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Public and Private Bureaucracies

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I. INTRODUCTION

In recent years, the economic theory of markets has been extended and deepened by explicit treatment of alternative ways of organizing production. One major field of study in this area is the behavior of publicly owned firms--crown corporations and government departments. The central question here has been that of the relative "efficiency" of public vs. private firms, and simple models have been developed--and fairly widely accepted--which apparently imply that public firms tend to be less efficient in some sense than private firms when both provide similar services. Moreover, a large number of empirical studies have been done of particular industries in which public and private ownership may both be found--airlines, railroads, utilities, hospitals, banks, radio and TV broadcasting, and so on, and these studies tend to document this prediction with impressive uniformity.[1]

In this paper, I will argue that neither the theory nor the evidence collected can discriminate between the following two alternative hypotheses: (1) government owned firms are less efficient than private firms; (2) government firms serve political markets more, and economic markets less, than private firms do. The first hypothesis is an exciting and important piece of economic reasoning. The second is rather obvious. But, I will argue, it is all that can be validly inferred from the theory and from the evidence.

I will also argue that public and private production should be compared, not merely in terms of ownership, but in terms of control, and in terms of the relationship between ownership and control in the two sectors. Consequently, a large part of the paper deals, in a contemporary way, with the old problem of the separation of (private)ownership and (managerial) control in the modern corporation, and its relationship to what could be called the separation of public ownership from political control in modern government. In particular, I compare the relative strength of the mechanisms available to "owners" of public and private firms to police their agents--the managers and employees of those firms--to ensure that their actions accord with the owners' interests.

The paper is organized as follows. The next section outlines the most widely-cited theories, and shows exactly what the implications of these theories are with respect to the relative efficiency of public and private enterprise. I then discuss the relationship between theories of governmental inefficiency and theories of managerial inefficiency in widely held corporations. Section III then turns to the mechanisms which protect owners (shareholders) from managerial discretion, shows that each of these mechanisms has its counterpart in the public sector, and suggests that, on balance, these mechanisms would appear to be more effective in the public sector. I then discuss the apparent paradox between this finding, and the evidence that government production is relatively inefficient. Section IV concludes the paper.

II. CURRENT THEORIES OF THE EFFICIENCY OF PUBLIC AND PRIVATE BUREAUS

Two major arguments have been put forward in the economic literature on the question of the relative efficiency of private and public bureaus. The first line of thought stems from the definition of a public bureau as an organization whose output is not evaluated in the marketplace. This definition is common to many economic writings on bureaucracy (e.g. Downs (1967), Niskanen (1971)). In some writings (Olson (1973), Alchian and Kessel (1962)) it has also served as the basis for a theory of their relative efficiency. Mancur Olson, Jr. (1973) argues that in private firms there is a clear measure of success or failure, which derives from the fact that private firms sell their output for a price. Government agencies, however, typically produce public goods, which cannot be sold because they cannot be divided up so that only those who pay get their share. The same characteristic "publicness" which leads these goods to be provided publicly therefore, according to Olson, has another implication--they will not be provided efficiently because there is no obvious measure of success or failure in their provision. In a similar vein, Alchian and Kessel (1962) argue that profitability, combined with rights to profits provides a clear and stronger criterion for evaluating the behavior of subordinates in for-profit corporations than in government agencies or not-for-profit enterprise.

Cotton Lindsay (1976) has suggested a different version of this argument. He looks at the unmeasurability problem in the U.S. context where Congress is given the task of appropriating funds to agencies. Presumably, they will want to do this on the basis of the agency's perceived performance. For this purpose he suggests that indexes will typically be devised of agency performance, e.g., in the case of public (veterans' administration) hospitals, indicators typically used include cost of treatment, average patient stay for given illnesses, bed occupancy ratio, etc. These are "visible" dimensions of performance. There are also "invisible" dimensions--quality of decor, bedside manner of doctors, and so on. Because the invisible aspects of performance cannot be monitored, Lindsay suggests, bureaus will not provide them, and Congress will not fund them. Hence, the average quality of public services will be lower than the quality of similar services provided by the private sector. And average cost of public services will be <u>lower</u> than the cost of private services. These predictions are borne out in a comparison between VA hospitals and proprietary hospitals.

