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WILLIAM NISKANEN - PUBLIC CHOICE AND POLICY

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Abstract			
<p>This study seeks to evaluate the work and legacy of William A. Niskanen, a foundational economist of Public Choice literature on bureaucracy and political thinker, as well as to investigate the academic literature on Public Choice Theory. What topics are studied by the literature currently and what future topics could prove fruitful? This is achieved with a literature review of Niskanen’s work and of related literature.</p> <p>The study finds that Niskanen’s original model of budget maximizing bureaucrat was altered in favour of discretionary budget maximization. Niskanen himself accepted this change in his later articles. Empirical research also shows that Niskanen’s model tends to be overly pessimistic about the outcomes of bureaucratic supply. Some empirical studies question the validity of the model, but others find evidence of the model working in some institutional contexts. Niskanen’s work is still considered to be foundational in public choice theory literature on bureaucracy. In addition, the study finds Niskanen’s studies on voting theory has provided better insight on the political divide in the United States. Later studies on political attitudes have shown that this division has continued to grow but did not evaluate Niskanen’s model’s validity.</p> <p>Niskanen’s career in the government was also considerable. Although he described his role to be a “minor actor”, he did have major role as the acting chair of Council of Economic Advisors in the end of his career. As a public servant he served the administrations of both Democratic and Republican presidents. Although not an academic study, Niskanen’s critique of Reagan’s administration in his book Reaganomics is an insightful look into the functioning of the United States federal government, and the reasons for failures and successes of Reagan’s policies. Niskanen did continue his academic work after the career as a public servant. His articles during his presidency in Cato Institute cover a broad range of subjects from bureaucracy and voting theory to optimal tax models and constitutional law.</p> <p>Niskanen remains highly cited author and his influence can be still seen in public choice literature. After his death Niskanen Center, a think tank named in his honour, further explores similar topics to its namesake. After Niskanen’s presidency, Cato Institute continues to be a major institution in the United States political sphere.</p>			
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1 INTRODUCTION

Dr. William A. Niskanen (1933, Bend, Oregon – 2011 Washington D.C.) was an American economist of Finnish heritage, whose contribution to business management, economic literature, and American policy continue to influence the World after his death. Niskanen achieved his bachelor of Arts degree from Harvard University. He continued his studies in University of Chicago achieving a MA and later a PhD from economics. He pursued his academic career as a professor of economics in University of California at Berkeley and University of California Los Angeles (*About - Niskanen Center*, n.d.). Niskanen's work with William Sharpe for Rand led to their contributions to better US Air Force's logistics. This continued to a career in President Kennedy's Department of Defence. Niskanen's honesty gave him some trouble, and his career for Ford Motors was cut short due to disagreement with the management. Niskanen wanted further investments to research and development, whereas the higher management wanted to lobby for import restrictions of foreign cars. After losing his job at Ford, Niskanen continued his career as a political advisor for Ronald Reagan, during his state governorship. This cooperation continued later during Reagan's presidency. Political disagreements in the administration, and between him and Reagan led to Niskanen's resignation from the Council of Economic Affairs (CEA). Niskanen continued a career in the political theatre, joining the libertarian Cato Institute. Ending up as the chairman of the organisation from 1985 to 2008. (Dudley, 2012; Rees Shapiro, 2011)

Niskanen's effect on US administration and politics should not be understated. His work in the Department of Defence was ground-breaking, and as a member of Reagan's administration, he helped to mould its' influence US economic policy. His contributions to economic literature pushed Public Choice Theory forwards. Among countless others, his contributions are given a lot of attention by economist and author Eamonn Butler in his primer on Public Choice Theory (Butler, 2012).

As a political actor, his influence shaped the public discourse and policy. His critique of the political decisions made by Reagan and Kennedy's governments, shows Niskanen's intellectual honesty and his deep understanding of the political space.

This work seeks to study the influence of Niskanen to the field of economics and to public policy, and to bring his work more attention as a ground-breaking economist of a Finnish heritage. This study will mostly focus on three major works of Niskanen. Two collections of his articles “Bureaucracy and Public Economics” and “Reflections of a Political Economist”, his recollections from his time in Reagan’s administration, “Reaganomics”, and the public choice literature inspired by Niskanen’s academic break throughs.

Public Choice Theory remains important part of economic literature, and recent developments in politics, such as realignment of Sweden and Finland towards NATO, rising interest rates, public response to Covid-19, and central bank policy during the last decade prove timely and valuable topics for current and future public choice authors.

2 PUBLIC CHOICE THEORY

Public Choice Theory studies the incentives of agents and organizations operating in an environment with no traditional profit motive. The theory starts from a premise that even if there is no way for an organization to make profit from the service they provide, they will still operate to maximize their own utility. The individuals within these organizations also maximize their own utility as a member of the organization, leading them to act in a way that maximizes their salary or non-financial interests, such as prestige of the position, ease of operations, political influence, etc. This behaviour causes “government failures” (as opposed to market failure), in what we traditionally consider non-market sectors. In one sentence, Public Choice Theory uses tools from economics to study the field of politics and public governance (Butler, 2012).

Many Public Choice theorists have studied how collective decision making affects the distribution of costs and benefits. For example, how different types of constitutions or legislative processes affect the political power distribution within a population, how review committees affect power of bureaucrats, or how non-profit businesses act to maximize their utility. Concepts like opportunity cost and asymmetric information are vital for understanding the behaviour of individuals in the political arena. (Butler, 2012; Niskanen, 1971)

For his work in studying exploitation in electoral systems, James Buchanan – considered often to be the father of Public Choice Theory (DiLorenzo & Block, 2016b), (although many economists (Butler, 2012; Volejníková & Kuba, 2020) give the honour to Duncan Black) – received the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in 1986 (Butler, 2012; *The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 1986*, n.d.). Other public choice economists have also received the price in number of years for their contributions on the theory (Butler, 2012).

Historically the theory came to challenge political and economic thinkers such as John Maynard Keynes and Max Weber, and the influence they had had for political and economic sciences and political practice in the post-war era. The post-war welfare economists who studied the net social benefits of public policy, started at the

assumption that the political decision-making process was rational and impartial (Butler, 2012; Niskanen, 1971). Public Choice theorists questioned this underlying assumption, and the conclusions of theories building upon it.

Niskanen's main body of work in the field of Public Choice literature was his magnum opus – *Bureaucracy and Representative Government*, a book in which he lays the foundation of the Public Choice Theory on behaviour of bureaucratic organizations and public officials (Butler, 2012; Niskanen, 1971). The book is quite bleak in its view of public officials' incentives, and even Niskanen did later state that later literature on the topic seems to indicate that the self-interested behaviour of bureaucrats was better controlled than he initially feared (Butler, 2012; Niskanen, 1975, 1994).

2.1 Bureaucracy and Representative Government

In this chapter, I will focus on Niskanen's book from 1971, *Bureaucracy and Representative Government*. The book expands on existing ideas of Public Choice Theory, as well as building a framework to model the behaviour of bureaucracy and the political decision-making process. By studying the motivations and incentives of individuals in the system, the "economic approach" used tries to find the weak spots that lead to inefficient solutions for the system modelled. This approach works on the assumption that bureaucrats behave like economic agents, trying to maximize their utility. Whether the motivations of the bureaucrat are benevolent or selfish, he will be benefitting the most by maximizing the budget available to him (even if you only want to excel in your job, budget maximization will help you work towards your goal through better equipment, more staff etc.).

Niskanen shows great knowledge of political theorists but shares criticism towards many of the existing points of view. He criticizes social scientists influenced by Max Weber (and earlier philosophers like Plato and Confucius) for having too rosy view of bureaucracy. Economists are critiqued for not studying the political institutions, leading to lack of theory on public organizations. On the other hand, Niskanen finds Ludwig von Mises' and the Austrian analysis of political organizations to be naïve in believing education and scaling back government are the solutions for inefficiencies of public governance. (Niskanen, 1971)

2.1.1 The Beginning

Niskanen divides questions on behaviour of bureaus to three different categories: constructual (structure of the system or bureau), behavioural (what are the consequences of actions), and normative (what action should be taken, based on the answers to behavioural questions). The book is not meant to be a management guide on bureaus. These questions are meant to guide in understanding general theoretical models. (Niskanen, 1971)

Niskanen defines a bureau as an organization, which does not operate on profit motive. The owners and employees cannot appropriate profit from the organization (the restrictions are somewhat loosened in more complex models of the book, by studying bureaus that operate partly in free market). Typically, a bureau will have a single sponsor that funds its operations, typically, a branch of government. This sponsor will have its own demand for the service, shown by the budget (B) it is willing to give for a given output (Q), the function of which is $B = aQ - bQ^2, 0 \leq Q \leq \frac{a}{2b}$. The trade between the bureau and the sponsor does not happen in per unit terms (like free market), but more like in game theory, where actions will lead to subgames where both try to gain the optimal outcome. This is further complicated by the fact that the outcomes can be highly subjective or impossible to measure, leading to modelling the value of a service based on more easily quantifiable metrics. For example, when evaluating school performance, governments might try to measure success by how many students graduate, as the actual value of the educational services is extremely difficult to evaluate (do we consider the higher income gained by the individuals or do we only consider higher taxes gained from the wages, how about life satisfaction or lower crime rate, what about political stability, etc.). This can make the actual quality (or quantity) of the service hard to find out. The quality of military can only be tested in war, Niskanen points out in his example. The bureaucratic model also leaves the end consumers out of the budget negotiations. They are replaced by the sponsor organization, which might not directly use the service at all. Niskanen stresses the importance of the structure of political organisations sponsoring the bureau. The model of governance also plays a role. In the United States, the budget must pass both houses of Congress. The politicians in these organizations have different constituencies and

election processes, which leads to differing incentives for the politicians. The bureaus can use these differences by bargaining their support for political goals in exchange for larger budget. The bureaucrats can also try to outlast or confuse any politician leading the bureau if they prove troublesome for the bureau. The politicians have to spend time campaigning and will change time to time, whereas the bureaucrats will have longer careers and understand their environment better because of this. However, maintaining credibility forces some level of truthfulness. (Niskanen, 1971)

2.1.2 Trade and Incentives

Niskanen argues some bureaus can be able to price discriminate more than private market alternatives. For some professions, the bureaus are the only employer of the trade or buyer of the product, leading to a monopsony in market. This, Niskanen states, has led to price discrimination in public contracts in these markets. As an example, Niskanen says, infantry officers will receive lower pay than pilots of the same rank, since they have less work in the private sector. Some bureaus (like the military) can also demand resources (such as public land or uranium) from other bureaus for below the market price. (Niskanen, William A., 1971)

Since, according to Niskanen, a bureaucrat acts to maximize his individual utility. Because many of the factors the bureaucrat gains utility from (salary, perquisites of office, public reputation) require money for the bureau, it is in the interest of the bureaucrat to maximize the budget of his bureau. From his premises Niskanen builds a total cost function $TC = cQ + dQ^2, 0 \leq Q, B \geq TC$. If the bureau is able to price discriminate for factor inputs, it might do so (even though it may at first seem counter-logical to a budget-maximiser). The price-discrimination allows a budget-constrained (a bureau which chooses optimal output due to the budget limitation $B = TC$) bureau to increase the total output and, as a consequence of smaller price per unit, increase its budget. However, if the bureau is demand-constrained (bureau with $B > TC$, but budget is limited by lack of demand), especially should the factor producer be a politically influential group, the bureau will probably avoid price-discrimination, as no one will be better off, and the discrimination may cause political pressure against the bureau. Instead of being efficient the demand-constrained bureau can choose a

production method based on the needs of its sponsor, or in layman's terms, to bribe the politicians to give them money. (Niskanen, 1971)

A bureau which provides multiple services can at the same time be economizing in some respects and wasteful in others, if a combination of two services, one of which is budget-constrained, the other demand-constrained is possible. By combining the two services, the bureau might be able to increase its budget compared to what the sponsor is willing to pay for production of one of the services alone. However, this combination requires larger output and budget but lower budget per good produced. (Niskanen, 1971)

In Niskanen's model, comparison of monopoly and monopolistic bureaucracy yields interesting result. A monopolistic bureau does not have a traditional supply function. Its supply function comes from the demand of its sponsor, until the minimum total costs become equal to the budget, or marginal value for larger output is 0. Similarly, a monopoly will sell at a set price at a level where marginal revenue equals marginal costs. Whereas the monopoly (whether price-discriminating or not) produces less than perfectly competitive market to maximize its profits, the bureau boosts output above the perfect competition equilibrium. The bureau wants to maximize its budget, which it can do by driving the collective surplus to zero (the difference between what a collective organisation would be willing to pay for the service and what it does). The non-price discriminating bureau-case is only preferred by the factor producers, who gain from the larger output level, whereas large consumers prefer the lower prices of profit-seeking monopoly. A price-discriminating bureau will supply even more, driving profits, collective surplus, and factor surplus all go to zero, at twice the output level of the competitive market equilibrium. This leads to Niskanen concluding, that oversupply is clearly a problem for the bureaucratic solutions and may be difficult to solve. At the equilibrium level the average cost for a unit can appear close to that of a competitive industry, however it is achieved only at much higher output. Even then, a profit-seeking monopoly solves few problems as an alternative to the bureau, as both provide suboptimal solutions in the market. (Niskanen, 1971)

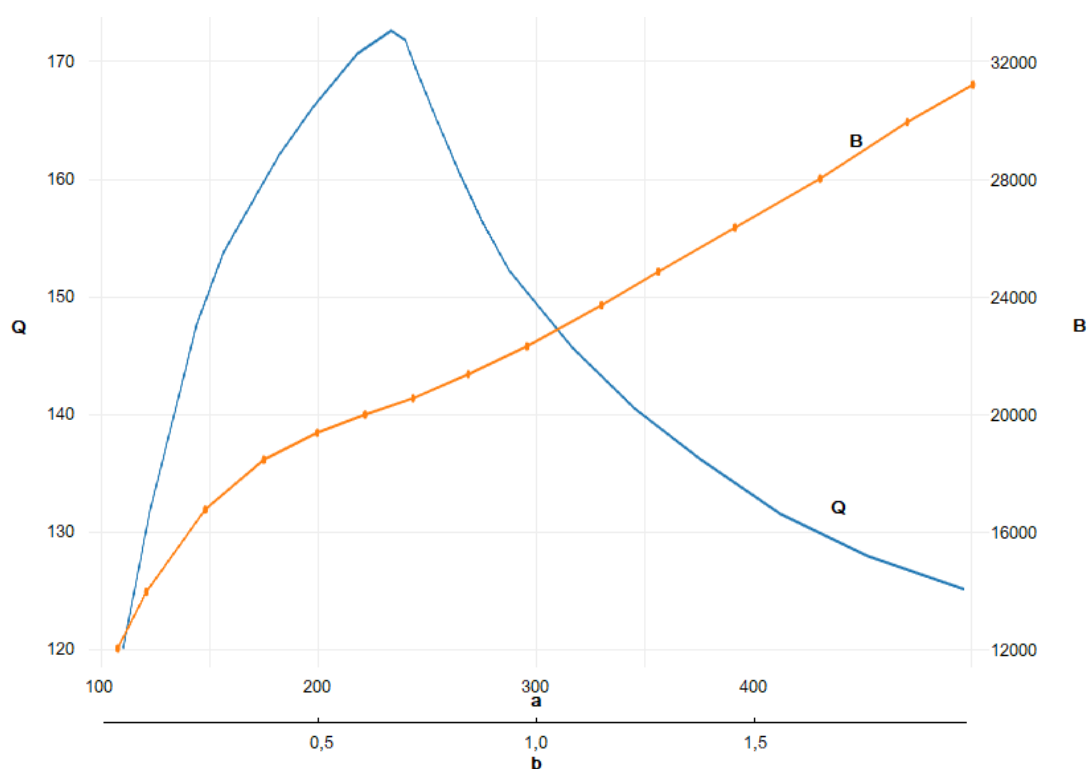
Changes in demand or costs will, at minimum, cause as large of a change in bureau output as for profit-seeking company in perfect competition. In fact, for a budget-constrained bureau with constant marginal costs, the output (and budget) will grow twice as fast as in the perfect competition case. On the other extreme, a demand-constrained bureau will only grow the output at the same pace as a company in perfect competition. As seen from the figure, reducing elasticity of demand (depicted in the functions with 'b') will increase the budget of the bureau. (Niskanen, 1971)

