

Organizational Design of a Welfare-Enhancing Public Bureaucracy: A Theoretical Perspective

(27.03.2009 draft)

Marina Nistotskaya
PhD candidate
Department of Political Science
Central European University

Prepared for the Annual Doctoral Conference, Department of Political Science, Central European University, 30-31 March 2009

Abstract

The paper discusses the theory of welfare-enhancing public bureaucracy, as advanced by Gary Miller in his influential article 'Above Politics: Credible Commitment and Efficiency in the Design of Public Agencies', published in 2000 and subsequent research (2001, 2005, 2007). Drawing on Bengt Holmstrom's study of moral hazard in team production (1982), Douglass North and Barry Weingast research on credible commitment (1989) and Thomas Schelling's research on delegation to agents (1960), Miller claims that there is no perfect solution to the problem of constitutional design of the state. In this second-best world, however, a de-politicized bureaucracy or civil service plays an important role in ensuring the occurrence of socially beneficial outcomes. Expanding Miller's larger statement of welfare-enhancing character of a de-politicized bureaucracy, the chapter explains how individuals components of civil service – meritocratic recruitment, seniority-based promotion and a pay system, and prospects of a life-term career prospects – shield bureaucratic decision-making from the day-to-day oversight by powerholders, thus enabling a socially efficient outcome to be achieved.

Introduction

This chapter outlines the theoretical foundations of the dissertation. Part one discusses the question of our interest: ‘How should public bureaucracy be organized so as to maximize social welfare?’ It specifies the notion of ‘organizational design of bureaucracy’ as a matter of the amount of political control over bureaucracy and the notion of ‘social welfare’ as the overall well being of society as a whole. Part two provides a brief overview of the relevant literature of both a theoretical and empirical nature. It considers early academic attempts to find a link between a depoliticized bureaucracy and greater social welfare. Major tenets of principal-agency theory, that up until recently dominated both academic scholarship and the policy arena, are considered before the chapter proceeds with a detailed account of the theory of an efficient system of interactive social production, as advanced by Gary Miller, and its implications for the organizational design of public bureaucracies.

1. The Notions of ‘Organizational Design’ and ‘Social Welfare’ Specified

The central question of this research is “What organizational design of public bureaucracy is most likely to be welfare-enhancing?”. Given the fact that the notions of ‘organizational design’ and ‘social welfare’ bear different meanings to different researchers, we shall first clarify the standpoint from which we approach the question in hand.

The production of public goods is one of the most widely accepted theories justifying the existence of the state,¹ and although modern states perform very many functions, the production of public goods remains at the heart of their existence. As an integral part of the state, public bureaucracies are characterized by their involvement in the production of public goods. The position taken within thesis (as informed by Gary Miller’s research) is that production of public goods equates to the situation of ‘team production’ (Falaschetti and Miller 2001) or ‘interactive social production’ (Miller 2000: 308), which is a generic situation, involving a group of people who are engaged in mutually interdependent activities. Because ‘the marginal productivity of each member of the group is dependent on how hard each of the other members is working’ (Miller 2000: 293) and individual contributions cannot be easily identified, one of the most

¹ Other justifications for the existence of the state include coordination and redistribution. For an overview of the theories of the state see Hardin (1997).

persistent puzzles of interactive social production – be it team, firm or the state – is how to arrange the relationships between the members of the production team so as it would yield the most efficient outcome (Holmstrom 1982, Hobbes (1651)? In teams this is the configuration of the relations between individual members of the team, in firms – between the owners and the production team (management and the workers) and in states – between the citizenry, elected and non-elected officials.² The latter is the focus of this dissertation and, consequently, by ‘organizational design of public bureaucracy’ we mean an array of instruments available to elected officials (as legitimate bearers of political authority) over none-elected ones.³ Moreover, since it has long been argued that personnel decisions constitute one of primary instruments of political control over bureaucracy (Hammond and Knott 1996, Lupia and McCubbins 2000, Page 1992, Peters 2001), the focus of this dissertation is on the personnel dimension of organizational design of public bureaucracy.