Finally, it is often argued that public employees have less incentive to be efficient, or a greater incentive to pursue nonpecuniary rewards such as leisure because they cannot "take home" the profits or benefits of greater efficiency. Put simply, in private organizations, unlike public bureaus, there is a "bottom line".

All of these arguments suffer from the same simple defect. To see it, it is helpful to use a distinction Albert Breton and I have made elsewhere (Breton and Wintrobe, 1982) between bureaus--the internal components of an organization such as the financial department of General Motors or the Department of Finance in the Canadian federal government--and bureaucracies--the agglomeration of bureaus which constitutes the whole organization--General Motors itself or the Canadian federal government. All of the arguments just listed compare entire organizations or bureaucracies in the private sector to individual government bureaus in the public sector, and this comparison is obviously incorrect. The relevant comparison is either between both organizations as a whole (firms vs. governments) or between individual bureaus in each (the financial department of General Motors vs. the Canadian Department of Finance). Comparing firms and governments first, it is clear that in both cases there is an adequate measure of the performance of the whole organization--profits in the case of firms and popularity as measured by election results and by opinion polls in the case of governments. On the other hand, the output of an individual bureau is typically unmeasurable whether the bureau is part of a private or public organization.

This is obvious in the case of the bureaus just cited (financial departments). At a more general and theoretical level, however, unmeasurability, or costs of measurement, has been the central explanation for why factors tend to be "internalized" within a firm rather than purchased on the market (Alchian and Demsetz (1972), McManus (1975), Cheung (1983), Yoram Barzel (1983)). All of these writers argue that if the factor's output could be measured at low cost, there would be no reason for that factor to be internalized within the firm. It would, instead, be purchased on the marketplace. The same argument has been applied to governments (Borcherding (1983)). Where factor outputs can be measured at low cost, government agencies would purchase them on the marketplace or via a contractual arrangement rather than internalize their operations into government bureaus. So there would appear to be no difference between public and private production on this score, as suggested by all of the writers above.

The second, and the most popular approach to the relative efficiency of public vs. private firms is the "property rights" approach. This argument emphasizes a difference in "ownership" rights between them and consequent differences in the incentives to owners to monitor management (Alchian (1965), DeAlessi (1974)). Owners of private firms (shareholders) can sell their rights in the market at relatively low cost, whereas the "owners" of the public sector (the citizenry of a particular political jurisdiction) cannot transfer their voting rights, and can dispose of them only by moving to another jurisdiction. This change in property rights (the change in the costs of ownership transfer) implies that, as owners of public firms, citizens will be less motivated to monitor the activities of their agent or manager--the politicans in office--than the owners of private firms (shareholders) monitor private managers. Consequently, government firms will tend to be less efficient than private firms. Specifically, according to DeAlessi,[2] the theory suggests that: (i) the incentive to politicians to detect and police bureaucratic behavior which is inconsistent with the owner's welfare is reduced; (ii) bureaucrats will have a greater incentive and opportunity to increase their own utility at the expense of their employers; (iii) bureaucrats or government managers will be more responsive to employees and unions; and finally, (iv) the control devices used in government will be less market oriented and political considerations "including those implied by the peculiarities of the voting system",[3] will become more important in determining the outcome of the decision process.

None of these implications, with the exception of the last one, follows from the theory. Nor does the theory, correctly stated, predict that there will be greater "waste" in public than in private firms though it is widely interpreted in this way. The theory suggests only that there is a difference between the incentive of shareholders to monitor corporate managers compared to the incentive to voters to monitor politicians. If voters monitor politicians less than shareholders monitor managers (because of the costs of ownership transfer), it would appear that politicians will have greater discretion than corporate managers. But this does not imply that politicians will monitor bureaucrats in the public sector any less than corporate managers monitor bureaucrats in the private sector. If politicians have greater freedom to neglect the interests of voters and to pursue their own objectives, why should they cede any of this to the bureaucrats under them? Why should their incentive to detect and police bureaucratic behavior which is inconsistent with their own objectives be any less than it would be to police bureaucratic behavior which is inconsistent with the objectives of voters? Why would they allow their bureaucrats more opportunity and incentive to increase their own utility at the expense of politicians? If politicians have greater discretion, the goals of public firms will reflect politicians' wishes more and voters' wishes less than the goals of private firms reflect the interests of their managers as opposed to their shareholders. This, and not the extent to which bureaucrats are monitored, and hence the efficiency with which bureaucrats carry out their tasks in terms of energy expended, dedication, selflessness and so on, is the only valid implication of the theory.