Bureau	Q	B
Budget Constrained: $a < \frac{2bc}{b-d}$	$\frac{\partial Q}{\partial a} = \frac{1}{b+d}$	$\frac{\partial B}{\partial a} = \frac{2a-c}{b+d} - \frac{2ab-2bc}{b^2+2bd+d^2}$
$a < \frac{2bc}{b-d}$	$\frac{\partial^2 Q}{\partial a} = 0$	$\frac{\partial^2 B}{\partial a} = \frac{2}{b+d} - \frac{2b}{b^2+2bd+d^2}$
Demand-Constrained: $a \geq \frac{2bc}{b-d}$	$\frac{\partial Q}{\partial a} = \frac{1}{2b}$	$\frac{\partial B}{\partial a} = \frac{a}{2b}$
$a \geq \frac{2bc}{b-d}$	$\frac{\partial^2 Q}{\partial a} = 0$	$\frac{\partial^2 B}{\partial a} = \frac{1}{2b}$
Competitive Industry:	$\frac{\partial Q}{\partial a} = \frac{1}{2b+d}$	$\frac{\partial B}{\partial a} = \frac{2a-c}{2b+d} - \frac{4ab-4bc}{4b^2+4bd+d^2}$
	$\frac{\partial^2 Q}{\partial a} = 0$	$\frac{\partial^2 B}{\partial a} = \frac{2}{2b+d} - \frac{4b}{4b^2+4bd+d^2}$

Table 1 Effects of Demand Shift, Niskanen (1971) p.67

This feature of the budget function makes it enticing for the bureau to manipulate the elasticity. Here, we must remember that the bureau does not have to decrease the actual elasticity of demand, but only the perception that the sponsor of the bureau has (as the

bureau does not generally face the users in “the marketplace”, but the sponsor of the bureau). In simpler terms, by promoting the bureau and what it does as a public necessity, e.g., by taking the politicians on a tour to a crowded hospital to show the need of the service provided. In graph 1, we see how changes in elasticity affect the quantity of output and budget of the bureau. Both a and b are used as variables and change in a way that keeps the market conditions constant for competitive industry (output = 100, and revenues and costs = 10 000). Change in parameter b describes the change in slope of demand. Low b represents elastic demand and high relatively lower elasticity. We can also see the budget-constraint changing to demand-constraint at the peak of function Q . In the demand-constrained region the bureau will cut its output as a response to reduced elasticity. Niskanen argues this may be the explanation for Parkinson’s Law – bureaus grow exponentially with time, regardless of demand for output. (Niskanen, 1971)



Graph 1 Effects of Reduced Elasticity on Demand, Niskanen (1971) p.71. In this graph $c=75$, $d=0,25$

Niskanen also argues, that a new bureau or a budget-constrained bureau with increased costs will (at first) be cost-conscious, because cuts in unit-costs produce larger

increases in its budget. However, in the long run, a bureau which has already made some cuts, will face diminishing returns on finding new ways to be more efficient. A demand-constrained bureau is not interested in efficiency, as cuts produce no change in its budget. Further, in the demand-constrained area, the bureau is indifferent to the slope of the elasticity of demand, as budget or output are invariant to it. In the budget-constrained area, however, bureaus with smaller output levels choose production methods with higher marginal costs and vice versa. (Niskanen, 1971)

2.1.3 A non-profit model

A non-profit, which operates by selling its product on the market, rather than relying on a sponsor, can also be viewed through the public choice theory. If the non-profit is budget-restricted, it behaves like a perfectly competitive market with free entry. In real world, the output or revenue of a non-profit can be a little bit higher (or price lower), due to tax exemptions to non-profit organizations.

These tax exemptions, or other competition advantages such as monopoly on the market, can lead to a non-profit operating in the demand-constrained region. If the non-profit can price discriminate, the output and revenue in both regions will be even higher and marginal prices lower. Under specific market conditions, a price-discriminating non-profit may end up in an equilibrium, where it gives the last unit for free and finances the unprofitable marginal units sold with the producer surplus from the discriminatory pricing.

2.1.4 The Mixed Bureau

A mixed system generates its funds through a mixture of budget from a sponsor and sales. Because of this divide into two separate methods of funding, the mixed bureau faces two different demand functions. Together they form the financing constraint of the bureau (budget + revenue \geq total costs). There are five different scenarios that this split can cause:

- 1) both influence output (if customer and sponsor both benefit from marginal value) with budget-constrained bureau

- 2) both influence output with demand-constrained bureau
- 3) customer demand is dominant (marginal value to the sponsor = 0)
- 4) sponsor demand is dominant with budget-constrained bureau (marginal value to the customer = 0)
- 5) sponsor demand is dominant with demand-constrained bureau.

A bureau might be able to price discriminate, for example by giving out discounts to customer segments (seniors, students, etc.) and forcing a customer to identify his/her segment when purchasing the service. Price-discriminating bureau will act like a bureau with two sponsors. The 5 scenarios apply also in this case.

In scenario 1.) a budget-constrained bureau, that sells at a uniform price, maximizes its budget in $B+R=TC$, where as demand-constrained bureau chooses the output that maximizes $B+R$. Combination of the budget and revenue models leads to higher output, compared to either operating model alone. In a scenario where budget function $B = a_1Q - b_1Q^2, 0 \leq Q < \frac{a_1}{2b_1}$, revenue (demand) function $R = a_2Q - b_2Q^2, 0 \leq Q < \frac{a_2}{2b_2}$, cost function $C = cQ - dQ^2, Q \geq 0$, and $c > a_1, a_2$ we would not see any output by only relying on either budget or revenue models. An increase in the sponsor demand will decrease the price to the customer but increase in demand of customer will increase the price. Increase in customer demand will also increase the willingness of the sponsor to pay, as it gets more services for the same budget, but this has diminishing returns. How changes in demand affect the revenue depends on the price-elasticity of demand. If elasticity is high, increase in sponsor demand will increase revenue (with decreasing marginal benefit), if elasticity is low the opposite is true (with increasing marginal benefit).

A price-discriminating bureau in scenario 1 is always budget-constrained, unless we allow the marginal utility to customers and the sponsor to be < 0 . The output is larger than without discrimination. The marginal price of output is smaller than with uniform price, but the average price is higher.

In the demand-constrained region (scenario 2) an increase in budget to push up supply will push out equal sum in revenue, leading to higher sales in lower prices. Here the

bureau will act like a monopolist with zero costs, will discriminate the sponsor but sell at uniform price to customers.

In scenario 3, consumer demand is dominant, but the sponsor still matters. This scenario happens when $\frac{a_1}{2b_1} \geq Q \leq \frac{a_2}{2b_2}$. There is no demand-constrained version of this scenario, because increase in customer demand relative to sponsor demand leads to the bureau acting more and more like a non-profit without any budget from a sponsor. In scenario 3, the bureau will extract the maximum budget from the sponsor it can (when marginal value to sponsor = 0). Equilibrium output comes from equating this maximum budget with total revenue function. An increased output does not lead to an increase in budget, making it less relevant to the bureau than in previous cases.

In scenarios 2 & 3, a price-discriminating bureau receives a budget from its sponsor independent of its behaviour. If budget constrained, the budget has only slight impact on raising the output and lowering the price of marginal unit, but the total financing of the bureau increases more than the budget, due to secondary effect in raising the revenue, compared to non-profit facing the same situation.

In scenarios 4 and 5, the marginal utility to customer = 0. Unless there is price discrimination, the price of service is 0, and thus $R = 0$. This makes the bureau act like an elementary bureau with no opportunity to sell its services. Scenario 4 comes about when budget is so high, that at the optimum Q , the equilibrium price is 0. Scenario 5 comes about by pushing the budget even higher, above the minimum total costs. A price-discriminating bureau faces completely symmetrical results in these scenarios as in customer demand-dominated scenario. The revenue is considered a lump-sum payment, independent of bureau behaviour.

For the customer, the most beneficial model of mixed bureau is one selling in uniform price and subsidized for each unit sold by the sponsor. This case leads to a supply similar to price-discriminating non-profit, but transfers the net benefits to the customers, in effect, selling the same output at demand value to the sponsor and uniform price to the customer. The net benefits to the total system, however, lack behind competitive solution. (Niskanen, 1971)

After this, Niskanen goes further into studying examples of bureaus supplying multiple services. Optimizing solution for a bureau supplying two services with different demand curves but same cost structure shows that the budget for the bureau exceeds that of two bureaus responsible for the two services. The reason for this is that the bureau can theoretically allocate costs from a single budget between the two services, without the sponsor knowing. The output of the service with comparatively lower decline in marginal value is higher than it is for the bureau with only one service. The opposite is true for the service with faster decline in value. The higher budget provided to bureaus with multiple services incentivizes the bureaucrats to broaden the scope of the bureau outside of the original purpose. However, this behaviour is not necessarily only a public hinderance as one might assume. These new fronts provide competition to services dominated by other bureaus and attempt to crush this behaviour might crush any competition the bureaus face, making them less efficient. It also fights against the natural development of bureaucracy, which will try to get pass the obstacle to maximize its benefits. If there are economies of joint production with the services (the production of one service benefits from the production of the other), the bureau can become more efficient in providing the service than two bureaus specializing in either one of the services. These products can be unrelated in use, only their production must benefit from one another (e.g., the military might be more efficient in logistics, if it also delivers the mail in peacetime).(Niskanen, 1971)

2.1.5 The Bureaucrat as an Investor

Unlike a manager in traditional economic theory, a bureaucrat is not interested in the present value of the bureau. A bureaucrat does not have capital tied to the bureau after he leaves his post, no stock-options, no benefits from future success. Therefore, his time horizon is shorter than that of the manager. A bureaucrat is interested in the present value of the total budget of the bureau during his tenure. Because the bureaucrat is only interested in the total budget in his tenure, he views the rate of interest for investments differently, depending on the cost structure of the project, but always evaluates the interest rate for him lower than the borrowing rate of the collective organization, leading to capital-intensive operations. If some of the costs fall outside the tenure, the bureaucrat can become less efficient than previously described.

Even the total budget of the bureau over time can suffer, as the suboptimal investment in earlier years, leads to worse budgets in later years. (Niskanen, 1971)

2.1.6 The Sponsor as a Ruler

The previously discussed models presupposed the sponsor is a passive subject, who exists only to study the actions of the bureau. This of course is not the case. The collective organization has its own interests and must consider not only how to stay in power as politicians, but in what ways stakeholders react to their actions. A prominent business deciding to move out could be disastrous for local government. Even political rivals moving could spell disaster. Within any state or town there are groups of people with different demand functions for any public service. Yet the representative in the collective organization is usually selected in elections where he advocates for a bundle of different services. This is limited further by candidates representing political parties with an incentive not to step on toes of any possible supporters. Furthermore, the higher you go, the harder it comes for the politician to know or estimate the cost conditions of the services he is leading. It is easier to estimate or find comparative examples of costs and benefits if you are a police chief choosing a new car for the force, than it is for the Minister of Interior to estimate the costs and benefits of a police reform (especially as there are multiple interest groups trying to sway the decision to benefit them). There is also no apparent tool to make the leader choose the best alternative for the entire population. At most, he can be expected to maximize his interest subject to the constraint of re-election. (Niskanen, 1971)

2.1.7 The Review Process

The optimal way to finance the service with taxes is that those with large relative benefits from the service are the ones who finance it the most. The progression in the tax may even be higher than the relative difference in the usage of the service (i.e., Group A utility=1, tax=1 but Group B utility=2, tax=2.5). However, the optimal distribution will be hard to determine for each service due to institutional constraints, leading to taxation based on the total package of services. (Niskanen, 1971)

Consider an example where there are three groups with differing demand on public service and identical income levels. If the minimum cost conditions of the service can be deduced (e.g., because the service is provided by competitive industry) the medium-demand voters elect the representatives who will be the deal breaker on the votes on level of the service. The representative knows the cost conditions, and can confidently rule on the budget needed. No review committees are needed, as everyone knows the cost conditions and the representatives of the middle group wants to stay in power, so they choose the optimal budget level for the group and reject any solutions that is sub-optimal for the middle-demand group. However, this is optimal for the total system only if the demand of the median voter equals the arithmetic mean of demand. The net benefits of the low-demand group can be negative even in the optimal solution for the system. With many similar services, the electors will exchange votes on one service, to gain majority on another where the demand-levels of the groups relative to one another is different. This will make no group relatively worse off, but the increase in total public services will make everyone worse off. (Niskanen, 1971)

Making the tax system to tax the groups based on the demand makes the solution closer to optimal, lowering the tax rate of the middle group, and raising the level of output. All groups will benefit from this solution compared to the previous case, where the low-demand group might have a net negative utility from the taxation. However, the equilibrium output is still lower than optimal, and the distribution of the utility still mostly favours the high to middle demand consumers. (Niskanen, 1971)

Because the high-demand group has disproportionately large utility for the public service, it is highly motivated in selecting, serving, and reviewing the actions of the bureaus providing the service. The last part means whatever reviewing body is set up to propose the budget or oversee the functions of the bureau, it will disproportionately be weighted in favour of higher-demand interests, on the condition it can still rely on middle-demand votes to push the budget through. As we can see, at best the reviewing body has disagreements on the level with which the high-demand group should be favoured. In this case the bureau tries to maximize the budget through asymmetric information and bargaining. The costs for the review committee to study the actual cost-conditions and more realistic budget will be expensive as the bureau has an incentive to not give this information away. At worst, the reviewing body and the

bureau are openly in bed with each other. In this case, the budget will be whatever the bureau wants, the low-demand utility will be negative, middle-demand zero, and high-demand positive, and the system will create some net benefit. (Niskanen, 1971)

For multiple “competing” bureaus with single review committee operating in budget-constrained conditions, the resulting supply function will increase the oversupply that can still pass the legislature, the benefits of the high-demand group as well as the disutility of the low-demand group. However, the review committee wants to maximize the quantity of output that can pass the legislature, leading to requirement of more efficient production for the bureaus. The total budget and output are invariant to the amount of competition among the bureaus. However, the total number of bureaus does not affect the efficiency either, as the review process creates a situation for all bureaus, that is like a budget-constrained monopolistic bureau. The oversupply will not fall but remains at the level before competition. If the bureau operates in demand-constrained region, the competition will result in more efficiency, and the committee will generally try to demand efficiency from the bureaus. This will not however reduce the oversupply, but only affects the total budget. If the committee cannot find the optimal budget levels for both bureaus, one gets too much the other too little, the first will try to hide the fact, while the other tries to lobby for bigger budget from different parts of the government or higher-ups of the committee, optimally to the legislature as a whole. This process may lead to smaller oversupply by forcing the middle-demand group representatives to resolute the budget-output proposals of the bureaus. However, the underfunding of the bureau must be significant enough to justify revealing the cost conditions. If the conditions are revealed, it will lead to smaller monopoly power for the bureaus, less oversupply, and less tilted outcome in terms of utility between the groups of consumers, as the two lower groups gain utility, but the high-demand group loses it. (Niskanen, 1971)