From the point of view of the amount of authority wielded by politicians over personnel decisions, bureaucracies are often viewed either as *politicized*, that is politicians retain full control over hiring, firing and promotion of bureaucratic personnel, or *de-politicized*, that is their staffing powers are limited. The notions of ‘patronage’ and ‘spoils’ are often used as empirical equivalents of the analytical category of a politicized bureaucracy, while ‘meritocratic bureaucracy’ and ‘civil service’ as a de-politicized one.⁴ In the light of the above, the research question of this dissertation can be reformulated as follows: “It is a politicized or a de-politicized bureaucracy that is most likely to maximize social welfare?”

This dissertation approaches the notion of ‘social welfare’ in the vein of welfare economics, that is ‘a vector of individual welfares’, where the notion of individual welfare stands for ‘an individual’s well being, or more explicitly, his or her happiness, with happiness subsuming both sensual pleasure and pain and spiritual delight and suffering’ (Ng 2004: 2). Happiness is by no means straightforward to measure as it is influenced by a vast number of factors. Welfare economists escaped this difficulty by assuming that ‘individuals are the best judges of their

² A relevant literature recognizes that ‘other stakeholders’ such as the citizenry as a whole and its subsets – interests groups (be they constituencies, business entities or others) exert less influence on governmental agencies than politicians (Miller 2000, Rainey and Steibauer 1999: 14).

³ This interpretation of the notion of organizational design could be viewed as a matter of the bureaucracy’s ‘grand design’ rather than a study of more nuanced features of public agencies’ design as the structure of goals and tasks, agency culture and such like (see, for instance, Rainey and Steinbauer 1999, Han Chun and Rainey 2005).

⁴ We discuss the notion of civil service in greater detail later on in the chapter.

welfare and that they maximize this welfare. So whenever they prefer x to y they are assumed to be happier at x than at y . So we can use their utility function (which represents their preferences) as an ordinal indicator of their welfare' (Ng 2004: 2). A dominant view within both the welfare economics literature and public policy, arising from such understanding of social welfare, is that the level of economic development is a key determinant of the level of social welfare as higher levels of economic development allow individuals to maximize their preferences better than lower levels.⁵ This highlights the importance of economic growth as 'the best mean to increase social welfare' (Clarke and Islam 2004: vii).

Therefore, the focus of our theoretical exploration is on a form of bureaucracy that is conducive to greater social welfare from a welfare economics viewpoint as opposed to the meaning of 'social welfare' suggested by governmental actions that seek to provide a minimum level of income, service or other support to such disadvantaged groups (as the poor, elderly, disabled and others).⁶ Consequently, by efficient bureaucracy we mean a bureaucracy that enhances the overall well being of a society. This is a 'macro-level' efficiency as opposed to a more narrow meaning of bureaucratic efficiency (micro-level) – that is how well the agency discharges 'the administrative and operational functions pursuant to the mission' (Rainey and Steibauer 1999: 13) – which is commonly used in bureaucratic studies (Brewer and Selden 2000, Lewis 2007, Wolf 1997). Since this dissertation is concerned with bureaucratic efficiency at the 'macro-level', the notions 'efficient' and 'welfare-enhancing' are used interchangeably.

2. Bureaucracy and Macro-Efficiency: Historical Overview of the Literature

It is somewhat paradoxical that the question of societal efficiency of politicized vs. de-politicized public bureaucracies has not received a rigorous theoretical treatment up until the late 20th century, although the first historical examples of the transition from a politicized to a de-politicized public bureaucracy go as far back as Hohenzollern Prussia (1640-1786) and France of

⁵ Although academic scholarship is trying to move away from a predominantly materialistic interpretation of the notion of social welfare to the appreciation of such issues as equity, political liberty, social relationships and the environment (Sen 1996, Hjalte et al 1977, Gerdtham and Johannesson 2001), welfare economists agree on the point that the level of economic development to a great extent determines the level of social welfare. As Mishin put it, the aim of welfare economics as a science is to develop analytical instruments that would allow us to rank, 'on the scale of better or worse, alternative economic situations open to society' with regard to their capacity to maximize the utility function (1969: 13).

⁶ Such governmental actions are, in their essence, targeted goods.