Now let us turn to the validity of theory itself. Do voters indeed monitor politicians less than shareholders monitor managers? As Fama (1980) points out, the proposition that it always pays investors to diversify their portfolio rather than to specialize in it implies that rational shareholders will tend to hold stock in a relatively large number of corporations. Thus the incentive to monitor the activities of each one must also be small. In other words, the same argument which is used to predict the inefficiency of government bureaus compared to private firms also implies that corporations, especially widely-held corporations, would themselves be relatively inefficient as compared with owner-managed firms. As Jensen and Meckling (1976) have emphasized, the apparent efficiency of the corporate forum, as evidenced by its growth, poses a major puzzle for this approach.[4]

Indeed, there is a striking similarity between the arguments which have been made with respect to private vs. public production and those revolving around the problem of the separation of ownership from control in the modern corporation. First of all, ever since the work of Berle and

Means (1932), it has been widely suggested that where stockholdings are widely dispersed, corporation managers will have some discretion to neglect the interests of their owners in favor of their own interests. Moreover, corporate managers, like public bureaucrats, are also held to be interested in nonpecuniary forms of consumption, such as excess staff, leisure or the quiet life (sometimes called organizational slack), and their position is said to allow them to pursue these forms of managerial discretion at the expense of stockholders (Williamson (1964)). Finally, the main interest of corporate managers, it is often suggested, is growth (Marris (1964), Baumol (1967)) for reasons similar to those which prompt theorists of government bureaucracy (e.g., Niskanen (1971)), to suggest that the main interests of government bureaucrats is the size of their bureau. The operation of a large corporation, like that of public bureaucracy, is thus explained in terms of managerial motives and the growth of corporations, like the growth of bureaucracy, is explained in terms of managerial rents. So the literatures on the role of managers in modern business corporations and that on managers in public bureaucracies have developed very similar themes, although largely independent of one another.

In the literature on private corporations, there has developed a substantial counter-attack to the Berle and Means thesis. According to this literature, shareholders have three major lines of defence against managerial discretion or utility maximization at their expense. These are: (i) executive compensation--if shareholders pay managers on the basis of the value of the firm, it will be in the manager's own pecuniary interest to run the firm in the interests of shareholders; (ii) the "market for corporate control"--managerial discretion or inefficient or wasteful management simply leaves the firm vulnerable to takeover bids. The stock price of the firm will fall, reflecting the inefficiency, and outside purchasers could, by purchasing a sufficient number of the firm's shares to gain control, install their own management, throw out the existing management and watch the stock price rise; (iii) competition among managers--if the managerial market is competitive, this factor by itself is sufficient to protect the interests of owners.

Each of these ideas has considerable merit, though whether the mechanisms are sufficiently powerful to eliminate the problem of managerial discretion is still being debated. The interesting point in the present context is that each of these mechanisms also has its counterpart in the public sector. Moreover, at least on an a priori basis, the strength of the mechanisms controlling political and bureaucratic discretion in the public sector would appear if anything to be greater than the strength of these forces in the private sector. In the following section we will outline each of these mechanisms in more detail and discuss the strengths and weaknesses of each in the public and private sectors.

III. THE SEPARATION OF OWNERSHIP FROM CONTROL

(i) Motives of Managers and Politicians

To take executive compensation first, it is clear that there are a number of ways in which owners can tie their manager's corporation-related incomes to corporate performance in the owner's interest, including direct ownership, stock option plans and so on. The mechanism is not perfect since managers may have other sources of income and since managers may also derive satisfaction from a number of sources of non-pecuniary income which are available to them only within the corporation: excess staff, being the manager of a large corporation as opposed to a smaller one, making a name for oneself in a short period of time in the hope of moving to another corporation and therefore neglecting the long-run interests of the firm for short-run gain, and so on. Broadly speaking, empirical evidence appears to support the hypothesis. In the most sophisticated study (Masson (1971)) executive compensation was found to be more positively related to stock returns than to sales or to the firm's current (as opposed to discounted future) profits. He also found evidence that firms where the proportional reliance on stock returns is greater do outperform other firms in the stock market.