2.1.8 Modelling the United States

Niskanen continues to build a toy model based on US political system of his time. The model states that income elasticity for linear demand function is equal to unity for zero tax bracket ($\eta_Y = \frac{y^*Y_i}{y^*Y_i - t^*C}$, if $t=0$, then $\eta_Y = \frac{y^*Y_i}{y^*Y_i} = 1$) and monotonically higher on

brackets higher than zero. Niskanen assumes the demand function for package of public services for each group is negative one with respect to tax price of the group. Further, the demand for public services is positively related to income (higher income leads to demand of more, and better-quality goods). He also uses model of taxes, which is proportional to income rather than progressive. Niskanen argues this assumption is good enough to describe the real tax rates of most Americans in 1971, since (although the tax system was progressive) the different exemptions and excise taxes counteract the progressiveness of the system. These assumptions together provide the basis for the conclusion: in this model, the tax charges are proportional to the level of demand of each group. Further he divides the states according to average income and number of representatives in the House of Representatives and the Senate, so that we get three equally represented groups, based on the average income of the states. He decides to use US public spending of \$200 billion (some could say arbitrarily) by combining federal spending on wages and services from other organizations. Simple model of costs where $TC=cQ$ is used, which ignores the factor surplus created by the bureaus to the factors used. Bureaus are also assumed to be perfectly efficient. These assumptions are done to simplify the model. For the same reason, a combination of 10 units of 20 billion USD is used. (Niskanen, 1971)

First Niskanen studies bureaucratic supply the new model. He assumes the bureau solution dominates committee. This creates a solution where the low-demand group is worse off, the middle-demand group is indifferent, and the high-demand group receives all the benefits of the system. The assumption of positive relation between demand for goods and income means that the benefits of the system mostly accrue to those with high income. This somewhat Piketty-ish notion can (in cases where emigration is expensive or limited by government) lead to a revolution that can be either violent or cultural. These revolutions can be financed by a counter-elite of wealthy minority from the small-demand group. This counter-elite may be consisted of extremely high-income individuals, who prefer expensive private solutions to the public good and suffer from high tax payments. The low-demand group will also include the extremely poor, whose demand is low, but the benefits due to welfare payment gives them a net-benefit from the system. The middle-group forms a middle-ground between these forces. In the case of United States, third party movements may rise from this group. This group might be chauvinistically patriotic, but feel conflicted

by the government, as even though they have been able to gather some wealth in the system, the bureaucratic system does not bring net benefits for it, like it does for the high-demand group. The two-party system will pay lip service to this group to prevent it from joining the counter-cultural force but keep the actual benefits to minimum. Niskanen argues this system creates structural divisions between the groups (some other schools of thought might call this class conflict), a surprising argument from political advisor of the Republican president Reagan. The high-demand group—which is mostly comprised by the moderately wealthy (according to Niskanen, in 1971 a rough estimate of the median family income of this group would have been \$13000), not just the ultra-rich— would use the functions it has in its disposal to convince the middle-demand group of the necessity of higher level of public services. Niskanen mentions journalists and professors as examples of typical professions represented in this group, including direct mention of using the press to their advantage. (Niskanen, 1971)

Niskanen also studies society based on two-thirds rule in parliament (with bureaucratic supply). This creates net benefits to the middle-demand group but leaves them still with sub-optimal solution. The low-demand group still suffers net negative utility, although smaller than in the previous case. Typically, the high-demand group would have lower net utility, but Niskanen uses an example which shows, under certain conditions, two-thirds rule can benefit the group even more than majority rule. A majority rule government, which uses competitive supply of services benefits all groups, although the benefits still trickle mostly according to level of demand. Even with net benefits, the low-demand group still would prefer smaller government. The middle-group will is in equilibrium, high-demand group would like larger supply and should be expected to oppose this solution alongside the bureaucrats, and industries benefiting from the bureau supply. (Niskanen, 1971)

Next Niskanen tries to build an optimal model for all groups. His solution is based on tax rates, which are dependent on the level of demand for the basket of services, not specifically on any model of government. The optimal level of services that provide optimal benefits for all groups are $[B_1 + B_2 + B_3] - TC = [(a_1 + a_2 + a_3)Q - (b_1 + b_2 + b_3)Q^2] - cQ$. This creates the same net benefits for all groups and lowers the supply of services. Some of the lowest earners would be exempt of taxes, the tax

system would be progressive, and the high-demand group's tax rate would still be lower due to lower supply. According to Niskanen, this system would disincentivize the inter-group conflict that exists in the current US model. However, there would still exist an incentive to try to lower the tax rate of one's own group, leading to a different equilibrium in the system. (Niskanen, 1971)

2.1.9 Normative Judgements and the Positive Theory

Experiments in public governance tend to balloon out of proportions, leading to failed experiments that have outlived their usefulness and initial budget. Niskanen proposes all government programs should be viewed as experiments, even if they at first seem promising. Changes to the system should be implemented incrementally, so that experimentation is cheaper and can be monitored easily. Because of the expensive price tag and hard-to-kill nature of the experiments, any new proposals should have high burden of proof for their usefulness. To study the viability of any new project (or his theory), we must first choose a normative theory to judge the outcome. Niskanen chooses to use the Pareto criterion as basis of what ought to be done (each person, or group, should be as well off as possible, without hurting other groups). Next, Niskanen clarifies some basic concepts of economics, his model should not be judged by the realism of its assumptions, but the accuracy of the predictions, or ability of others to disprove them. Third, one must compare what judge the outcome to that of the normative theory (how close to pareto optimal equilibrium is the outcome). Niskanen reminds the readers to be careful not to forget the difference between normative and positive theory. Just because what is, is not what ought to be, does not mean the outcome is not the best out of possible alternatives (i.e., do not confuse reality with theoretical utopia). After the clarification of these criteria for how to achieve good legislation, the problem becomes, why would any politician or bureaucrat follow them? Indeed, it is better for both, if they can post hoc justify their goals and turn failure into fanfares. Even the voters accept this to some extent. They will accept a little dishonesty if it gets them good results. (Niskanen, 1971)

2.1.10 Changes to Bureaucracy

In chapter 18 Niskanen proposes changes to the bureaucratic process. Competition among bureaus should be encouraged and trend of policies to gather similar services under one bureau should be stopped. Any creation of new national monopolies for one service should only happen if economies of scale can be shown to exist to justify the creation. Optimally, the structure of bureaus and the bureaucratic system should be in a constant flux. According to Niskanen, any argument that grouping together these functions brings them to tighter executive control is also not convincing. Niskanen argues this only creates a position of secretary that will represent not the President, but the special interest of the bureau (compare this to the high-demand group dominating the bureau). As in competitive industries, bureaus will naturally bring about competition with each other, as they develop new services that are related to their production. This will create bureaus that have different methods of production and cost functions, but which will produce similar services. Competition among bureaus leads to larger likelihood that each bureau operates in budget-constrained region and have more incentive to choose efficient production methods and not overuse factors that are represented in the review committee. This will not, however, solve the issue of oversupply. (Niskanen, 1971)

Second way to introduce a better system is to incentivize better behaviour from the bureaucrats. To change the incentive for profit maximizing to one of maximizing the difference between obtainable budget and minimum costs within competitive bureaus. Niskanen mentioned three ways to achieve this. 1. The ability of high-ranking officials to appropriate leftover budget for themselves at the end of the year. For lower positions a raise would be given for cutting costs above target rates. 2. Giving out monetary prizes after the tenure for consistent efficient management. These would be given by bipartisan, diverse, and overlappingly tenured committee appointed by the executive branch and confirmed by the legislature. 3. Allowing the bureaus to spend the budget left in the end of the year towards projects of their choice. (Niskanen, 1971)

Given how throughout Niskanen has been until this point it seems confusing why he spends so little time on these points. Proposals 1 and 3 seem downright naïve to the possibilities of corruption, in fact, proposal 1 seems to actively promote it. Proposal 3

at least tries to present that the monetary gain would only go towards public benefit. Even Niskanen points out the difficulties in system 2 to judge the actual performance of the bureaucrats, rather than his ability for personal branding.

Niskanen returns to more convincing analysis when looking at how bureaucrats react to studies about their efficiency. Demand-constrained bureaus do not have the incentive to change their behaviour according to new information, instead they will try to push down or dilute the informational value of the study to continue operating as they have been. Budget-constrained bureaus do have the incentive to change operations to be more efficient, but all the benefit will be absorbed by the high-demand group and will increase the net losses of the low-demand group. This is not necessarily better for the system, and certainly is not Pareto-optimal. The main problem of the bureaucratic method remains over-supply, not inefficiency. A special case exists when a representative of the middle-demand group is at the head of the bureaucracy. In this case, the studies will lead to reduction of both inefficiency and over-supply. This is not, however, a stable situation, as the bureau and representatives of high-demand group will try to push out the leader and substitute their own. (Niskanen, 1971)

2.1.11 Political and Market Alternatives

An alternative to the bureau model is to give out subsidies to private producers. In areas where private companies compete with the bureau, the competition can get rid of some of the inefficiencies of the bureaucratic solution. A per-unit subsidy for production is often more efficient way to increase supply than a lump-sum grant, and is commonly used by governments (farming subsidies, universities, etc.). Often however, governments will try to affect production methods, leading to perverted incentive structures. This in turn, can lead to market inefficiencies that drive the equilibrium further away from the optimal solution. If the government wants to subsidize a particular group, the voucher system can be utilized. Even in areas of government where private competition is traditionally non-existing, private companies build the facilities of the bureau or produce some of the goods they use. Companies could even be allowed to bid to manage specific types of operations in the bureau, such as post services. (Niskanen, 1971)

For the political process, Niskanen tries to find alternatives to tackle the eventual domination of the high-demand group. For the review committees, Niskanen proposes politicians to be assigned randomly to a review committee and reshuffled after a period. This would prevent the natural selection of high-demand group representatives to the review committees. Niskanen accepts that this could raise criticism over the ability of legislators to specialize and become better at their niche. However, he argues, this specialisation will not happen in any case. Instead, the politicians will meddle with the bureaucrats to the benefit of high-demand voters. The same randomization is proposed to the secretaries in the executive branch. Further, additional review committees – or a specialized policy research institute – could be assigned to review the same functions of the state. These could offer alternative budget solutions to the original review committee. Expanding the review process to include circulating review bodies, would make it harder for the high-demand group to force their solution through the political machine. Other solutions would be the previously studied solutions of increasing the portion of votes needed to pass laws (with the risk of increasing deadlock in legislation) or reworking the tax system to take into consideration the demand for public services. In my view, here Niskanen perhaps does not appreciate the complexity of public governance. I would argue, even with randomness in the review processes and executive secretaries, the bureau staff would be able to muddle the field for the secretaries, until the next committee or politician comes along. (Niskanen, 1971)

2.1.12 The takeaway

In the end, Niskanen argues that the inefficiencies have expanded the government to a size far too large for public good. He suggests somewhat radical changes to the political system, normalizing the use of presidential veto to force the two-thirds majority for some legislation, and progressive tax system. Competitive supply of public goods by introducing more competition between bureaus, bureaus, and private companies, reworking the incentive structure of senior bureaucrats, and taking back control of the review processes from the high-demand groups. Financing services, the demand of which is homogenous except regards to income, should be done by the lowest possible level of government. This would decrease the inefficiency in low-cost

areas, that would unjustly benefit from national (or federal) budget, which would not necessarily be able to find the low-cost solutions in their review.(Niskanen, 1971)

2.2 Niskanen's other writings on Public Choice Theory

2.2.1 Bureaucrats and Politicians

In *Bureaucrats and Politicians* (1975), Niskanen refines his theory of budget-maximizing bureaus based on later academic literature. He accepts a discretionary-budget-maximization (discretionary budget is explained in the following chapter, chapter 2.3) as the new basis for bureaucratic behaviour. He also studies politicians as a part of the developing theory of political systems that is built around public choice literature. He argues for a “*vote-maximizing legislators*” as the basis of action for elected officials, a view expressed among others by Breton and Wintrobe (1975). Breton and Wintrobe argue, Niskanen's focus on bureaus, leaves the politicians too passive in his models. Instead they retune the model to take into consideration politicians answer to suboptimal solutions caused by bureaus. They state that politicians will institute controls to limit the power of the bureaus, which the authors state comes mainly from bureaus ability to control information flow to the politicians. Breton and Wintrobe suggest that this would lead to high need for controls to bureaus that offer non-standard services, in contrast to bureaus that offer easily comparable services with low variation. Their look to the literature on the topic indicates that their prediction might be correct.

Niskanen (1975) argues that unlike Breton and Wintrobe's study, the theory should specifically look at the review committees and their incentives, rather than the whole legislature. He restates his argument that these committees are dominated by high-demand representatives, but clarifies that these do not need to be higher absolute demand, just higher demand than the tax payments towards the service by their constituency. The committee's incentive to reduce inefficiency will remain the same as committee with randomized members. This incentive might be influenced by purchases of goods from the constituencies of the representatives of the committee, or other corruptive action. These deals that benefit the home constituency will also be

less likely to be monitored as efficiently, as the politicians have large influence over their staff and little to gain in inspecting these deals. (Niskanen, 1975)

Niskanen (1975) states that there are number of hypotheses for empirical research that can be derived from his Bureaucracy and Representative Government and the following literature:

- 1.) The Overspending Hypothesis. Government budgets are generally too large for the preference of median voter. Niskanen's analysis of presidential election results between 1896 – 1972 seem to confirm this. Large increases in spending and federal revenue are both significantly negatively correlated with popularity. Increase in taxation had larger effect than increase in spending, indicating that there is a "tax illusion" in the way the voters see the effects of government expenditure and taxes. Niskanen also points to other existing literature that seem to indicate that government services are provided in a way that is not consistent with "*models of responsive governments and efficient production*". Instead, monopoly power of the government seems to lead to increase in government spending. (Niskanen, 1975)
- 2.) The Production Inefficiency Hypothesis. Overspending may also be caused by inefficiency by producing given level at higher cost. Niskanen states that empirical research on the topic is (was) scarce, but the studies that do exist, seem to confirm the prediction. Bureaus seem to be less efficient than market competitors providing similar services and larger bureaus seem more inefficient than smaller ones. Efficiency seems to also be affected by competition for the production of a service. (Niskanen, 1975)
- 3.) The Oversupply Hypothesis. The bureaus tend to oversupply the good. Niskanen does not find empirical studies that have addressed this hypothesis. He does however point out that non-profit firms and bureaus seem to offer more output in some dimensions that is consistent with the hypothesis. However, this alone is not enough to prove or disprove the hypothesis and more empirical studies are needed. (Niskanen, 1975)

- 4.) The Overcapitalization Hypothesis. Bureaus will prefer overly capital-intensive production methods. This is due to bureaucrats' high time-preference. A bureaucrat will only care of the performance during his tenure, as only that is likely to affect his salary and prestige, leading to higher than optimal present rate of investment. Niskanen points out empirical studies that seem to support this hypothesis. (Niskanen, 1975)

- 5.) The Bureaucratic Structure Hypothesis. Consolidation of bureaus to larger organisation increases the monopoly power of the bureaucracy due to less competition (or points of reference for reviewers), additional levels of management, and smaller incentive for individuals to look into the bureau. An empirical test by Niskanen is consistent for the hypothesis in cases of Department of Defence and Department of Health, Education, and Welfare, but the coefficients are not significant for other bureaus studied. (Niskanen, 1975)