Louis XIV (1638-1715).⁷ The most prominent instances of the transition from patronage to civil service – the Northcote-Trevelyan Report (1854) in the U.K. and the Pendleton Act (1883) in U.S. – have been extensively studied,⁸ however not from the ‘grand design’ and macro-efficiency points of view.

It is well known that Progressivists, who in 19-century USA led the campaign for the institutionalization of meritocratic administration, used the argument of micro-level efficiency. They believed that the increased competence, inherent in meritocratic recruitment and a long-term service would lead to a better bureaucratic output (Hoogenboom 1961, Knott and Miller 1987, Schultz and Maranto 1998, Skowronek 1982, Van Riper 1958, Wilson 1887). However, the quest for the macro-efficiency, e.g. increased well being of the society as a whole, was also clearly on the agenda of the American Progressivists. As Theda Skocpol notes, at the end of the 19-century in the USA political parties ‘came under sustained attack from reformers who wanted to pursue ‘the public interest’ in non-partisan ways’ (1992: 71). A politically open bureaucracy, delivering particularistic goods to the politicians’ favored constituencies instead of public goods, was clearly an impediment to the reformers’ aim. ‘The removal of politics from administration’ – one of the most important Progressive values – was clearly about achieving ‘the public interest’. Nevertheless, welfare-enhancing intent of the Northcote-Trevelyan Report and Pendleton Act (1883) remained under-researched up until the end of the 20th century.

The first scholar who paid systematic attention to the interaction between politicians and bureaucrats in achieving macro-efficiency was one of the founding fathers of comparative bureaucracy studies Max Weber. He wrote: ‘Historical reality involved a continuous, though for the most part latent, conflict between chiefs and their administrative staff for appropriation and expropriation in relation to one another (Economy and Society: 264). Weber suggested that at the heart of the conflict between ‘chiefs’ and ‘their administrative staff’ is a phenomenon known in the contemporary academic parlance as ‘the asymmetry of information’. As Weber wrote: “The ‘political master’ finds himself in the position of the ‘dilettante’ who stands opposite the ‘expert’,

⁷ Hohenzollern Prussia was the first country in modern European history to introduce meritocratic hiring to its administration (Finer 1932, Fischer and Lundgreen 1975, Morstein Marx 1957), followed by France of Louis XIV (1638-1715) under whom the *Grand Corps* received a significant autonomy (Fischer and Lundgreen 1975, Peters 1995).

⁸ To mention some Shefter 1978, Silberman 1993; Simon, Thompson and Smithburg [1950] 1991; Skowronek 1982; Van Riper 1958; Weber [1922] 1978; Wilson 1989.

facing the trained official who stands within the management of the organization” (1946: 232). He anticipated that the task of combining information advantage (located on one side - bureaucrats) and authority (located on the other - politicians) would inevitably create problems for the efficient functioning of the state. Weber assumed that the growing rationality of bureaucracy was inevitable – the ‘iron cage’ of modernity – and feared that a fully developed bureaucracy would take the ‘over-towering’ power position (1946: 232). Therefore, Weber’s solution to the asymmetry of information problem was a combination of organizational features that would allow bureaucrats to built competence but at the same time preserve the ultimate control of the political masters. Weber’s famous ‘rational-legal’ type of bureaucracy included both competence-enhancing features – such as meritocratic recruitment and prospects of advancement in a lifetime career – and authority-preserving features - vertical hierarchy of authority and rigid operating rules and procedures, providing clear lines of accountability (Economy and Society: 289). Such a bureaucracy, according to Weber, was ‘the most perfectly adapted form for achieving the highest level of performance’ by a capitalist society ([1922] 1978: 973).