Turning to the public sector, it is perhaps unnecessary to belabor the point that the incomes, prestige and power of the chief executives of the public sector (governing politicians) are tied to their performance in a very direct way: their wish to stay in office. Again, the mechanism is not perfect. Politicians are interested in other things besides remaining in office: leisure, extra staff, spending public resources on projects that enhance their own personal prestige but are unwanted by the electorate, and so on. However, it would certainly seem foolish to suggest that popularity and re-election prospects do not act as a powerful disciplinary force upon politicians in office.

Of course, government bureaucrats are not directly motivated by the re-election prospects of governing politicians and their incomes are not directly tied to the popularity of the government. The same is true with respect to bureaucrats in the private sector and the profits of the firm. Stock option plans are an ineffective way of motivating them: the contribution of any one bureaucrat to the overall profits of the firm is negligible and there would be no reason for him/her to take this into account in decision-making even if his/her income were entirely based on the overall profits of the firm.

(ii) <u>Elections vs. Takeover Bids</u>

Another mechanism which disciplines managers in the private sector is the possibility of a takeover bid. Excessive managerial discretion or inefficient management tends to lower the price of that firm's stock, i.e., to open a gap between the actual value of the firm and its potential value if it were managed efficiently. It supplies a profitable opportunity to investors with sufficient access to large sums of capital and a willingness to bear risks to bid for a controlling interest in the firm. If their bid is successful, and they can successfully replace the inefficient management of the firm with efficient management, they may profit substantially by the increase in the value of the firm's stock to nearer its potential value.

If this market for corporate control were to operate costlessly, divergences between the actual and potential value of firms would be quickly eliminated and the problem of the separation of ownership from control would vanish. There are, however, two reasons to expect that this market will not function in this way. The first is the rather interesting and paradoxical free-rider problem recently pointed out by Grossman and Hart (Grossman and Hart (1982)). To see the problem, consider the following hypothetical situation. Firms A and B are identical. Both have been inefficiently managed for some time and in both there is a substantial divergence between the actual and the potential share price. Accordingly, takeover bids have been launched against both firms. The bids, however, have been put forward by different groups of investors. The group bidding for firm A is one of the most competent and successful in the country. Moreover, if their bid is successful, it is known that they will install a management team which is ruthless, hardworking and almost unbelievably dynamic, and which has a record of turning around ailing firms which is unsurpassed. The potential investors in firm B, on the other hand, are a small and little-known group. Moreover, word has leaked out that, if their bid is successful, they plan to use the firm as a tax write-off. The management team they plan to install is headed by the brother-in-law of one of the investors, who is currently unemployed, and has no fixed address.

Which takeover bid is more likely to succeed? The group taking over firm B, of course. All of the shareholders in firm A would no doubt love to see the takeover bid there succeed. But each individual shareholder would be a fool to sell his share and watch others profit from the installation of a new and efficient managerial team. Accordingly, each shareholder attempts to "free-ride", hanging on to his own shares and hoping others will sell theirs so that the transfer of ownership may be effected. Since every shareholder reasons in the same way, no shares are sold and the takeover bid is unsuccessful. In firm B, on the other hand, from all appearances the takeover, if successful, will tend to depreciate the value of the firm. The rational shareholders may want to sell and the takeover bid will be successful.

Of course, the real world is not constructed so simply as our hypothetical example. In particular, information as to the likely prospects of the firm in the event that the takeover is successful will seldom be so complete as it is in our example. In addition, investor groups which are planning to increase the value of the firm, will be able to make a better offer to shareholders than groups who are planning to run the firm into the ground. To the extent that this is so, and that post-takeover prospects of a firm are surrounded by uncertainty, "good" takeovers, i.e., takeovers which are in the long-run interests of the firm, may take place. Still, the principle, however bizarre, remains: the more competent the management team attempting the takeover, the less likely is that takeover to succeed. And to suggest that the market for corporate control may nevertheless function effectively if only shareholders are uninformed or, better still, misinformed, does not enhance our faith in it by a great deal.