2.2.2 A Reassessment

In "A Reassessment" (Niskanen, 1994), Niskanen further addresses some of the developments in academic literature building on his contributions to public choice theory. He poses that review committees maximize the utility of its members subject to the approval of the legislature and voters. The truthfulness and implications of this assumption are however still unknown according to Niskanen, as the subject had not been studied at the time of writing A Reassessment. Niskanen states that this should be at the forefront of future research. (Niskanen, 1994)

Niskanen also points out that his original model does not address the path dependency of budget decisions, where former budgets set a base level or normalize higher spending. He does use this point in his critique of Reagan administration (Niskanen, 1988). Niskanen points out studies by Vincent Munley, Thomas Romer, and Howard Rosenthal (Romer et al., 1987; Romer & Rosenthal, 1979) which analyse the effect this has on overspending on public goods. These studies seem to point to smaller deviation from the preferences of median voter than that predicted by Niskanen's original model. These studies also point out, that increase in median preference, will

increase the approved budget by a larger amount. The same multiplying effect applies also for inflation. (Niskanen, 1994)

In the end of Reassessment (Niskanen, 1994), Niskanen expresses his satisfaction that the topic of bureaus and regulatory agencies have gained interest in academic literature in the fields of economics and political science, and that the fields seem to benefit from advances made by the other. Niskanen states plainly that his original idea of budget-maximization should be dropped in favour of discretionary budget. He suggests further research to be done in studying the political environment of the bureaus and how it affects them, as well as further research in specifics of bureaucratic model (how real-life competition or prospect of private employment after serving in a bureau affects bureaucrats etc.). (Niskanen, 1994)

2.2.3 Autocratic, Democratic, and Optimal Government: A Sketch

Autocratic, Democratic, and Optimal Government: A Sketch (2008a), first published in *Economic Inquiry* 1997 and later expanded into a book of the same name, studies performance of governments in states based on autocracy, democracy, and optimal government model. Although, inspired by writings of Schumpeter, Olson, and Fukuyama, Niskanen considers each of their contributions to be too affected by the conditions of the time of writing. Fukuyama showing optimism after collapse of the Soviet Union and end of Cold War, Schumpeter and Olson showing pessimism during rise of fascism and communism, and the US defeat in Vietnam and economic stagflation respectively. (Niskanen, 2008a)

Niskanen proposes that because a dictator can mostly focus on maximizing his own discretionary budget, instead of focusing on median voter approval like democratic leaders. A dictator has incentives that lead to fundamentally different type of government to democratic nations. Because a dictator can mostly ignore the median citizen, he can more easily build a revenue maximizing tax-model. From a democratic government-model, Niskanen notices that the ratio of median to average transfer payments is larger than median to average ratio of tax payments. This makes the median voter predisposed to support larger government, as he benefits from the transfer payments more than loses from additional taxes. More careful look into

different types of democracies reveals large differences in how the size and distribution of costs and benefits. In general, democratic system always provides preferable outcome to autocratic system (except for the tyrant). There is however trade-off between frequent elections and long-term fiscal horizon. (Niskanen, 2008a)

Niskanen admits that he assumes fixed costs (for defence, interest payments etc.) to be constant for each government type, leaving some uncertainty about the applicability of the model (Niskanen, 2008a). Factors that could impact the size of fixed costs could include incentive to revolt for subsections of the population. In democratic governments this would be relevant for the low-demand population, where as a dictator would have to worry about a larger segment of the population. Another factor that might be impactful is the ability of the population to move out of the reach of the government. This could increase the fixed costs by increasing the costs of securing the borders and keeping the population from leaving or facing the lower income from having fewer people to tax. As the low-demand group in democracies is made of mostly lowest income groups, the probability of migration may be affected in two ways. If the costs of moving are small (country is small in area, cheap transportation is available, visa restrictions are few) the probability of lower income groups to move may be higher than general population. However, if the costs are high (the country is large or secluded, transportation is expensive, or travel restrictions exist), migration may be more difficult for the low-demand group. On the other hand, this might lead to larger risk of rebellion.

For each of these reasons, one could assume that the fixed costs would be larger for the autocratic government in same conditions, compared to democratic government. Autocratic government model is less beneficial for the median citizen, leading to larger segments of the population to be incentivised to rebel or migrate. A democratic government model could also be forced to offer the low-demand group better deal by increasing the transfer payments or reducing taxes to a level, to a level where expected returns of migration or rebellion would be less than the costs of the status-quo system. Including these factors to the model might affect the fixed costs or redistribution of the government types. However, it is unlikely to change the order of preference for the types of government for any individual. For autocratic government, this would more likely lead to either increased costs (propaganda, border control, internal security

costs), or to lower net costs to parts of population that can be relied upon to keep the government functioning. Democratic government could be forced to a solution that is closer to optimum government model.

2.2.4 Bureaucracy: A Final Perspective

In *Bureaucracy: Final Perspective*, Niskanen studies the development of economic literature on bureaucracy. He notes the few early examples that studied these institutions, such as Ludwig von Mises's *Bureaucracy* (1944). Mises's most important idea according to Niskanen was the recognition that bureaus do not operate on per-unit basis like regular markets. Unfortunately, Mises turns his focus away from this issue to focus on government more generally and countering communist ideas for public management. Later contributions of early Public Choice Theorists like Tullock and Downs lead to more economic approach in the scientific study of bureaus. Tullock focusing on his own experiences in bureaus, Downs building on Mises's ideas. (Niskanen, 2008b)

Niskanen admits his early writings reflect some of the biases developed during his career as a defence analyst. The lack of focus on career prospects being one that can be seen in *Bureaucracy and Representative Government*. Niskanen again concludes that discretionary budget is superior maximand for a model of bureaucracies. He also admits that sponsors are not as passive as his early models conclude, but bargain with - and monitor the actions of - the bureau. Niskanen reviews literature on the power relations of different institutions in setting budget levels of the bureaus. The literature, according to Niskanen, seems conflicted on the issue. Niskanen himself holds that bureau and specialized committee hold most power and collude to set the budget level, with little executive and legislative bodies holding little power. Niskanen hopes future research to be done on the relations between committees and legislature in American political system. (Niskanen, 2008b)

Empirical evidence on the state of bureaucracy in the USA seems to indicate that the oversupply hypothesis of Niskanen does not hold. On the other hand, inefficiency seems to be supported by empirical studies, although competition among bureaus

reduces the effect. The size of the government seems to be larger than preferred by the median voter. (Niskanen, 2008b)

2.2.5 Government failure

Bringing Power to Knowledge: Choosing Policies to Use Decentralized Knowledge (Niskanen, 2001a) and On the Origin and Identification of Government Failures (Niskanen, 2002b) study the problems of public management. The first article focuses on the decentralised nature of knowledge and how it affects public action. Niskanen advocates for decentralized and localized government and warns against large sweeping social programs, which can have large unseen and unexpected results. The latter article covers the sources of government failure, which Niskanen categorizes to monopoly, externalities, information, and principal-agent problems. Niskanen shortly covers the empirical research on the topic of government failure. His general conclusions are that the US government is past the wealth-maximizing size and that a rise in tax level has negative effect to election results of the incumbent and to migration to the state. Niskanen still points out that even with the evidence of government failure, the alternative solutions may be worse. Niskanen finishes the article by advocating for unchangeable constitution to limit government power. (Niskanen, 2008d)

2.2.6 Niskanen on Elections and Voting Theory

In U.S. Elections Are Increasingly Biased Against Moderates (2004), Niskanen concludes that statistical analysis from the 2002 congressional elections indicates that the moderate candidates were more likely to lose their seat. He further sites on results of party unity scores, which show the American political parties have become more partisan on their voting behaviour in both houses of parliament. This seems to be counter to traditional Voting Theory models in Public Choice Theory, which state that both parties would fight for median voter and therefore advocate similar policies. If size of the party voter-base is large enough in the constituency, the politician is better off trying to attract the median voter of the party, leading to growing political divide like seen in Niskanen's study. This growing divide will make federal government harder to govern. Later research seems to indicate this divide has continued after

Niskanen's study (Hankins et al., 2017; *Political Polarization in the American Public*, 2014).

One of Public Choice Theory's major subfields is Voting Theory, which covers how voting systems affect the policies advocated. The Standard Theory of Voting Behaviour states voters make a decision on whether and for whom to vote, based on the stated positions of politicians and how much utility they provide the voter. Niskanen is unhappy with this model, as it lumps the voters together to a single joint decision on voting, and assumes the candidate considers the voters' decisions on whether to vote and who to vote for are invariant to the positions of the candidates. The theory also assumes that the positions of candidates and voters are known by the other party, allowing candidates to try to maximize votes by adopting positions close to median voter, and allowing the voter to choose the candidate (or no-candidate) that maximizes his utility. Often the model also assumes a single peak on the preferences of the voters and two candidates. (Niskanen, 2007a)

Niskanen argues that a new model should be used that allows the candidates to consider both of the voters' decisions. If to vote, and who to vote for. In the model the candidate pick positions where the amount of swing votes gained, equals the extreme votes lost. This, Niskanen argues, better reflects the polarizing results of early 2000's elections and political campaign strategy of Republican Party (motivate the base to vote, pay less attention to swing voters). Niskanen points out that the general population seem to have become only slightly more polarized, but the political base of the parties has moved further apart (Klinkner & Hapanowicz, 2005), a view counter to Hankins et al (2017) and Pew Research (*Political Polarization in the American Public*, 2014). Niskanen does however point out that if his model correctly maps on reality, the political system could still get more polarized like described by the newer research (Hankins et al., 2017; *Political Polarization in the American Public*, 2014). (Niskanen, 2007a)

2.3 Criticisms of Niskanen and Public Choice

2.3.1 Criticism in Academic Literature

Thompson (1973) pointed out in his review of *Bureaucracy and Representative Government*, that bureaucrat's utility, not budget, should be the maximand in the model. Thompson points out that at the equilibrium point, bureaus are efficient if the output is at a level for which the marginal value for the government is positive, and inefficient only if the marginal value is zero. Niskanen (1975) admits this does not fit the real-life behaviour of bureaus.

Thompson (1973) also argues that Niskanen's argument that the bureau is able to dominate the budget negotiations between bureau and patron are incorrect. The information asymmetry and relative elasticity of supply and demand curves only affect the price limits of bargaining relation. In bilateral monopoly relative costs and returns of commitments determine the solution price. Thompson states that group of trustees deal with multiple bureaus while bureaucrat faces single group of trustees. Further, a bureau head can simply be replaced if he does not provide a service at a given price if the price level is higher than supply price. Thompson states, trustee, using simple average cost at bureau-recommended level and assuming constant costs of production, could improve the utility of his constituents (Niskanen (1975) admits that this reduces the inefficiency, but does not necessarily remove it). Further, competition for higher positions in the bureau, incentives the bureaucrats to tell on each other.

Thompson (1973) continues picking apart chapter 14 of the book, which he believes presents a model inconsistent to the earlier one. In the Chapter, Niskanen presents a model with review committee. Thompson argues these models are never resolved and ponders, why would the legislature set up the review committee, if its results would always be biased and so unreliable. He also criticizes Niskanen's assumption that higher income leads to a utility of public services, which rises faster than the tax rate. Thompson points out other assumptions could be made, giving models that predict undersupply of public services. Despite this, Thompson agrees with Niskanen's main policy suggestions, that the competition between bureaus produce better results. Thompson, however, does not believe it to produce Pareto optimal results, and says

that Niskanen's argument for it is a misreading of price theory. Thompson also reminds the reader, any changes that increase competition must be made with the relative loss of economy of scale in mind.

Thompson (1973) provides a well-thought-out critique of Niskanen's book. However, I argue, at times, his criticism overlooks parts of Niskanen's writing. For example, he argues that according to Niskanen the social surplus (average delivery times) of the US postal services should be zero to the median voter. However, Niskanen specifically states that this is only the case for the total basket of public goods. Thompson could argue that a politician could easily gain favour of median voter, by forcing this to be the case, by threatening to fire the bureau head or lifting a bureaucrat willing to give this solution to replace him. However, a single politician does not have an incentive to care for the median voter. He is only interested in the voters of his voting district. Further, the political parties are made up of politicians like these, and as seen in Reaganomics (Niskanen, 1988), the political compromises needed to keep up a broad coalition that the two-party system demands, makes general attempts to cut these inefficiencies difficult. Further, even if the bureau's budget is cut to an efficient level, the bureau can try to overstate the difficulties the budget cut caused to rile up support for more funds. The political blowback for news stories of hospitals closing down, for example, could make efforts to make the hospital network more efficient politically difficult. For these reasons I find Thompson's assertion that "*trustees – not the bureaucrats – decide on the final budget of the bureaus*" to be a bit simplistic. Technically he is correct. However, his reasons for dismissing Niskanen as hardly as he did, is not completely founded.

I also find Thompson's (1973) argument that the Chapter 14 review committee does not fit his original model strange. My reading of the book was, that an addition of a review committee fleshes out the range in which the final budget of the bureau is set (with power of asymmetric information and relative elasticity). I did not get the feeling that Niskanen argued these would set the price level, only that these affect the range of solutions that are possible in the model (this is what I understood Thompson also argued). Perhaps other research on information asymmetry affected how I read Niskanen's argument. Niskanen's densely packed writing style also made reading slow at times. However, his argument for utility-maximizing bureaucrat is close to critique

of Niskanen's budget-maximizing model I had. The bureaucrats might have other ambitions independent (more or less) of budget, that push the behaviour to different solutions.

Migué and Bélanger (1974) suggest that instead of budget, difference between the budget and minimum sum of money to produce the given level of output should be used as the maximand. In other words, that part of the budget, which is available to the use of the manager/bureaucrat. They name this "*discretionary budget*". Migué and Bélanger argue Niskanen's theory of budget-maximizing bureau equates budget-maximization with output-maximization within the bureau's budget constraint. If this is correct, the authors argue, "*no expenses other than those contributing to productivity are incurred since these would compete with output*". The article goes on to reform Niskanen's mathematical models according to the discretionary budget maximization. To the bureaucrat, new functions give a parabola profit function from which he will choose a point at which the marginal rate of substitution between increasing output and other expenses (salary, office etc.), will be the same. Depending on the bureaucrat's preferences the bureau can be output-maximizing or discretionary-budget-maximizing, or anything in between. In general, if the bureau is not output-maximizing the equilibrium output is lower than in Niskanen's models. This can even provide a Pareto-efficient outcome, in which the bureaucrats consume all the surplus from a market that is at the same output level with perfect competition. (Migué & Bélanger, 1974)

Lynn (1991) critiques Niskanen from insufficiently taking into account the real-life networks that exist in bureaucracies, where bureaucrats base their behaviour on how they expect others to react to their behaviour. A more interaction-focused models expanding on Niskanen's case have indeed shown outcomes without gross inefficiency or over-supply (Bendor & Moe, 1985). Further, Lynn argues, the model leaves out the variety of bureaucrats and how they are appointed. This overlooks the differences in incentives of politically appointed executive bureaucrats and civil servants. Ambiguity of costs and benefits also plagues the analysis of bureaus. Existence of cheap public goods changes consumer behaviour or may carry externalities that affect either the costs or benefits. An example of this could be cheap medical treatment leading to higher output through fewer sick days or higher employment. Lynn concludes his

article by pointing, that even though Niskanen's model is seminal to the theory of bureaucratic supply, the variability in conditions in real-life bureaus means predicting behaviour with the model is difficult. When do bureaucrats maximize discretionary resources, when budgets? The conditions affecting these decisions are hard to quantify a priori.