The next wave of interest in the relationships between politicians and bureaucrats did not come up until the 1950-60s, when public choice scholars began to apply the tools of economic analysis to politics (Arrow 1951, Buchanan and Tullock 1962, Downs 1957). By emphasizing the self-serving motivations of both politicians and bureaucrats, environmental uncertainty and the asymmetry of information, public choice scholars depicted politic ‘more as common sense, as opposed to romance’ (Buchanan 1995). The early public choice literature on bureaucracy, launched by William Niskanen, assumed that governmental agencies would use the information and expertise in administering specific public policies to obtain from relatively uninformed and inexpert politicians either the largest possible budget (Niskanen 1971, 1973) or the expansion of governmental functions (Downs 1967, Breton and Wintrobe 1975), which would eventually lead to the overprovision of public goods, e.g. a socially sub-optimal outcome. Early public choice scholars remained largely pessimistic about the politicians’ capability to effectively monitor and correct the behavior of bureaucrats and therefore achieve socially efficient outcomes (see, for instance Chapman 1979).⁹

⁹ The title of Niskanen’s latter work (1973) is very telling ‘Bureaucracy: Servant or Master?’

The next generation of scholarship on the topic, associated with the development of principal-agency theory (PAT) by political scientists in the 1980s, was more confident about the principals' capacity to discipline bureaucrats. As with Weber and early public choice theorists, the information asymmetry between principals (those, who hold formal authority) and agents (those who have information advantages) has been the major concern of principal-agency scholars. The PAT's hallmark solution to the problem of information asymmetry is outcome-based incentives: in a canonical principal-agency model a powerful principal sets *ex ante* outcome-based incentives and sanctions to control the performance of her agents.¹⁰ With the help of incentives, the agent's actions are aligned with the principal's interests and a greater efficiency is achieved. Whereas PAT was initially framed as a puzzle in business settings (Spence and Zeckhauser 1971, Holmstrom 1979), it has been applied for a variety of situations in politics: between the citizenry as principal and politicians as agent (Downs and Rocke 1994) and especially between politicians as principal and bureaucrats as agent (Calvert, McCubbins and Weingast 1989; McCubbins, Noll and Weingast 1987, McCubbins and Schwartz 1984; Moe 1982, 1985; Weingast and Moran 1983, Weingast 1984, Moe 1989). In the latter case, political scientists conceptualized political power as a form of incentive and used it as an underpinning for a theory of politico-bureaucratic nexus.

In his pioneering research on the American presidency and bureaucracy, Terry Moe (1982) empirically investigated the link between the ideological preferences of American presidents and bureaucratic output of three regulatory federal agencies over the 32 years period (1945-1977). Contrary to the dominant perspective on the politicians' capacity to oversee bureaucracy, Moe claimed that presidents were successful in achieving 'a degree of direction and control' over bureaucracy (1982: 198).¹¹ Moe pointed out at the presidential power to appoint senior bureaucrats as 'the fundamental mechanism of presidential influence' (200). A year later, in their seminal article, titled "Bureaucratic Discretion or Congressional Control?", Weingast and Moran claimed that the US Congress's committees 'possess sufficient rewards and sanctions to create an

¹⁰ For a critical overview of the evolution of the principal-agency models see Miller (2005).

¹¹ It should be noted that Terry Moe was one among first to recognize that in the situation of multiple and warring principals – which is a product of the separation of powers and highly competitive partisan politics – the ability of bureaucrats to use information asymmetries to their advantage is enhanced and the politicians' capacity to control is undermined (1987, 1989). Moe concludes that impossibility of political principals to extract the maximum effort from their bureaucratic agents is 'inherent in our democratic system as a whole' (1989: 324) or, in words of Gary Miller, the ability of politicians to control bureaucrats by the use of incentives is limited by the system of separation of power (2005: 211).

incentive system for agencies' (1983: 768). In the 1984 paper, analyzing incentives available to politicians, Weingast pointed to the congressional influence over the appointment of bureaucratic officials as one of them (157-160), implying that through the politicization of bureaucracy politicians align the agent's actions with principal's interests and therefore achieve better results. Thus, politicians' authority over personnel decisions was asserted by PAT literature as an important incentive device, and a greater politicization of bureaucracy was suggested as a dominant strategy for the achieving beneficial societal outcomes.