The other problems with the market for corporate control as a device for disciplining managerial behavior may all be subsumed under the rubric of transactions costs. Takeover bids of this type will, of course, be resisted by the existing management of the firm, and the group attempting the takeover can expect a long and costly battle. Takeovers are risky, require access to large amounts of capital, and can be enormously costly to organize. For all of these reasons it would appear that the probability of a takeover declines as the size of the company increases, and managers of the very largest firms are probably immune from the threat of takeover.

It is not surprising, then, that evidence on the effectiveness of the market for corporate control has not been very favorable. Although takeovers are numerous, many are of an entirely different character and are made for entirely different reasons than for the purpose of throwing out inefficient management. Often they simply represent the purchase by large firms of small profitable firms: in Singh's (1975) study of British firms, the acquired firm was more profitable than the acquiring firm in almost half the cases studied. Other studies have produced direct (although undoubtedly imperfect) estimates of the extent of managerial inefficiency necessary to induce a takeover bid. In Hindley's (1970) pioneering study, the value of a firm could drop to two-thirds of its potential value before a takeover bid would be launched. Smiley's (1976) study used two different methods: in one, this estimate was raised to 86%, but in the other he found that "the value (at the time of the decision to tender) of total wealth losses of tendered firms is 50% of what the firm would have sold for had its management maximized profits throughout the ten year period prior to the offer. Alternatively, the market price of the firm is only one-half of what it would have been had the firm maximized profits."[5]

The analogue to the takeover bid in the public sector is, of course, the general election, at which time opposition parties "bid" for control of the machinery of government. How do general elections compare with takeover bids as a means of disciplining existing management? They can be compared in terms of the two issues just discussed: the free-rider problem and cost of organization. Unfortunately, no empirical evidence has ever been collected on the extent to which politicians maximize their popularity, as opposed to pursuing other interests, and so our comparison will have to be limited to theoretical considerations.

To take the free-rider problem first, it has been recognized ever since the work of Anthony Downs (1957) that political markets suffer from a tendency to free-riding on the part of the electorate. The costs of voting--getting registered, becoming informed on the alternative policy positions of different candidates, finding the polling booth, etc.--are positive. If the benefits from voting are calculated as the probability that one's vote will make a difference to the election outcome, multiplied by the net benefit to the voter of having his preferred party win the election, then the benefit to voting is approximately zero. Hence the net benefits--benefits minus costs--of voting are negative and the rational voter will not bother.

The situation improves slightly if the election outcomes are not viewed strictly in terms of winners and losers, but if the number of votes received by each party is deemed important. On this view of the political process (Stigler (1972)), the goal of political parties is not merely to gain office, but to gain influence over public policy. The more votes a party receives, the more influence it has. Unlike the Downsian view, the Stigler view is capable of explaining the existence of minority parties--parties like the NDP who never appear likely to gain office at the federal level, but gain influence over the political process so long as they receive the votes of a substantial minority of the population. If the Stigler view is adopted, then it is not necessarily irrational to vote, since every vote "counts". The amount of influence is small, but then so is the cost of voting, and no general prediction can be made as to whether the rational voter should vote or not. However, the importance of this qualification should not be exaggerated. In the Downsian view, the voter faces a very small probability of having a very large influence on the outcome of an election; in Stigler's view the voter has a very large probability of having a very tiny influence. Either way, the impact of a single vote is small, and there will be a tendency for voters to free ride.

Fortunately, however, this tendency is not borne out by empirical evidence. The paradoxical fact is that most of the time most voters do vote. Moreover, in every other respect, voting patterns appear to be quite rational:

voting turnout is larger in close elections, and in elections where the issues are more hotly contested; more educated voters vote more frequently than less-educated ones, and so on. To explain the existence of voting, however, it appears that one has to rely on altruism or a sense of civic duty on the part of the electorate, however unpleasant resort to such factors may be.