Campbell and Naulls (1991) expand on the variability of bureaucrats and their motives for action. The study focuses on interviews of bureaucrats in Anglo-American countries and inspection of the systematic environment of bureaus these countries. Campbell and Naulls find differences in the importance of budget-maximization between administrations that is not only dependent on the bureaucrats' preferences, but also the incentives set by the administration. They warn that Niskanen's model has limitations that make it hard to apply to other nations. The warning is also expressed by Peters (1991), who studies the applicability of Niskanen's theory to European context (including Finland). Most importantly, Campbell and Naulls find evidence that questions Niskanen's argument that bureaucrats are motivated by personal utility, instead they point out that their interviews suggest maximisers tend to be "expansive" about what government can do and are devoted to their professional niche. Instead, bureaucrats motivated by personal utility tend to be budget-minimisers, and look for solutions from efficiency increasing areas (clarification of mandate, organizational changes etc.).

I would like to push back on the last point. Clarification of mandate, organizational changes, and other reforms mentioned, are not necessarily budget-minimizing. Clarification of mandate may lead to expansion of mandate, as more and more borderline cases are normalized to be within the scope of the bureau. Organizational change may increase the discretionary budget of the advocating bureaucrat or otherwise ease his job. As Niskanen points out in his political analysis many times, there is a certain amount of gridlock that is necessary in a democratic government. This is not limited to political decision-making but is also important for the bureaus. On one hand, too specific mandate may prevent the organization from reacting or preventing crisis, on the other, too vague guidelines may lead to government overreach. This does not, however, mean Campbell and Naulls are wrong. The budget-

maximizing bureaucrat is also questioned in other studies, such as Dunsire (1991), although differing opinions also exist in scientific literature (Blais et al., 1991).

Although Niskanen's budget-maximizing bureaucrat might be too cynical view of people's motivations, public professions could also attract people who generally approve of larger government, like Blais et al. (1991) seems to be suggesting. Political leanings concerning area of expertise might also warp the behaviour of bureaucrats subconsciously, even when they might regard themselves to be motivated by other factors. This might even be beneficial for the bureaucrat. Positive effect between research findings favourable to central bank policies and career performance has been found among central bankers (Fabo et al., 2021). Similar effect might also hold for other bureaucracies, although more research would be needed to prove this. The political slant is there (Blais et al., 1991; Blake, 1991), but whether it leads to Niskanenesque solutions is not yet shown. Haaparanta and Puhakka (1992) also point out that the size of the bureaucracy can be weaponized, if governments are prevented from reducing the size of the bureaucracy (e.g., by labour laws). Bureaucrats focused on issues important for the current government can be hired to tie the hand of future governments if the ruling party (or parties) fear being ousted in the next election.

Kiewiet (1991) reviews empirical studies on Niskanian bureaucracy. He argues that many of the empirical results critical of the model are somewhat flawed, either for studying Niskanenesque models, not Niskanen's models, or focusing on flawed metrics that are not unequivocal to the variables they are meant to study. Kiewiet points out studies which use variables that, he states, better match these variables, and finds that they provide conclusions that are (in general) more in line with Niskanen's theory. There are however specific sectors, such as government funded science, that may not reflect Niskanen's theory. In the case of science, there does not seem to be evidence of oversupply, but rather undersupply. This may be due to the fact that government funded science studies topics that has positive externalities that private firms cannot reap, leading to market undersupply.

Popularisation of application of economic analysis in areas typically considered subject of other fields of science, has led to scientists from other social sciences blaming economists of scientific "imperialism" (DiLorenzo & Block, 2016b; Khalil,

1995; Suvanto, 2016; Taimio, 2018). This describes the perceived attitudes of economists towards other fields, the lack of citations from – or co-operation with – scientists from other fields, as well as number of other issues seen in the phenomenon. Other criticism of public choice theorists was, that while pointing failures of government, they forget to inspect their own biases. Many of the early public choice theorists did, or at least were perceived to, lean towards liberal right-wing political views. This does not change the quality or truthfulness of their argument. Some legal scholars have also accused that cynical views of public choice theorists deteriorate the public spirit, creating a self-fulfilling prophecies (Torgler, 2022). Quite interestingly, the Public Choice Theory is also critiqued for imperialism over political science among other things, by economists of the Austrian School (DiLorenzo & Block, 2016a), another school of economics often considered to be in support of smaller government. (Butler, 2012)

Finally, Niskanen, in his 2008 article *My Resent Contributions to Public Choice*, lambasts younger generations of public choice theorists. Niskanen states they focus on “technique” of mathematically presented models inaccessible for most outsiders, while paying little attention to major changes in political reality. This, Niskanen states, is stagnating the development of Public Choice Theory. (Niskanen, 2008e)

2.3.2 Author’s Criticisms

In the book, Niskanen argues *“The most important difference between levels of government and private collective organizations is not... individual's influence on the activities...or the degree of coercion... but the cost of transferring membership”*. However, in practice, one cannot conclude that. There is a difference in the degree of coercion. The lack of total “exit” from the market for governments that exists for other kind of organizations. Even if highly theoretical, the lack of possibility to choose to stay out of the market for government, becomes fundamental when we study the example of low-, middle-, and high-demand groups in Niskanen’s example. If the low-demand group had a cost-free way to secede from or re-enter into a government, the political model would be forced into a solution that would not produce net-negative solutions to large parts of the population, as the benefits gained by high-demand or middle-demand groups would vanish as the net-payers of the system would exit.

Niskanen himself talks about the possibility of revolts or political upheavals in the system, but his book does not go deep into how the possibility would influence the outcomes of his model. Only, that any revolution would create new system, with new low-, middle-, and high-demand groups, that would maximize their benefits in the new political system.

Another aspect of bureaus that Niskanen does not cover in depth, is the bureaucrat as a political actor. He hints at the theoretical possibility of bureaus trying to resist and outlast politicians (Niskanen, 1971), and even gives hints of real-life resistance to policies in his other work (Niskanen, 1988), but does not go further in his theory to the possibility that bureaus might try to topple a politician. There is no reason why Niskanen's model would not lead to a bureau acting in a way that would benefit their preferred political candidate. Bureaus can affect public conversation and perception by publishing data at a convenient time or present it in a way that guides public opinion on an issue. With these tools, a bureau might be able to change the way people perceive the success of politicians. This is perhaps better addressed by Migué and Bélanger's (1974) discretionary-budget-maximizing model, which would allow maximization the personal benefit for the bureaucrat. But neither, in my view, fully address this point. It is however, somewhat covered by Campbell and Naulls (1991) in their review of political science literature.

3 NISKANEN AS A POLITICAL AGENT

Niskanen served a long career as a political agent in both public institutions and public policy research institutes. Serving both Republican and Democrat administrations, as well as chairing the influential libertarian think-tank, Cato Institute, from 1985 to 2008. Niskanen also worked as a defence policy analyst for the research institute, Rand Corporation, working to optimize operations of the United States military. (Dudley, 2012; Niskanen, 1988; Rees Shapiro, 2011)

3.1 The Reagan Administration

Niskanen was interested in Ronald Reagan's politics from early on. They first met in 1972 in a meeting described by Niskanen as "*the birth of the modern tax limitation movement*". Now a political supporter of Reagan, Niskanen first served Reagan during his term as the Governor of California in 1974, as well as his campaign in 1976 pre-election for Republican presidential nominee. Later Niskanen would choose to stay out of the successful 1980 campaign but did prepare papers for the post-election transition teams. Niskanen describes his role as a "*minor actor*" in the administration. (Niskanen, 1988)

Niskanen's 1988 book on the Reagan administration, titled "Reaganomics", provides detailed information on the policies and inner workings of Reagan's administration. The book mainly focuses on large picture of the administration and politics of the time. The personal relationships between Niskanen and the other members of the administration is also mentioned at times. Niskanen admits his unflattering remarks about proposals from some of the more influential members of the administration, may have caused him losing his bid to be the chair of the Council of Economic Advisers, which he was the acting chair of in the later days of his career in the administration. Niskanen seems to also have been somewhat unsuccessful in arguing for the stances he held, mostly due to political convenience of the opposing views. (Niskanen, 1988)

Perhaps the most valuable part of the book comes from Niskanen's thoughts on why the administration failed or succeeded in its goals. The following chapters will study Niskanen's reflections in Reaganomics, as well as literature on the topics.

3.1.1 Economic Theory and literature during the Reagan Administration

Niskanen mentions three economic viewpoints that affected the politics during Reagan's presidency. The Keynesians, supply-siders, and monetarists, of which Keynesians had dominated the field after the Second World War. In the 60's the birth of Monetarism and Rational Expectations Theory – as well as Public Choice Theory – started reshaping the macroeconomic thought. Finally, the introduction of microeconomics-focused economists to public institutions lead to growing influence of supply-side economics. Niskanen defines it as “*application of microeconomic theory to the effects of fiscal policy on the incentives to work, save, and invest and on the allocation of resources in the economy*”. This viewpoint, along with the monetarism, was also popular in Reagan administration. Because of the different schools of thought among the advisors, the administration struggled to balance the differing opinions. This problem was compounded with Reagan's style of leadership, which Niskanen describes as too nice for the post. (Niskanen, 1988)

Niskanen states that the idea that reducing the tax rate would lead to increase in tax income (in United States, during Reagan's presidency), comes from a layman misreading of supply-side economists, particularly Arthur Laffer. Niskanen points a finger specifically towards Jude Wanniski and the Wall Street Journal. Wanniski does seem to hold a view that tax cuts in 1970's tax levels would increase the tax revenue (Wanniski, 1978). Early on in Reaganomics, Niskanen stresses that: 1. The supply-side view is not a self-standing macroeconomic theory that competes with monetarism, instead the theories complement each other, 2. That the misreading of Laffer curve is not supported by the professional opinion of any economists, and 3. That this point was not made in any of the Reagan administration's budget projections. (Niskanen, 1988)

The academic literature seems indeed to have been far more careful in expressing the possibilities for a self-funding tax cut, but there was a study showing that they could be achieved in Sweden, but not in United States (Feige & McGee, 1983; McGee & Feige, 1982; Mirowski, 1982). Some economists also disagree with the political premises that form the foundation of “Reagan revolution”. Klein (1983) argues that 1. The US economy was not in such a chronical deceleration as described by Reagan and

his supporters 2. The US administration was not as bloated when compared internationally but was actually one of the smallest in developed nations. 3. The US tax rates are not high as Reagan claimed, but one of the lowest in developed nations. 4. That public spending is not as unproductive as Reagan implies. 5. That “returning government to the people” wrongly implies that it ever left the hands of the electorate. However, this study seems to somewhat miss the goals of the government, from the political rhetoric. Interestingly Klein, despite different approach, seems to agree on some points with Niskanen and Public Choice Theorists. The budgetary imbalance tells of voters’ unwillingness to pay for the level of public goods demanded. The increases in defence spending will make balanced budget even harder to achieve. The problem of competitiveness The United States has, is due to Schumpeterian “trustified capitalism”. Klein even points out how this fits The US car industry, stating the exact same point that led to Niskanen’s dismissal from Ford Motors. The paper is an interesting critique, but the failure to separate the ideas behind the policy from the political compromises and posturing used to advance them, leads Klein to agree more with some of the administration more than he knows or likes to admit.

The concept of Laffer Curve seems to have been making waves also in Public Choice literature. Public Choice theorists seem to have focused on how the existence of revenue maximizing tax rate, the shape of the curve, and the difficulty of finding the curve affect political and government action, or government budget outcome, or vice versa (Buchanan & Lee, 1982; Forte, 1987; Waud, 1985).

Of the studies, Forte (1987) seems most interesting for studying the effect Niskanen had for the field of economics. In the study, Forte models managerial tax bureaucracy (a profit-maximiser), a Weberian bureaucracy (one interested in rule of law and correct application of rules), and a Niskanen-Peacock Bureaucracy (budget-maximizing bureau), and how these models behave when facing the Laffer curve. Forte argues, that according to a “Niskanian paradigm”, the Niskanian bureaucrat (NB) will maximize budget by engaging in cost-maximizing behaviour. NB will also prefer large measures to counter tax evasion, as it provides good justification for budget increases from the sponsor, as well as complex and broad tax system that maximizes collection costs. However, if the tax rate is set at the peak of the Laffer curve, NB will become more permissive towards tax evasion. The existence of - some - tax evasion pushes the peak

of the Laffer curve to the upwards and to the right, allowing larger tax revenue. Something that Forte leaves does not mention, is that if the scale of the tax avoidance can be modelled, allowing high tax rate with some tax avoidance becomes even more enticing, as a study showing growing tax avoidance in the face of larger tax rate may be an efficient tool for NB to argue for budget increase. (Forte, 1987)

3.1.2 Regulation

Although deregulation seems to be a major focus of many of the critics of Reagan, Niskanen considers Reagan's inability for larger reforms a failure and a missed political opportunity. Some of the limited reforms Niskanen considered successes was to abolish the Council on Wage and Price Stability, which system of voluntary (Niskanen uses quotation marks around the word "voluntary") wage and price guidelines. On many of the regulatory issues, Reagan faced interest groups (such as farmers) he relied on, increasing the political price of regulatory reforms. Liberatory reforms of financial institutions seems to be one of Reagan's achievements in Niskanen's eyes. One of the problems in this industry, Niskanen argues, was the limits on size and geographic expansion of banks made them vulnerable to local economic shocks.(Niskanen, 1988)

Niskanen worked on environmental policy proposals in 1981. One of these proposals included congestion-toll for several pollutants and a market system to trade the permits to emit these pollutants. This system would have partly replaced older laws, which mandated compulsory reduction of sulphur emissions. Another proposal created two systems for reducing car emissions, from which each state could choose the one better suited for reducing car traffic to meet their environmental goals. Niskanen complains a lack of leadership from the White House and over-dependence on Environmental Protection Agency (EPA) resulted in underwhelming performance of the new EPA administrator Anne Gorsuch, which lead to a halt of Niskanen's proposals. A year late EPA adopted a congestion-toll based on total amount of all pollution from the polluter, as well as a permit banking system, where the permits could be hold on to and spend on future time periods. Niskanen criticizes these reforms, as they were not connected to any legal change, but were purely regulatory changes of the EPA, leading to lower possibility of success for larger legal reforms on the issue. (Niskanen, 1988)

In 1985 EPA started working on a bill to address water pollution scandal. Niskanen criticizes this bill for putting lion' share the costs of the program to the federal government when the benefits of the program are mostly regional. This law however, was rushed through without scrutiny. Congress even doubled the budget of the program. Niskanen claims he tried to intervene but was too late on the issue. Niskanen points out that this bill was a classic case of bureau maximizing its budget. (Niskanen, 1988)

Niskanen also worked on cutting down Japanese auto-industry import restrictions (right after getting fired from Ford Motors for that exact stance) and import restrictions on foreign steel. Both times Niskanen was steamrolled by political interests. Reagan had relied on the support of the workers in car manufacturing and after being appointed to argue the case against steel restrictions, Niskanen heard from his colleges, the case was already settled and using his political power to overturn it would be disadvantageous and futile. Later attempts to argue against subsidizing exports and restricting imports as a way to address the foreign trade imbalances also proved unsuccessful. Niskanen believed that his professional opinion was disregarded because the trade imbalance gave a believable rationale for politically convenient protectionist measures. (Niskanen, 1988)

3.1.3 Monetary Policy

According to Niskanen, the Reagan administration was the first in the United States to recognize the role of monetary policy as the most important tool to affect total demand. Reagan's plan to battle inflation was based on steady, slow reduction in the growth of the money-supply to avoid the negative consequences such policy might cause in the economy. The most important actor in this stage of monetary policy, according to Niskanen, was Paul Volcker (Niskanen & Moore, 1996), the head of the Federal Reserve, appointed by Carter, but who already before Reagan's presidency, had worked to cut down the high inflation. Niskanen goes as far as to say Reagan's inability to address the public deficit worked against Volcker's efforts but does give credit for Reagan as an advocate of lowering inflation in other ways. In Reaganomics, Niskanen describes the relationship between Reagan administration and FED as complex. There

was at times difficult, leading to lack of communication and co-operation. (Niskanen, 1988; Niskanen & Moore, 1996)