The optimism of the studies that showed that efficiency of firms and governments may be enhanced through the application of a suitable incentive system coincided with a neo-liberal quest for a more politically responsive, accountable for results and entrepreneurial in its spirit public bureaucracy (Farnham and Horton 1996, Pollit 1993). The ascendance of New Right ideology to power in major Anglo-Saxon countries in the 1980s was followed by a radical reform of 'old public administration' in many countries, including the USA, UK, New Zealand, Canada, Australia and the majority of the EU states. This reform, known as New Public Management (NPM), involved many ideas and practical measures, however the main thrust of NPM reforms has been that 'markets forms of coordination should whenever possible be substituted for hierarchical coordination' (Pollit and Bouckaert 2000: 83-84). Namely, 'the 'agent' ('subordinate' in old-fashioned hierarchical terms) agrees to supply the 'principal' (supervisor, boss) with a defined set of outputs within a fixed period at a predetermined cost' (Pollit and Bouckaert 2000: 84). In New Zealand, for example, through the State Sector Act 1988 and the Public Finance Act 1989, ministers were able to hire (on fixed-term contracts) from outside the bureaucracy 'chief executives' to run their ministries. In exchange for a performance agreement to deliver specific results at which the minister and her government were aiming, 'chief executives' were given 'free hands' over personnel policy decisions. As Schick notices, 'chief executives' were able to recruit to bureaucratic posts those who were 'willing and able to take charge' and shed those who shirked responsibility or were unproductive (Schick 1996: 41). In other words, in the 1980s in many countries around the globe important decisions about hiring, firing and promotion of the bureaucratic personnel were brought back under the control of politicians.

Despite the power of PAT's claim that a politicization of bureaucracy is the key to macro-efficiency and the increased number of politician appointees in public bureaucracies reported by

scholars in countries as different as the USA (Light 1995, National Commission on the Public Service 1989, 2003) Australia, Britain, Finland, France, Germany, Japan and Spain (Derlien 1996, Schnapp 2001, Suleiman 2003), there is a dearth of empirical research justifying the existence of causal relations between a politicized public bureaucracy and macro-efficiency. In New Public Management scholarship the value of a politicized bureaucracy has been primarily discussed in what Michael Barzelay called the ‘policy and doctrinal argumentation’ type of the literature as opposed to the ‘research’ type of the literature.¹² Outside the NPM literature, empirical research studied the value of a politicized bureaucracy primarily from a micro-efficiency point of view (see, for instance, Maranto, 1998, 2001; Nathan 1983, Randall 1979, Wood and Waterman 1994).

Despite the pervasiveness of the ‘incentive revolution’ (Miller and Whitford 2006: 214) in both academia and policy-making, a de-politicized bureaucracy continued to be an empirical fact and a focus of interest for social scientists. Civil service not only remained the prevailing mode of personnel policy in developed countries, but was also adopted by the countries of Central and Eastern Europe after the change of political regime in 1989 (Gaidushek 2007; Meyer-Sahling 2004, 2006; Nunberg 1999, 2000). As to social science, it has never abandoned a critical enquiry into the value of a de-politicized bureaucracy for social welfare.¹³ Surprisingly, empirical research made a big leap ahead of theoretical justification of the welfare-enhancing properties of a de-politicized bureaucracy with case studies arriving ahead of comparative research. Thus, for instance, Jameson Doig provided a detailed account of de-politicized Port of New York Authority delivering much needed transport infrastructure in the Big Apple region in the 1920-1930s (1988). Steven Erie (1992) demonstrated how meritocratic bureaucracy of Los Angeles was a key driver for the impressive regional development in the beginning of the 20th century. At the same time, a number of studies pointed to patronage-based administrations as a key element of a system that maximizes rents for the ruler, but not public goods provision (Johnson and Libecap 1994, Keefer and Vlaicu 2007, Miller 1989). Although these case studies constituted a significant contribution to the field, the extent to which their findings were characteristic of other de-

¹² Derek Bok’s article – in which he argued that the citizenry is better off with politicized bureaucracy because the latter ‘counteracts inertia, ensures an influx of new ideas, and keeps government in touch with a variety of interested groups and constituencies’ (2003: 265) – would be a good example of this stream of research.

