust lower transactions costs. Preferences shown certain groups in hiring, attention to education, class, and ideological convictions, care in examining recommendations, encouragement of professional association memberships, are predicted to increase the level of trust in an organization. Horizontal trust relationships among equals and co-workers, on the other hand, can raise the level of opportunism and deadweight costs, since these can act as devices to disguise or cover up chiseling and malfeasance.

Consider political and social environments where a group has a great deal of social capital embeddedness (Granovetter 1985) which lowers the political cost of formal political contracting. Here social capital is complementary with political action as vertical trust

relationships lower the transactions costs of political interaction, while shaping organizational structures and process behavior accordingly. Setting aside whether the notions of social capital theory are yet operational, introducing trust norms into the theory of public supply seems a useful addition to rational choice politics. Courts and legal services, education, the military, fire and police services, and social work all come to mind as activities characterized by deep horizontal and vertical relationships well beyond the links of formal contracting. Can anyone explain the behavior of the fire and police forces in response to the "September 11" incident of the World Trade Center and Pentagon bombing without this element?

4. Conclusion

Our general theme has been that institutions play important roles in channeling behavior in public sector supply and that their shape reflects to some significant degree differential transactions costs. Knowing how institutions condition relative transaction costs at the margin of exchange to the various parties, at least in some first-order sense, is important if one is to understand why some bureaucratic structures have survival value over others. Bureaucratic structures and processes adjust to the private benefits and costs as these costs are internalized by the various individuals and groups that bear them. One key characteristic that varies among the different supply arrangements is the ease of making political transfers. We believe that a more thorough understanding of the positive political economics of bureaucracy must proceed before any serious normative speculations about the bureaucratic invisible hand are undertaken. Finally, we would like to reiterate the major theme that public sector supply mechanisms have many margins of choice beyond the neoclassical price-quality dyad, including the constraining force of social values in enforcing contracts.

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