Niskanen does criticize the Federal Reserve. He accuses that for most of history the FED has acted mostly pro-cyclical and inflationary monetary policy. leading to suboptimal results. Niskanen blames some of these failures on Keynesian models of the FED, which used real prices and could not address problems of inflation, and limiting the models of the effects of monetary policy on its effects on interest rates. The restrictions of these models led to creation of monetarism in the mid 1950's, which stated that change in money supply directly changes demand. This theory grew in popularity in the 1970's. At the beginning empirical studies seemed to reflect the theory well, with general price levels following M1 money supply with approximately 6-month lag. Later money velocity, as well as rational expectations theory, was introduced to develop the models further. Rational expectations theory states, only unexpected changes in monetary policy will lead to general rises in price levels. While any expected change, will not have any effect on real prices. The FED started applying these rules in its monetary policy by trying to achieve stable and publicly announced goals for the growth of the money supply. However, Niskanen argues government has an inflationary bias, as unexpected growth in money supply leads to reduction in the real costs of public debt. In late 1970's the market lost interest on official money growth targets, as excess public spending had led to higher than announced money growth and corroded trust on the official targets. (Niskanen, 1988)

Reagan's initial economic plan included a plan to use announced, slow, and incremental reduction of money growth to reduce the inflation without creating an economic downturn. This plan was inconsistent with the economic assumptions that the administration's budget projections were based on. Reagan's expansionary fiscal policy caused by the administration's inability to cut down spending also fought against these goals, showing the inflationary bias Niskanen points out. In the end the "monetarist experiment" was ended, as the economic conditions started to demand for a more loose monetary policy. Many political factors worked against the experiment and Niskanen points out the monetarists had some successes, but the theory failed to explain changes in money velocity. Volcker, according to Niskanen, also tried to achieve a reduction of money growth that was faster than initially planned. Niskanen

theorizes this stemmed from Volcker's belief that the political support for restriction of money supply and inflation was fading, and he wanted to act quick, while the political sentiment was still favourable. According to Niskanen, the failure of the monetarist monetary policy led to a lack of any solitary basis or guiding principle for monetary policy. (Niskanen, 1988)

After the monetarist experiment fizzled out in 1982, "Bakerism" (named after Jim Baker, a new Treasury secretary from 1985 to 1988) started gaining ground. This was not an economic theory like monetarism, but more a political line taken by Jim Baker in office. Niskanen describes the principles of his policy as "*Texan's aversion to high interest rates and politician's indifference to longer-range policy effects*". Baker tried to tackle the foreign exchange balance with international co-operation on exchange-rates. Niskanen seemed to have been unconvinced about these plans. (Niskanen, 1988)

Niskanen ends his chapter on monetary policy by turning to the reasons for the downturn in money velocity in early 1980s. The consensus at the time expected continued higher money velocity. Increase in plastic money, higher interest rates leading to faster circulation due to rising opportunity costs for investing, Keynesian understanding that public deficit would boost demand, as well as general post-war trend all seemed to indicate the fact. However, the velocity decreased, and continued to decrease after the recovery. The continued decrease, Niskanen argues, shows Keynesian effect of the deficit was not the primary factor that ended the recession. Niskanen argues that the turn in money velocity, was due to reduction in interest rates due to deregulation of the interest rates and financial system, which led to decreased willingness to invest. (Niskanen, 1988)

Finally, Niskanen suggests improvement on the implication of monetary policy. Niskanen argues that the goal of monetary policy should be a target level of monetary base (currency and bank reserves), with variations in demand measured by domestic final sales (DFS, GNP without the change in net change in inventories or exports and imports). The preferred monetary policy path of DFS would be recommended by the administration, approved by the Congress, and executed by the FED, which would be accountable for the Congress for any divergence from the goals. Niskanen argues the most important factor should be the DFS and the Congress should refrain from

pressuring the FED to reach any target unemployment, inflation, or real growth. Niskanen warns that even this would not rid the system of politicians' bias towards inflation, but he states that even now, "*the FED is independent the same way Finland is independent, by accommodating to the strongest external pressures.*" An alternative would be to tie the dollar to a commodity, but the history of gold standard shows the problems of deflation, and frequent recessions. Niskanen concludes that the most important lesson of Reagan and Volcker era is that for fiat-currencies, successful monetary policy relies on support from the administration. Niskanen does complement them from successful policies, but reminds that even better would have been to achieve longer lasting institutional framework less vulnerable to political pressure. (Niskanen, 1988)

3.1.4 Fiscal Policy

According to Niskanen, the initial goal of the fiscal policy of Reagan's administration was not to balance the budget or to use public deficit as a tool to drive aggregate demand. Change in public deficit was considered an outcome of actions taken, but not a tool or a goal to be used or achieved. Niskanen says deficit was initially only briefly mentioned in conversations in the administration. According to estimates used by the administration, the policies planned by the administration were forecasted to achieve a balanced budget by fiscal year 1984. (Niskanen, 1988)

Unfortunately, Niskanen argues, the forecasts used by the administration were not realistic from the beginning but reflected partly the hopes for the desired outcome of the policies advocated. The forecast for real GNP did not consider the monetary goal of reducing money supply steadily to lower inflation. (Niskanen, 1988)

The attention given to supply-side economics lead to bipartisan support of application of the theory as the public policy. The Democrat-lead Joint Economic Committee hoped for spending restraint and reduction of tax rates in its annual reports of 1979 and 1980, a stance later advocated by President Reagan. (Niskanen, 1988)

Niskanen points out that candidate Reagan was shy in showing concrete examples, where the budget cuts could be implemented. This made it hard for the administration

to find suitable programs to cut when Reagan got into office, a problem made worse by the fact that, according to Niskanen, the economic program of the administration was based on finding a consensus on what were legitimate role of the government, and where had it overstepped that line. Niskanen points out he stressed this to the transition team and spoke about it in lectures and news columns (Niskanen & Harrington, 1981). One of the few parts of Reaganomics where Niskanen goes into his role in the administration. The author also gives an example of why consensus was hard to find (which also shows how politicians reacting to high-demand voters) by recalling a time when his proposal to close radar stations the air force found redundant. This led to Niskanen being called to a congressional hearing. Another time Niskanen tried to organize a interagency group to address federal power marketing administration pricing policies. This led to group of congressmen accusing Niskanen was taking “*bread from the tables of widows*”, as well as some Republican senators introducing an amendment to prohibit the use of any further federal funds to study the issue. (Niskanen, 1988)

The possibility of finding the budget cuts necessary for the administration was that the President made most of the transfer payments and social services “*core social safety net programs*” that were exempt from any reductions. The decree protected 35% of total federal outlays. Here Niskanen also lays out his and Treasury economist Steve Entin’s proposal for the basic old age, survivors, and disability insurance (OASDI). Niskanen and Entin argued the best way to reform the program, which was running out of funds, was to restrict short-term cuts to more well-off beneficiaries, while addressing the rising long-term costs by indexing the retirement payments to prices rather than wages as well as slowly increasing the retirement age for receiving full benefits. In the end this proposal was abandoned for more general cut to the program, which lost in the Senate with 92 voting for resolution critical of the proposal. (Niskanen, 1988)

In chapter 3 introduction, Niskanen describes the tax reform early on in Reagan’s administration “*the major achievement*” of the initial economic program. The initial program reduced income taxes across all income groups and increased depreciation allowances to encourage investment. According to Niskanen, later attempts to continue renewing the tax code between 1982 and 1984 were muddled with political

controversy, leading to compromises and proposals that tried to achieve good will in voters. Niskanen describes the net effects of these reforms in chapter 3: “*The net effect of the... tax measures from 1981 through 1984 was to improve the structure of the federal tax system while maintaining the federal tax receipts share of the GDP at about the average of the Carter administration—a substantial achievement... The primary effect of these changes was to reduce the marginal tax rates on both labor earnings and income from business investment.*” The reforms after 1984 were also difficult for Reagan’s administration, and Niskanen admits, some of the early changes that were viewed as achievements for the administration were rolled back by later reforms out of political expediency. Leading to proportional tax increases to parts of the population (Kozma, 2013; Niskanen, 1988). (Niskanen, 1988)

Later economists have had some disagreements about the effects of Reagan’s economic policies (Kozma, 2013). Many economists argued that the tax policies and supply-side economics are to blame for the fast expansion of public deficit, as well as the early 1980s recession (Krugman, 2004; Miner, 1989). Krugman questions the economic achievements of Reagan, tributing the successes of Reagan to Keynesian effects rather than any of the results of Reagan policies acted. Miner questions whether Reagan’s administration truly believed that the Congress would not be able to achieve the budget cuts, or whether the deficit was an unstated and accepted result from the beginning. This question also comes to mind while reading Niskanen in *Bureaucracy and Representative Government* and *Reaganomics*. The former is far more bleak about the prospects of reducing government spending than the latter. If Niskanen thought that budget cuts are antithetical to the modus operandi of a bureaucracy, just ten years before Reagan took power, how did he expect to see such a cultural shift within few years, without major preceding crisis forcing the change? Niskanen does at times claim that the government saw pushback or even puppeteering of politicians that seems similar to that seen in Niskanian bureaucratic theory, but he does not at any point predict these problems to appear. Even if his theory states it will. In *Reaganomics* Niskanen states that Milton Friedman argued for tax cuts as a method of pressuring the downsizing of the government. Niskanen, however, writes that he himself believed James Buchanan and Herb Stein’s argument that tax increase would lead to downsizing, by increasing the perceived costs for public services. Niskanen points out

that the academic literature at the time of writing seems inconclusive which, if either, of the views is correct. (Niskanen, 1988)

Niskanen alongside another former contributor to the Reagan administration Moore, defended the tax reform from its' critics, stating: 1.) Claims that the lowest earning population made less in real dollars, than at the start of the Reagan presidency, try to lay blame on Reagan for the continued negative effects from the Carter administration during the start of his presidency. Niskanen and Moore state, if one cuts the year 1981 (Reagan's first year in office), and only studies 1982-1989 when his reforms started to take effect, the family income rose by 11 percent. 2.) Claims of lower economic success compared to his predecessor and successor is not true, shown by several economic figures, such as economic growth, economic growth per working-aged adult, median household income, and employment. 3.) The Reagan tax cuts did not cause the public deficit, defence build-up, the depression early on in Reagan's administration, and unexpected rapid decline in inflation were more major causes. Although later analysis of the issue seems to question this 4.) The economic recovery during Reagan's administration was not due to Keynesian effects of deficit, as shown by the decreasing inflation (if the recovery was driven by Keynesian effects on demand, why would the inflation decline?), in fact, the authors state, the nominal demand went down during Reagan's administration. (Niskanen & Moore, 1996)

3.1.5 Financial Crises

During early 1980s, American banks suffered a financial crisis due to several factors colliding together. Banks were highly regulated, and their business was limited to their home state -or smaller region- as well as in the case of Farm Credit Institutions, to a specific industry. Great example of these limitations was Continental Illinois, an investment bank with 41-billion-dollar portfolio, which operated from a single building in Chicago. Controls on interest rates also had for a long time skewed the market towards riskier products. This was particularly worrisome for savings banks which had issued large amounts of fixed-rate loans. These restrictions were put in place, to limit the threat of banking crisis. Unfortunately, these restrictions made banks vulnerable to local shocks. The fast decrease in inflation and the external value of the dollar also created a shock to industries with high levels of debt or dependence on

foreign markets. Many claim the deregulation of the financial market was the reason for this crisis, but Niskanen argues the regulations on interest rates caused money to flow to riskier investments. Mandatory insurance programs gave banks an incentive to offer more riskier assets, as if the investments failed, the last men to pay the bill would be taxpayers or other banks. (Niskanen, 1988)

The financial crisis led to losses, changes in management, mergers, and bailouts of several banks (including Continental Illinois). Niskanen admits that in general the administration and the Fed worked well in solving the crisis, although some mistakes were made by over-willingness to try to correct market failure. Niskanen comments on the bail out of Continental Illinois by stating five lessons that can be learned from the crisis and the resulting bail out. 1.) The Federal Deposit Insurance Corporation has the correct tools (subordinated loans) to fight similar crisis but lacks the funding to wield them in large enough scale during financial crisis. Fed has the funds to do this, but requires collateral for the loan, which may cause a secondary crisis for the bank. 2.) Greater separation between banks and their holding companies must be made in the case of financial aid, so that the holding company does not reap the benefits of financial aid to the bank. 3.) The bail out of Continental Illinois set a bad example that banks would not be allowed to fail. 4.) The deposit insurance system has bloated out of proportion of the original goal, preventing bank runs. 5.) The underlying conditions that led to the crisis were not corrected and the existing deposit insurance system was not compatible with the deregulation of the financial industry. (Niskanen, 1988)

Niskanen was appointed chairman of the interagency pension review group. This group was responsible of reviewing the Pension Benefit Guarantee Corporation (PBGC), a government agency, which operated mandatory insurances for private pension plans. The system suffered structural flaws and underfunding from flat rate insurance payments. These problems made it profitable for some companies to quit their pension program at the expense of the PBGC. Unfortunately, the lack of acute pension crisis limited the political will to pass a bill raising the payments and tightening the provisions for termination of the plan. Niskanen ends his chapter on praising the administration in crisis management, but warns that without correcting the underlying issues, the potential for crisis does not go away. (Niskanen, 1988)

Niskanen (1988) explains that fears of inflationary effects of higher growth and lower unemployment (a view sometimes expressed by Volcker and Martin Feldstein, chair of the CEA 1982 - 1984) should also be dismissed during the recovery. Niskanen claims there is a weak short-term relation between unemployment and interest rate, but on long-term, the relation is not stable. Further, for a given total demand, increase in output is deflationary. He complains he was unable to convince Volcker or Feldstein of this view. Niskanen and Feldstein seem to have had more disagreements whether the effects of monetary policy (Feldstein's view) or high return on investment (Niskanen's view) dominated in recovery from the early 1980s depression. Niskanen describes the longest conversation between the two during Feldstein's tenure lasted only ten minutes. After Feldstein left, the 1985 Economic Report seems to have supported Niskanen's view on the recovery. (Niskanen, 1988)

Policy changes were later made to try to address some of the perverse incentives by the government bailouts and regulations (Boyd & Gertler, 1994). Boyd and Gertler also found that the smallest, and largest banks performed particularly poorly. The first due to lack of economies of scale, the latter due to trust in too-big-to-fail status. Unlike Niskanen Boyd and Gertler do not believe interstate banking restrictions were a primary cause to the crisis. While it may have led to failure of many (particularly small) banks, the authors claim only smallest banks were restricted (due to lack of economy of scale) in diversifying their portfolios geographically. Middle-sized to large banks could open loan production offices in other states, the largest ones could even lend outside the country. Further research shows the changes done after the 1980s banking crisis were not enough to eliminate the moral hazard of too-big-to-fail banks (Nurisso & Prescott, 2020; Wilson & Zhao, 2022). Even after the 2008 crisis, there seems to be doubts whether the question has been resolved (Thosar & Schwandt, 2019). However, Le Meehagn, and Minford (2018) show that while good monetary policy can create stability, central banks have an incentive to over-regulate to the point where regulation leads to distortion of the market leading to destabilization.