How does the tendency toward free-riding among voters compare with that among shareholders? There appear to be a number of differences between them. First, free-riding among shareholders favors the status quo. To the extent that existing management can count on shareholders to free-ride during a takeover bid, i.e., not to sell their shares to the group tendering the offer, existing management is protected from takeover. There is no such implication with respect to free-riding in political markets: it favors neither the incumbent nor the opposition. Secondly, the force of altruism or civic duty which mitigates free-riding behavior in political markets is unlikely to appear in the market for corporate control. Thirdly, voters surely are much more exposed to political information than they are to information concerning how the companies in which they have shares are being managed. In the latter case the only information available to the small shareholder is the company's annual report, a document produced by the group whose jobs are in question. Voters, on the other hand, are subject to an avalanche of information from many points of view by the media. The quality of this information may be low, but it is surely no lower than the typical company annual report. Finally, more accurate information in political markets does not have the perverse quality that information has in the market for corporate control. If voters correctly come to believe that the opposition is better able to run the government than the incumbents, they are more likely to vote for them, rather than less likely to sell their shares to them as is the case in the market for corporate control.

With respect to the costs of organizing a takeover, again the market for political control appears to offer a superior capacity for disciplining incumbent management. Unlike the private sector, managers in the public sector are forced to call elections at predetermined intervals. There is, moreover, a permanent opposition to whom the executive is continuously accountable. The costs of organizing by opposition political parties are heavily subsidized in most democracies. Finally, the incumbent managers must face the opposition in an organized campaign in which the views of contending parties are put forward to the owners, and heavily reported by the media. Imagine how much shorter the tenure of chief executives in the private sector would be if they were forced to face the sort of takeover bid that chief executives in the public sector are regularly exposed to!

Of course, private firms unlike public firms, are exposed to competition in the market for their products and this can act as a powerful incentive to the managers of private firms, but that is not the issue here. If the difference between the public and the private sectors is simply the difference between monopoly and competition, then other factors, such as the difference in ownership between them, are largely irrelevant. Most discussions of the problem of the separation of ownership from control are prefaced by the assumption that product-market competition is imperfect. An alternative view, put forward by Jensen and Meckling (1976) is that if the separation of ownership from control results in considerable managerial discretion, competition in the product market will be imperfect, since managers cannot be counted on to maximize profits, and hence will not compete as vigorously as would owner-managed firms. On either of these grounds, competition in the product market is insufficient to motivate managers to maximize profits, and the issue we are examining is the strength of alternative mechanisms which would protect the owners' interests. And it would appear that elections exercise a more powerful discipline on governing politicians than takeover bids do on managers in the private sector.

(iii) Managerial Competition

The last mechanism to be discussed is competition among managers. The essential argument here can be found at least as far back as Alchian's (1969) paper. An important recent contribution is that by Fama (1980). The basic point made by these authors is straightforward: the separation of ownership from management presents no difficulty because there is a market for managerial jobs, and this market is competitive. Managers face competition for their jobs both from lower-level managers and from managers in other firms. So managers need not be owners in order for them to be motivated to be efficient. All that is required is that the rewards of managers do depend on their performance, so that efficient managers tend, over the longer run, to earn more than inefficient managers--what Fama calls "ex-post settling up" -- and there be effective competition for managerial jobs. Evidence for the latter proposition is found in the existence of managerial mobility.

Proponents of the managerial competition model do not deny that there are substantial opportunities for managers to pursue growth, sales, leisure or other forms of nonpecuniary consumption. They point out that this must be imputed to the cost to owners (stockholders) of "policing" the management. If the cost to owners of supervising or policing managerial efficiency are high, these writers admit, managers will no doubt have discretion to pursue their own interests. What they do argue, and in this they are surely correct, is that the existence of such opportunities should not be confused, as it often has been, with monopoly power. If competition for managerial jobs is perfect, managers earn no rents no matter how large their discretionary opportunities. To see this point, suppose that managerial jobs in one particular firm--firm A--intrinsically offer more opportunities for discretion than can be found elsewhere. This does not imply that managers in A will earn more rents than managers elsewhere. If managerial wages in firm A were no lower than elsewhere, managers everywhere will want to work for firm A. As a result managerial wages in A will simply be bid down by competition among managers. In short, opportunities for managerial discretion are identical to other nonpecuniary advantages which sometimes attach to jobs, such as prestige or pleasant working conditions. As in the analysis of any other form of nonpecuniary advantage, the larger are those opportunities, the lower the salaries of managers will be in competitive equilibrium.