¹³ There is also a large body of literature exploring the link between de-politicized bureaucracy and micro-efficiency, including such influential research of Kaufman (1956), Hecló (1975, 1977), Ban and Ingram (1990), Rauch and Evans (2000), Suleiman (2003) and Lewis (2007).

politicized bureaucracies remained unclear. Therefore comparative research was needed to provide a serious justification for the claim of welfare-enhancing properties of a de-politicized bureaucracy.

A giant step forward was made in 1995, when James Rauch published the first comprehensive comparative empirical research on a link between the organizational design of public bureaucracy and macro-efficiency. He found that the institutionalization of a de-politicized bureaucracy in 144 U.S. cities during the 23 years of the Progressive Era (1902-1931) had a positive effect on the share of municipal expenditure allocated to investment in infrastructure – road and sewer, which in turn was positively correlated with the level of both manufacturing employment and value-added growth (Rauch 1994). Interpreting the central finding Rauch suggested that a de-politicized bureaucracy was able to offset the politicians' preferences to spend more on policies that yielded immediate benefit (such as police and fire service), therefore increasing voter satisfaction and enhancing the politicians' chances for re-election, than on policies (such as infrastructure investment) that had long gestation and did not pay off until after a couple of election cycles (1968-1971). Continuing this research program, Peter Evans and James Rauch examined the relationship between the extent of meritocratic recruitment and career stability in the core economic agencies in a sample of 35 less developed countries for the 1970-1990 period (1999). Having collected an original data set on the bureaucratic structures of those countries through a mail survey of more than a hundred country experts, they found that 'meritocratic recruitment and predictable, rewarding career ladders are associated with higher growth rates' (760).¹⁴ Evans and Rauch suggested that bureaucrat's commitment to the agency's long-term goals (rather than politicians' interests), structured through meritocratic recruitment and predictable career ladders (1999: 752), could possibly be the mechanism that connects a de-politicized bureaucracy with economic growth. At the same time, they emphasized that the aim of their research was 'to establish a basic connection between bureaucratic structures and economic growth, thereby providing additional incentive to explore alternative mechanisms that might account for the connection' (1999: 753).¹⁵ Thus, whereas the welfare-enhancing properties of a de-politicized

¹⁴ In their companion study Rauch and Evans found that meritocratic recruitment is positively associated with lower levels of corruption and overall bureaucratic quality as measured by country risk agencies (2000).

¹⁵ Having adopted both the analytical approach and the measure of 'Weberian' bureaucracy from Rauch and Evans's research, Henderson *et al* (2007) established a relationship between states with 'Weberian' state apparatuses and their ability to reduce poverty in a sample of 29 developing and middle income countries.

form of bureaucracy were revealed through a robust statistical association, an elaborate theory that would connect the two was still missing.

3. A Theory of Welfare-Enhancing Bureaucracy

A theory that persuasively linked a de-politicized bureaucracy with social welfare was advanced by Gary Miller in his influential article ‘Above Politics: Credible Commitment and Efficiency in the Design of Public Agencies’, published in 2000 and subsequent research (2001, 2005, 2007). Drawing on Bengt Holmstrom’s study of moral hazard in team production (1982), Douglass North and Barry Weingast research on credible commitment (1989) and Thomas Schelling’s research on delegation to agents (1960), Miller claims that there is no perfect solution to the problem of constitutional design of the state. In this second-best world, however, a de-politicized bureaucracy plays an important role in ensuring greater societal efficiency (2000: 290).

3.1. Interactive Social Production in Firms: Holmstrom’s Impossibility Theorem

A starting point for Miller was Holmstrom’s impossibility theorem (1982).¹⁶ Holmstrom tried to rationalize the prevalence among American corporations such organizational structure under which ownership was separated from management and labor as compared to partnerships. Holmstrom assumed that a partnership equates to a situation of ‘team production’ – when a group of people are engaged in mutually interdependent activities and divide the benefits of their team work fully among themselves (1982: 325). The latter characteristic of team production is known as budget balancing. Another generic characteristic of team production, according to Holmstrom, is ‘moral hazard’ – while the output of the team’s work reflects the contribution of many individuals, individual contributions cannot be perfectly observed. Since joint output is the only observable indicator of individual inputs, then the low performing team members cannot be identified and her non-cooperative behavior may yield an inefficient outcome (1982: 325). Given this, the question Holmstrom asked was ‘...whether there is a way of fully allocating the joint outcome x so that the resulting noncooperative game among the agents has a Pareto optimal

¹⁶ In fact, the fundamental problem, underlying Holmstrom’s research, was studied prior to Holmstrom (Hurwicz 1979, Walker 1978) and attracted Miller’s attention as early as 1994 (Miller and Hammond). Holmstrom here is credited as a starting point for Miller’s analysis because he provided a formal answer to the questions raised in previous research.