Carré and Gauvin (2018) study the capture of central bank institution by the financial sector. They present literature from multiple points of view, including Public Choice, that present a theory of central bank capture by financial institutions. They end up separating the literature broadly to two viewpoints. "Financial School" and

“Democratic School”. The former view the phenomenon of central bank capture, as a process where the financial sector captures the institution to hike up interest rates and prevent inflation. The authors’ hypothesis states that the incentive to increase the capture would thus grow during financial crisis, as the monetary policy is more likely to be inflationary. The Democratic School views the process as a power-struggle between interest groups, and changes in economic conditions change the relative interest of these groups towards central banks. The capture of the central bank by the financial sector happens not only to limit inflation, but to reduce regulations on the industry. Carré and Gauvin place Public Choice Theory in the former group. I disagree with this assessment of Public Theory perspective. A Niskanian budget-maximizing central bank – even if completely captured – would only hike interest rates if it would benefit the central bank employees during the term of their employment. The incentives of these employees would be determined by how much political control over the central bank there is, who appoints the bankers and how their term can be terminated, etc. Many of the effects Carré and Gauvin present as uniquely Democratic School contributions could be argued from a Public Choice Theory point of view. Niskanen (1971) describes how changes in political structures and relative power of political groups can affect the incentives of institutions, which could lead to similar effects as the political struggle described by Carré and Gauvin. Public Choice also agrees that appointments of new central bankers with financial background would likely be more costly during the financial crisis. In fact, I find no reason Public Choice Theory would contradict any of the hypothesis (H2 – H4) that the authors use to evaluate the rigorousness of the Democratic School against the Financial School.

3.1.6 Conclusions

Niskanen’s critique of Reagan and the administration begins from the most fundamental premises of his leadership. Perhaps showing his libertarian leaning, Niskanen argues Reagan’s acceptance of New Deal and Great Society, as well as leaning on the post-war consensus in part of his policies, gelded the revolution promised by the political movement behind him. Furthermore, Niskanen claims Reagan was unwilling to cash-in the political good-will he collected with his base. According to Niskanen, this led to unnecessary compromises and changes in policy, that prevented or limited important political reforms. Even if they fit the political

program that Reagan wanted to advance. Reagan also failed to create working system of parallel channels of advice and his White House was uninterested about the work being done in his administration. He did, however, manage to create valuable policy review institutions that Niskanen predicts will continue to live on. (Niskanen, 1988)

The two-party system also made the coalition Reagan formed so broad (Niskanen lists traditional Republicans, supply-siders, social conservatives, neo-conservatives, business community, and labour unions), any coherent course for policy was hard to maintain. Compromises to keep everyone aboard had to be made. These compromises also made it hard to weed out the nonessential outlays from the federal budget to reduce public spending. It was hard to find a program that did not benefit a part of the coalition, even if as Niskanen puts it, Reagan was “*the most conservative president since the 1920’s*” with a Republican Senate majority. Niskanen complains that both the high inflation during Carter’s administration, and the high deficits of Reagan administration, were direct results of systematic bias of political incentives that favour short-term benefits over long-term commitments. Risk aversity of politicians who have secured re-election also discourages any reforms, even if needed, if there is no acute demand for it. This, Niskanen argues, was the reason for Reagan’s lacklustre delivery of his promise of “Reagan Revolution”. Further, Niskanen claims, the inability of the political system to address these issues erodes the rules and governing culture set for the federal government by the constitution. He concludes that any attempt to try to cut the federal budget or the budget process is doomed to fail, without changes in distribution of political power in the federal government and constitutional changes. (Niskanen, 1988)

Niskanen states the US economy saw increases in foreign and domestic investment, new family formation, financial wealth, and disposable income (the per adult growth of real personal income was lower, but changes to benefit and tax systems increased the disposable income). Unemployment did rise from late 1970s to 1982, as did the average length of unemployment. Niskanen argues this is partly explained by increased participation of women in the workforce, increasing competition for jobs and smaller effect of unemployment on total family income of dual-income households. Women, especially women with minority background, experienced the largest increase in employment and median real earnings. Although Niskanen admits he was scolded both

publicly and privately for addressing the issue of gender wage gap in a debate for setting wages of both sexes at “comparable worth” of work. (Niskanen, 1988)

The poverty rate increased in early 1980s due to the economic downturn. Niskanen argues the nonelderly poverty rate is mostly determined by ratio of poverty line to median family income, or in other words, general economic conditions. Lower economic growth since 1973, not welfare dependency is the main cause according to Niskanen. He further states, that the limited changes that Reagan administration did to the welfare policy – most of which were changes to non-cash benefits for people above poverty line – did not have significant effects on poverty rate. They did raise the effective tax rate on the working poor to as high as 250%. Niskanen points out the political deadlock that this problem encompasses. The solution of these tax rates requires increasing benefits of the working poor or decreasing benefits of those who do not work. The Republicans will oppose the former, Democrats the latter, making no progress possible. Niskanen brings up Charles Murray’s (1984) case that large welfare benefits may create welfare dependency, particularly in urban areas. He dismisses the idea, citing longitudinal samples (Duncan & Hoffman, 1986) that show no proof of this happening. Instead, they show that poverty is a temporary state for most people affected, and that non-urban areas are most affected. He also states no connection is found between family status and welfare benefits, except for single mother’s decision to live outside her parents’ home. Niskanen points out this does not mean that the welfare system was without flaws or should not be improved. As an example, he argues food stamp and other programs that offer services towards a specific good could be cut to save the administration costs and increase money benefits. (Niskanen, 1988)

While the reasons for economic successes under Reagan are debated by economists, the consensus is that the economy did well under Reagan (Kozma, 2013; Krugman, 2004; Miner, 1989; Niskanen, 1988; Niskanen & Moore, 1996), and that some of his policies (whether they were intended to work as they did or not) positively affected the economy. Even the harshest critics agree that the defence spending got The US out of the early 80’s recession, even though it might have been self-inflicted (Krugman, 2004). The negative consequences, most serious of which being the deficit, might have made it harder to react to later crisis (Miner, 1989). The threat of chronic and growing

deficits was not missed by Niskanen, who points it out in Reaganomics arguing from a Public Choice perspective that this discrepancy in demand for public services and the level of taxation cannot prove to be a lasting solution. Niskanen is satisfied with how well the administration handled crisis. However, he criticizes the administration for bad prevention and inability to find long-term solutions for the problems surrounding it. (Niskanen, 1988)

Niskanen predicts that baby-boomer generation will play a major role in future politics due to the size of the generation. He describes this generation as fiscally conservative, but somewhat socially liberal group, with little party affiliation. Niskanen states, “*a candidate of either party that can articulate a vision of international restraint, economic opportunity, and social tolerance, however, would capture most of this new generation.*” This prediction seems to echo in many political campaigns in the last decades, particularly President Obama’s first campaign in 2008. He also predicts George Bush (Senior) will run for president from the Republican Party and considers the possibility of Al Gore running from the Democratic Party. Niskanen argues that government decisions are path dependent. Therefore, the changes in level of budgets and public deficits will continue to affect future decisions by normalizing the level at which they are set. Showing his libertarian side, Niskanen ends the book with a warning that Reagan may be a temporary halt in the “progressive loss of liberties” due to ever expanding state power. (Niskanen, 1988)

For economists, Niskanen leaves questions to be addressed from this period. He states none of the economic schools are able to explain 1.) “*The combination of strong domestic investment (through 1984) and high real interest rates.*” 2.) Increase in real value of the dollar through early 1985 and its drop afterwards. 3.) The increase in trade deficit. 4.) Decline in money velocity. Niskanen also argues for stronger microeconomic basis for the new macroeconomic theory and states that maintaining a stable path of total demand may be the new monetary rule after the end of “high church” monetarism. (Niskanen, 1988)

3.2 Cato Institute

During his career at Cato Institute Niskanen wrote on number of political issues. Some of his main concerns were the continuing government expansion and interventionist foreign policy of The United States, particularly the Iraq War. The following chapters cover Niskanen's writings (and speeches) during his time in the Cato Institute, mostly collected from his last major book release *Reflections of a Political Economist* (2008d), a collection of his articles published from 1997 to 2008.

3.2.1 Economic Policy

Niskanen (2006) criticizes the Republican Party for unfounded belief that tax reductions would cut down the size of government. This, Niskanen states, has been the party line for decades, despite there being no relation between federal spending as a share of GDP and lagged federal deficit as a share of GDP. As stated, balancing the budget through cuts to federal spending is also unlikely due to incentives of politicians and bureaucrats (Niskanen, 1971). Secondly orthodox price theory suggests that reduction to tax rates would reduce the cost of public services to citizens, increasing total demand (Niskanen, 2008e). Niskanen wonders Milton Friedman's, Gary Becker's, and Ed Lazear's (chairman of the Council of Economic Advisors in 2008) endorsement of the policy. Friedman and Becker understood the effect of price controls on private markets well, why then, did they advocate them to the public sector? Niskanen suggests institutional changes, where spending exceeding 110 percent of total receipts in the second prior year would require a super majority.

The *Economic Burden of Taxation* (2003) studies the effects of taxation to GDP. Niskanen estimates the elasticity of fiscal effects to economic growth with two methods. 1.) By estimating long-term relation of non-defence spending per potential worker, $1 - \bar{t}$, and $1 - \bar{t}_p$ (\bar{t} = average tax rate, \bar{t}_p = average taxrate second prior year), to real GDP per potential worker, output per hour of business sector, and hours worked in business sector divided by number of potential workers. 2.) By solving Niskanen's model of fiscal choices of democratic governments backwards from known fiscal choices to matching implicit elasticities.

These methods give out similar results (short-run elasticities: method 1. = 0,748 and 2. = 0,772. Long-term: 1 = 1,212). With elasticity rounded to 0,8 and average tax rate to 0,3, Niskanen gets a rough estimate of cost of government spending of 2,75 USD to every tax dollar collected. Niskanen further calculates the optimal size of G/Y (government spending per total output) for the elasticity, arriving at around 10 percent.

In *Should the Ex-Im Bank Be Retired?* (2001b) Niskanen argues for the dissolution of Export-Import Bank, an organization with the goal to aid US export industries by promoting US companies and issuing credit to foreign companies willing to buy US products. Originally it was created to enable Soviet export credits. Niskanen critiques the argument of possible credit-market-failures as a justification of the existence of the bank. According to Niskanen, if the possible lack of financing is a sign of risk, not market-failure. Certain externalities, such as environmental or foreign policy benefits, may justify a subsidy, but Niskanen argues, this is independent of any business from a specific US company. Niskanen's mention of foreign policy benefits makes me somewhat disagree with this statement. Financing foreign purchase of specific US-made technologies – fighter jets, for example – may bring technological path dependency, which brings further investments and political leverage. This leverage and continued investment may justify certain level of favouritism, especially in a country like The United States, which guards foreign exports of defence equipment carefully. According to Niskanen, another traditional argument for the system is to counter subsidies from other nations. Niskanen argues The US should use penalizing tariffs on all goods to counter these subsidies, rather than introducing its own subsidies.

In *On the Death of the Phillips Curve* (2002a), Niskanen studies the existence of the Phillips Curve. Instead, he cites Milton Friedman's Nobel lecture (1976) in arguing that there is a lagged positive relation between inflation and unemployment (in addition to immediate negative component), giving a function where equilibrium unemployment is $U^* = a - bI + cI_{-1} + u$. Niskanen uses US data from 1960 to 2001 to estimate the significance of these factors, resulting in $U^* = 3,672 - 0,5641*I + 1,144*I_{-1} + u$. Niskanen's take away from these results is that there is no trade-off between unemployment and inflation beyond same year. Instead in long-term there is a positive relation and minimum sustainable unemployment rate is around 3.7 percent. He

concludes that steady growth of aggregate demand at zero inflation rate is also consistent with this unemployment rate.

3.2.2 Foreign and Military Policy

While chairing the institute, Niskanen wrote many articles and held speeches against government expansion and American military involvement in Middle East (*Cato Institute Event: War Against Iraq 12/13/01 - YouTube*, 2014; Niskanen, 2008c), once again showing Niskanen's unphased attitude in face of political opposition, as majority of Americans supported the war early in the conflict (*Public Attitudes Toward the War in Iraq: 2003-2008 | Pew Research Center*, n.d.). He also criticizes the War on Terror, and the effects it has had on civil liberties and inefficient public spending in The United States. In "The Economic Basis for Military Capability", first published in 1999, Niskanen does, however, encourage vigilance over whether economic growth of Russia and China may lead to military threat against United States, even if the growth itself should be welcomed. Niskanen also warns that while democracies have shown resilience against more tyrannical adversaries in World Wars and the Cold War, does not mean that democratic countries will not suffer losses. The history is not over yet. (Niskanen, 2008c)

3.2.3 Science Policy

In his articles on US science policy, Niskanen warns politicians of too much optimism in research and development (R&D) and global treatise against climate change. In his article R&D and Economic Growth: Cautionary Thoughts, Niskanen concludes that according to his regression analysis from federal spending on R&D from 1956 to 1993, only investment on defence industry research showed near-term benefits on productivity. Long-term effects, Niskanen says, cannot be evaluated from his data. Niskanen concludes by advocating better structured government science policy with a sharper focus on encouraging R&D in the private sector, which might have better knowledge and incentives to carry out research where it is most needed. In "Too Much, Too Soon: Is a Global Warming Treaty a Rush to Judgment?" Niskanen attacks the preparation of Kyoto Protocol. In his view, the organizers had not conclusively shown that the tools proposed are the best available, that they will even work, or that any

action on climate change should be taken. Where his demands for better analysis of economic (and climate) effects of the measures to be taken may be warranted, Niskanen does venture out of the realm of economics to comment on issues of climate science. Surely an uncomfortable stance for the Niskanen Center, which openly advocates for strong measures to counter global warming (*Climate*, n.d.). (Niskanen, 2008c)

3.2.4 Social Policy

Niskanen pondered the slow growth of productivity and real wages already in *Bureaucracy and Representative Government* (1971). In “Creating Good Jobs and Good Wages”, Niskanen goes back to study US labour policy. In addition to the two trends mentioned before, Niskanen focuses on increased variance in wages by skill level. Niskanen brings up the possibility of consumer price index wrapping the picture. This is familiar point from *Bureaucracy and Representative Government*. More interestingly, Niskanen argues this could be due to a major technological change, which may raise wages in professions that can adapt the technology early on. Similar changes can be observed during industrial revolution in The United States and Britain (Greenwood, 1999). Another factor may be the effect of rapidly increasing international trade, which has brought more competition to low-skill-intensive industries. The importance of this effect is still in debate according to Niskanen, with estimates ranging from 10% of total change to 100%. Change in unionization, job-related skills, and attitudes may be another factor, however, immigration does not seem to be a major factor to the increased variation. (Niskanen, 2000)

Niskanen argues school reform as one of the solutions to boost wages and productivity, however, increased real spending per pupil has not brought the desired change. Niskanen argues that according to studies comparing public and Catholic schools, the latter show better results more cost efficiently (Coleman et al., 1982). This leads to Niskanen advocating for school voucher system. Later he also advocates for vocational schools for trades. Niskanen also advocates for flexible labour laws on hiring and firing employees, stable aggregate demand as a basis for monetary policy, continued liberal trade and immigration policy and tax reform to help those not covered by employer plans, dual income families and self-employed. Unspecified policy changes to reduce

number of births to single mothers to reduce the resulting effect on education levels, crime, and employment. (Niskanen, 2000)

3.2.5 Niskanen on the Constitution of the European Union

Niskanen also commented on Treaty establishing a Constitution for Europe, a failed treaty of the European Union that was replaced by the Treaty of Lisbon. Niskanen evaluates what features in its constitution have made the US a long-lasting republic and how it could be improved. Niskanen believes that the declaratory nature, original structure of congress (pre-Seventeenth Amendment), clearly defined and few powers granted to federal government, The Bill of Rights, and clear and brief document readable for a layman form the strengths of the US constitution. While unclear authorisation on constitutional dispute resolving methods led to politization of the Supreme Court. The lack of state powers to nullify authority of the federal government led to power imbalance after the seventeenth amendment (which made senators democratically elected officials, rather than representatives of each of the states' legislatures in the federal government). There is no authority for states to secede, which according to Niskanen, set the conditions for American Civil War. Finally, Congress, with the approval of the Supreme Court, has delegated many of its powers to regulatory agencies, creating a number of non-elected bodies whose actions do not need separate approval of the Congress. (Niskanen, 2005)

Niskanen is happy to find the proposed EU constitution trying to reduce many of the weaknesses he finds in the US constitution. The Council of Ministers represents the member states' interests. Delegation of powers require unanimity from European Parliament and the Council. Although not perfectly clear, the EU constitution is less vague about resolution of constitutional disputes. The EU proposal also included provision for secession. Niskanen does criticize the document for unnecessary prose about goals and values of the EU yet does not clearly define the relation between the union and its member states. The constitution gives the Commission too much power compared to the Parliament. The free movement of people combined with right to social services in any country to any EU citizen creates pressure to harmonize the services or face large immigration movements between states. Affirmative action and demands of non-discriminatory processes are incompatible. Lastly, Niskanen warns

Europeans to think if what they want is an EU constitution, and to carefully limit the authority of European Union to redefine its own powers over member states.