To be sure, there are real effects of managerial discretion: the corporate form of organization will be less efficient than it would be if managers could be costlessly policed (the output of corporations from given inputs will be smaller), and the corporate sector itself will be smaller than it otherwise would be. But stockholders will not bear the costs of managerial discretion; managers will "pay" for it themselves in the form of lower wages.

It is not clear whether this theory is meant to be applied to managers at the top (chief executive) level or to managers at lower levels. For the argument to work with respect to chief executives, it must be supplemented by some institutional mechanism by which the contracts of chief executives are renegotiated. The two possibilities here are takeover bids, and boards of directors. The first possibility has just been discussed. The weaknesses of the second possibility are well-known. Corporate boards of directors tend to be either relatively passive, or management controlled.[6] Consequently, managerial competition would not appear to have much force as a device for disciplining chief executives in the short run. Moreover, for corporations of reasonable size, the salary of chief executives would probably have to be negative in order to compensate owners for even slight deviations from profit maximization on the executive's part.

From a longer-term perspective, however, the general idea that what mainly motivates managers is their future prospects in the managerial market has considerable appeal. Efficient managers will acquire a reputation for efficiency, and executives compete against other executives (including executives in other corporations) in order to acquire a bigger reputation, the value of which is reflected in the salary and other benefits which a successful executive can command in this market.

The same notion has equal force in the market for politicians. Governing or elected politicians may not compete against each other in any direct way, but each has a considerable incentive to perform successfully in office in order to have a chance at higher office. Over the longer run, efficient politicians, like efficient executives can expect to be rewarded by promotion to jobs carrying more prestige, more power, and more income, and these future prospects would appear to be a powerful disciplinary force against the short-run temptations available due to imperfect monitoring on the part of voters or shareholders.

Unfortunately, just how powerful these forces are, and their relative strength in the public and private sectors is difficult to assess. There are enough examples in both sectors of individuals for whom long-term prospects were obviously not strong enough to deter them from short-term exploitation of their position to know that they are not perfect. However, research into these issues is only just beginning, and it would certainly be premature to draw even hazy conclusions at this point.

Managerial competition may also be an important and underrated force within bureaucracies. For example, whether "the firm"--the bureaucracy as a whole--maximizes profits or not clearly depends on its internal organization; that is, on the incentives to division or bureau heads within the firm, and on the capacity of the chief executive to control and coordinate them. Alchian and others see competition among managers within the firm as one force promoting profit maximization by the firm itself.

Similar considerations are equally relevant in explaining the behavior of bureaucrats in the public sector. From the point of view of managerial competition, a government bureaucracy appears to be a competitive labor market, a market in which there is effective competition amongst subordinates for jobs, and competition among bureaucratic superiors for subordinates. Public managers who do not perform as satisfactorily will be replaced; those who do perform satisfactorily are still under pressure to do better from ambitious underlings, from bureaucrats in other agencies, and from outsiders. Mobility within a bureaucracy such as the Canadian federal government is very high, and the incentive to governing politicians to replace inefficient bureaucrats is obviously strong. In short, there is no reason to believe that the market for managers in the public sector is any less competitive or efficient than the market for corporate managers. Theories of government bureaucracy which attribute monopoly power to heads of bureaus in the public sector, on the ground that no other agency is producing <u>that</u> particular output (e.g., defense, foreign affairs) miss this simple point: the bureau may be a monopoly, but the bureau <u>head</u> is no monopolist.

There is, however, one flaw in the argument that competition among managers eliminates the problem of managerial discretion. This argument has been made in detail elsewhere (Breton and Wintrobe (1982)), and can only be sketched here. To see the point, suppose that the most important way in which managers can exploit their position vis-à-vis owners is by forming networks within the firm. For example, it is often suggested that "inside" directors on a company's Board normally vote as a solid unified block under the direction of top management.[7] If so, they form a network, and these Board members will receive something in exchange from top management for this favour. Many other networks exist within the firm, and are commonly referred to as an organization's "informal structure". One implication of this line of thought is that networks--to the extent that they are informed by individuals or groups who are potentially in conflict or competition--can be utilized to neutralize that competition. Another implication is more subtle. If the rewards to managerial discretion do not primarily arise from one's formal position in the organization, but through "membership" in certain networks, then competition for those perquisites will not result in bidding down wages, but in bidding down the rents to network "membership Competition to get into these networks will result in the elimination of rents to network membership, but it will not diminish--in fact it enhances--the power of those networks and their capacity to operate the organization in their own interest, rather than the interests of its owners. On this view, competition among managers does not necessarily eliminate the problem of the separation of ownership from control from the private sector, and it does not eliminate the influence of bureaucrats on public policies on the public sector.

(iv) The Evidence

What, then, of the massive amount of evidence which documents the inefficiency of public production? These studies tend to show that costs of production tend to be higher in public than in private production when both provide similar services. In part, the error here is also due to the simple confusion between bureaus and bureaucracies. Private firms provide services in economic markets, i.e., to markets in which there is a (more or less) simple exchange of goods for money. Public firms may do this to some extent but, being public, they are subunits of and responsible to the government as a whole, and therefore to the political marketplace (the market for votes) as well.

Since political objectives cannot be realized at zero cost, and since these non-zero costs are included in the measured costs of public firms, these studies reveal nothing about the relative efficiency of public and private firms: one cannot know whether the extra costs incurred are simply the costs of serving these objectives, or a genuine inefficiency.

This point has been made many times before (e.g., Breton (1974), Borcherding (1983)). The authors of many studies suggest that they have controlled for this factor by pointing out all the ways in which the public and private firms are similar (perhaps the most famous example of this is Davies' study (1971)). However, one could also list all the ways in which a man resembles a woman, and come up with a very long list.

The special difficulty with studying political markets or markets within organizations from an economic point of view is that trades in these markets are often not made in money, often do not take the form of legally enforceable contracts, and certainly do not necessarily appear on balance sheets. For example, Foster (1971, Chapter 5) describes how one can search in vain for a precise statement of the duties of Britain's nationalized industries in the statutes governing them, in White Papers, in ministerial statements, directions to the Boards, or anywhere else. He goes on to describe the subtle ways variously described as persuasion, pressure, arm-twisting, informal discussions, and so on, in which Ministers exercise their influence over the policies of those industries. And this point, which perhaps needs emphasis in the case of the relatively arms-length relationship between politicians and government corporations, surely needs none with respect to that between politicians and departmental bureaucrats. In one way, then the error in all of these empirical studies is the same as the error in the theory pointed out earlier: they compare the outputs of bureaus in the public sector-entities which even though they may themselves operate in economic markets, are merely parts of a larger organization--and responsive to demands originating from the whole organization, with self-contained units or bureaucracies in the private sector.

III. CONCLUSION

The argument of this paper may be summed up as follows. Theoretical comparisons between public and private production in the literature are severely flawed. One simple flaw is that the studies often compare bureaucracies in the private sector to bureaus in the public sector. This leads to simple logical errors such as the allegation that one cannot measure the performance of a public bureau, while one can measure that of a private firm, and so on, and it has led to a large amount of inappropriate empirical work.

Moreover, in both public and private firms, there tends to be a separation of ownership from effective day-to-day control. The extent to which the managers and employees of those firms serve the objectives of their owners therefore depends largely on the availability and strength of the mechanisms available to police the management, and on the degree of control of management over their employees. A number of mechanisms which give management an incentive to act in the owners' interests were examined, and, on balance, it would appear that these mechanisms, if anything, fare better in the public sector, though this conclusion must be severely qualified because of the lack of research--both theoretical and empirical--on many of the issues involved. Perhaps, however, it can serve as an antidote to the facile conclusion of "property rights" and other theories which draw the opposite conclusion or the basis of much more limited considerations.

FOOTNOTES

[1]See the recent survey by Borcherding (1983).

[2]DeAlessi (1974), p. 7.

[3]loc. cit.

[4]The growth of public enterprise, on the other hand, is not typically viewed as evidence in favour of its efficiency.

[5]Smiley (1976) p. 30.

[6]See Herman (1981) Chapter 2, or Report of the Royal Commission on Corporate Concentration (1978), Chapter 12.

[7]See Herman (1981), and Royal Commission (1978).

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