After the failure of the Constitution project, Niskanen returned to give an alternative perspective. Niskanen proposes a different path for integration in Europe. Europe of nation states, and a voluntary integration in the few areas where Niskanen finds governments to have economies of scale such as defence, trade policy, environmental policy, and scientific research. Fields where no economies of scale can be achieved would remain internal to nation states. Such fields would include agricultural policy. Next an Association of European National States would be formed. This would be supranational organisation with no common citizen and a leadership that is appointed by governments of member states. The Association would have no power to tax but would get funding from grants from the member states proportional to their representation in the leadership. The power of the association would be carefully limited and ability of majority of governments in it could nullify any decision. Any nation could also secede peacefully without intervention. Finally, a more carefully crafted constitution and European State would be formed. (Niskanen, 2007b)

4 CURRENT LITERATURE ON PUBLIC CHOICE THEORY

4.1 On The Study of Public Choice Theory

Volejníková and Kuba (2020) study the context in which Public Choice Theory is viewed to exist. Where originally, they pose, that the theory was viewed as an independent subfield of economics, from the 1980's forwards, it has come over time to be seen as a part of New Political Economy (NPE). This school of thought synthesizes multiple approaches into an eclectic approach to study political economy. NPE stresses the importance of institutional environments that effect the economy. Volejníková and Kuba argue, because Public Choice Theory studies larger institutions and incentives, rather than focusing on modelling the conditions within current system, the theory offers helpful insight across time and political context, which the context dependent theoretical structures do not.

Torgler (2022) studies how Public Choice Theory could contribute to Law and Economics, looking at the development of the experimental methods and scientometric analysis of the frequency of experimental studies in law, public choice, and eminent journals in economics. Torgler comments on the history of the crosspollination of sciences of Law and Economics, citing literature and number of schools of thought from the cross-section of the two disciplines, and their behavioural subfields. He points out that many of the books and studies fail to consider the contributions of Public Choice Theory and the perspective it could offer to the study of Law and Economics. This has led to weaknesses in the analysis of Law and Economics, such as assumption that common law is efficient, or law enforcement apparatus acts as Weberian system with no fault lines. On the other hand, public choice theorists focus more on process-oriented efficiency, leading to less focus on efficiency of end-state outcomes, the focus of law and economics.

Buchanan and Tullock were influential to the development of laboratory experimental methods to the study of rules of process and the power of institutions in shaping collective choice. Along with development of game theory research, these were important steps in developing empirical methods in several social sciences, such as economics, political sciences, and law. Plott (2014) describes Public Choice Theory

as behavioural, as it assumes public decisions reflect equilibrating tendencies resulted from interactions of institutions and people. Plott states Public Choice studies the variants in equation: preferences \times institutions \times feasible set \times solution/equilibrium = outcomes. Torgler adds that information could be added as a variable. This makes laboratory experiments valuable in studying Public Choice, as key parameters can be held constant to study effects of a variant. By 1980's economics, political science, and public choice had accumulated large literature of sound empirical studies. (Torgler, 2022)

4.2 Developing Countries and Public Choice

Public Choice Theory is an important tool especially in nations, where institutions are not strong enough to discourage corruption and budget-maximizing behaviour. Political instability may also lead to more frequent circulation of elites, leading to changes not only in the low-, middle-, and high-demand groups, but also the bureaucrats and leaders. This may make large systematic changes more frequent and, if there are restrictions on firing bureaucrats, faster bloat of the bureaucracy and perhaps less-experienced bureaucrats. Because of this, developing nations make for excellent case studies of public choice literature.

Habibov and Auchynnika (2022) find that in post-communist countries informal payments (unofficial out-of-pocket payments, the author of the work you are reading would simply describe it "a bribe") on public health services lower self-rated health, and negatively affect the trust on public health services, as well as pushes well-off customers to private healthcare services, creating a two-tier healthcare system. This worsens the popular support of public healthcare and may in the end be fatal for public healthcare.

De Almeida Lima and Reis Machado (2020) show that Brazilian tax policy has a negative impact on wealth generation of publicly traded companies. The authors suggest simpler, more business-friendly tax policy. Estrada and Bastida (2023) point out that budget increasing mayoral candidates in Honduras have had greater electoral success. Investment expenditure, however, seems to not be significant factor, even though physical improvements in roads etc. could be assumed to be more visible for

voters, and thus more easily create support. Progressive parties are more likely to be reelected, Estrada and Bastida believe this is due to their support of broad public sector. Further, evidence from Turkey point out that regional interest groups lead to faster growth of government in less developed regions (Sağdıç et al., 2021). Turkey's policy for the Syrian refugee crisis seems to also serve to maximize the support of the nation's ruling party, AKP(Mccarthy, 2021).

The Public Choice Theory is not necessarily the only factor in play. Fambeu, Mbondo, and Yomi (Fambeu et al., 2022) study the effect of public spending on happiness in Africa from 2006 to 2018. They find that generally there is no effect, but for the poorest countries, public spending is positively correlated with happiness. This is against the Public Choice Theory prediction and more align with neoclassical hypothesis. The authors however warn that self-reported happiness is unreliable metric as the answers can be influenced by context in which the question is asked, such as weather during the survey. Further there exists major data limitations for the countries studied.

4.3 Public Choice Literature of Covid-19

The pandemic saw fast change in preferences of the public and in many countries politicians and bureaus were left to find the best course to navigate the new environment. Several studies have been made to study the political response from a Public Choice Theory perspective. Karadimas (2022) finds politicians followed maximized their own utility (vote-maximizing) by implementing popular policies, rather than implementing the optimal policy. The pandemic also allowed politicians to expand public spending, as spending on healthcare and combating the economic downturn caused by the pandemic became more acceptable. Interestingly, he finds Sweden's political institutions gave much power to the public health experts, which led to its more laxed response towards Covid. Later, legal changes were made that allowed politicians larger control after the previous policy became unpopular. According to Karadimas, this shows the political response, at least in Sweden, followed public support, not expert opinion.

Coyne, Duncan and Hall (2021), agree with Karadimas, that while epidemics include external costs from transmission of the disease, the government cannot be assumed to

act as benevolent social health planner, due to incentives created by the political institutions and environment they exist in. Even being a Weberian agent proves impossible, as public choice and epistemic challenges prevent design of welfare maximizing policies. Policies taken have unpredictable negative externalities that cannot be considered at the moment of implementation. Coyne et.al. argue for more local and polycentric approach to epidemics, as they present different issues for different communities, not single, uniform crisis.

March (2021a, 2021b) argue that the Food and Drug Administration (FDA) regulation slowed the development of medical responses to Covid-19, restricted the diagnosis and treatment of the disease, and increased the cost of development of treatments. March suggests that less stringent regulation would help face future crisis faster and cheaper than the current system.

5 FUTURE DIRECTIONS OF PUBLIC CHOICE

This chapter proposes some of the author's ideas for future public choice research.

5.1 Public to Private

Niskanen defines a bureau as an organization, which does not operate on profit motives, usually gets its funds from a single sponsor as a lump sum, not through single independent transactions in the margin. I propose the basic principles of public choice could also be used to study incentives inside for-profit corporations.

Large corporations rely on number of departments, which do not directly affect the production of the product sold, but work on supporting structures, which create value by enabling or advancing the smooth operation of the company. Examples of this could be legal departments or human resources. These departments can be highly specialized in their field, which, together with not directly affecting the number of products manufactured, makes evaluation of the value they create difficult to outsiders. Can the difficulty of evaluating the value of human-resources or law department make them act as budget-maximisers? Or does the competition from outside law firms, and opportunity to hire review bodies to evaluate these departments, force these departments to act in the interest of the corporation? If review bodies are needed, does it not already point towards the threat of budget-maximizing behaviour? What incentives do these departments have to maximize profit? Or do they try to maximize the perceived value of their service, to maximize the discretionary budget of the department (subject to the constraint of increased funding to review processes)?

5.2 Finland and NATO Policy

During 2022 Finland saw drastic change in public opinion towards NATO-membership due to reignited war in Ukraine. After the change in public opinion, the support for application for the membership became almost uniform in the parliament (Orjala, 2023). Previously reports supportive of the membership received backlash and most political parties had been against NATO membership (Aunimo, 2016; Lehto, 2016; Nurmi, 2019; Pesonen, 2022; *UM: Nato-Jäsenyys Vahvistaisi Suomen Asemaa*,

2007). Public Choice Theory could help study the incentives of political parties in both, the current and former stances taken by political parties and politicians, as well as what role did the public opinion play in changing them. Further studies into the financing or political backing from agents (used either in economic or political sense of the word) aligned with foreign interests, could provide valuable information on the functioning of Finnish political landscape. E.g. did companies, non-profits, or political parties with ties to Russia effect the public policy, and did the public opinion drive policy as some of the literature on Covid-19 responses seem to point out? Interdisciplinarity with political scientists or historians could also prove valuable in studying these ties.

5.3 Public Choice and Geo-Economics

Geo-Economics is the study of application of economy and economic policy to geopolitical interests. Public Choice Theory could help further this field by studying the politicians or bureaucrats' incentives and how they affect the application of geo-economic policies. E.g. have close trade ties led to too lenient policies to counter Russian and Chinese influence? Can ties between political parties/politicians/bureaucrats and foreign countries explain policies taken? Can the policies taken be used to evaluate corruption or foreign influence in the country?

6 CONCLUSIONS

This chapter seeks to answer the several questions posed in the introduction of this work. I have divided them by political and academic legacy of William Niskanen, and the future of Public Choice Theory as a field.

6.1 Niskanen's contributions on economic theory

Niskanen's studies, particularly *Bureaucracy and Representative Government*, remain highly cited to this day, with Google Scholar finding 52 citations in 2023 already (as of 28.3.2023) and over 12 000 citations in total. Even if later developments in literature have modified the theory (e.g. the move to discretionary profit), the study remains a key text in understanding modern Public Choice Theory.

The empirical evidence for the theory seems inconclusive and dependent on the aspects of the theory stressed, countries studied, and methods chosen (Arapis & Bowling, 2020; Bednarczuk, 2022; Blais & Dion, 1991). Other factors, such as Baymole's Disease could explain the growth in public expenditure better than budget-maximizing model (Bednarczuk, 2022). Many bureaucrats even seem to hold budget-minimizing preferences (Arapis & Bowling, 2020). In my opinion, this does not however necessarily contradict the model. Low-demand group leaning bureaucrats could try to maximize the relative benefit of the low-demand group. As a part of attempted take-over of the system, the number of budget-minimizing bureaucrats could even become majority, before forming of a new status-quo in the system and starting to maximize the utility of the new high-demand group.

6.2 Niskanen's contributions on public policy

Niskanen's work early in his career contributed greatly to the efficient running of the Department of Defence. This was however more in the role of a bureaucrat, working in the management of public institutions. His political work would come only later during his career during his time in Reagan's administration and Cato Institute. His academic work however, caused waves in public policy before Niskanen himself

moved to work in politics. British Prime Minister Margaret Thatcher required his staff to study Niskanen's *Bureaucracy and Representative Government* (Ingraham, 1997).

In his writings, Niskanen seems unsatisfied with his ability to drive for change in Reagan's government. He at times points out the disagreements between him and some of the other staff, which he states could have hindered his career prospects. Niskanen's career peak happened after the main drive for Reagan revolution had given way to political and economic realities. Niskanen also found the president unwilling to use his popularity to drive through change at the cost of political capital. (Niskanen, 1988)

The influence of Niskanen's career at the head of the Cato Institute should not be understated. Cato Institute is one of the most influential think tanks in the World and has been efficient in driving policy and debate (J. McGann, 2021; J. G. McGann, 2016). The criticism of The US involvement in Middle East, environmental policy, and expanding government continue to be major themes in right-wing movements. Niskanen, however, seems to fall in shadow of more famous political advocates. Even with over 20 years of experience leading Cato Institute, Niskanen has left surprisingly small influence on online political conversation outside his work on public choice. One explanation for this might be a legal battle over the ownership of Niskanen's shares of the Cato Institute after his death (Allen, 2012; Vogel, 2012). Another might be the emergence of first the Tea Party Movement around 2010 and the MAGA (Make America Great Again) movement during 2015-2016. Both these movements supported restrictions on size of government, criticized the mainstream environmental policy and American involvement in the Middle East, but also at times differed on how to address these issues. The Tea Party Movement supported lowering taxes despite Niskanen's warnings (Douthat, 2010), while the MAGA movements protectionism would clash with Niskanen's views on free trade. It could be that these more populist strains of American right-wing politics, took over the habitat of Niskanen and his more centre-right allies.

After death of William Niskanen, Niskanen Center was named in his honour. It continues to operate as a think tank and research institute, studying public policy and institutions. The goal of Niskanen Center is to drive cultural and social change, as well as promote an open society (*About - Niskanen Center*, n.d.). The think tank has grown

considerably, with total expenses in 2020 at \$4.6 million and in 2021 6.6 million (*Building a Road to Recovery for a Divided Nation*, 2021; *Providing a Fresh Roadmap for a Divided Nation*, 2023).

6.3 Future of Public Choice Theory

Economic literature around the institutional context of markets, and of political economy, have become more prevalent in the academic literature (Volejníková & Kuba, 2020), which suggests that the future of Public Choice Theory seems vibrant, even if it was as a part of NPE or other eclectic approaches. Multiple crisis (Covid-19, Russian occupation of Ukraine, rocketing inflation) give a number of topics for current and future public choice authors to study.

The empirical proof for budget-maximizing bureaucrat as a general model seems unconvincing, but some evidence exists, that suggests the model may hold in specific contexts. Discretionary budget as the bureaucrat's maximand, in my opinion, seems still relevant. Evidence which points out that "unselfish" motives are better at explaining bureaucrat behaviour, might still be explainable through the discretionary-budget model. Larger budgets and wasteful use of money may draw attention of review bodies or lower public support for the program. In addition, the bureaucrats view of the prestige of the employment might suffer, if he starts to view the job as pencil pushing for exuberant amounts of money. These factors might lower the marginal utility from the budget increases, while still keep the basic idea of rational, utility maximizing bureaucrat alive. It would also allow larger differences in different systems. In some systems, bureaucrats might act more in line with traditional discretionary-budget-maximisers, in other systems cultural or other factors might push them to act more "unselfishly".

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