Nash equilibrium?¹⁷ (1982: 326). In other words, Holmstrom was looking for an (collective and output-based) incentive scheme that would induce each member of the team to undertake the actions that would result in the output efficient for the team as a whole.

Holmstrom's answer to the question was in the negative. The essence of his argument is that the design of an incentive scheme that yields socially efficient outcome is constrained by three mutually inconsistent requirements: Pareto optimality (minimal efficiency requirement), Nash equilibrium and budget balancing. Presenting his argument formally, Holmstrom shows that any budget-balancing Nash equilibrium is Pareto suboptimal (socially inefficient) and any budget-balancing Pareto optimal scheme is not Nash equilibrium (is unstable due to the self-interest of one of the participants) (1982: 326). In other words, Holmstrom's impossibility theorem shows that as long as team members fully divide benefits created by their work between themselves, there will always be a team member who would prefer to slack on her effort to x – the output level of the team, therefore preventing the achievement of such Pareto optimal x .

As long as we insist on budget-balancing... we cannot achieve efficiency. Agents can cover improper actions behind the uncertainty concerning who was at fault. Since all agents cannot be penalized sufficiently for a deviation in the outcome, some agent always has an incentive to capitalize on this ... (Holmstrom 1982: 327).

Holmstrom argued that the best solution to the impossibility theorem would be to sacrifice a budget-balancing requirement, e.g. the distribution of benefits produced by the team should involve a larger set of people than the number of actual team members, whose actions determined the size of the benefits to be distributed. Consequently, Holmstrom argued that efficient team production requires a residual claimant – someone who does not take part in the production process but simply claims a share of benefits created by the team. Holmstrom emphasizes that for the scheme to be credible the residual claimant cannot be a team member, because her value to the efficiency is exactly in staying aloof from the production process. The presence of a passive residual claimant relaxes the budget-balancing requirement, allowing the attainment of the efficient outcome. Seen from this point of view, the separation of ownership and labor in modern corporations, which isolates shareholders from the day-to-day participation in the production

¹⁷ Nash equilibrium refers to a situation when there is at least one stable outcome in which each member of the team finds that her own self-interest is maximized, given the action of other participants. Pareto optimality refers to a situation when all team members should be in agreement that there is no other outcome (other than Nash equilibrium) in which they would all be better off. (Miller 2000: 294).

process, was recognized by Holmstrom as playing a budget-breaking and therefore efficiency-enhancing role.

The criticism of Holmstrom's solution to the problem of the efficiency of an interactive social production system is that it assumes away the problem of morally hazardous behavior¹⁸ on behalf of the residual claimant. As early as in 1984, Mukesh Eswarm and Ashok Kotwal in response to Holmstrom noted that the group punishment scheme¹⁹ – one of the incentive schemes, involving a passive residual owner that was suggested by Holmstrom – gives the passive owner 'the clear incentive to engage in morally hazardous behavior' (581). Presenting their argument in a formal fashion, Eswarm and Kotwal argued that since under the group punishment scheme the residual owner's share of the team's benefits increases drastically when the team does *not* reach the agreed level of the joint output (x), the residual owner prefers the team members to shirk. The scheme, therefore, gives the residual owner 'a clear incentive to bribe one of the agents to engage in a marginal amount of shirking' (Eswarm and Kotwal, 1984: 579). Effectively, by taking actions that affect the outcome of the production process (as bribing a team member), the residual claimant herself becomes a member of the production team herself, whereby re-imposing the budget-balancing, efficiency-retarding, condition. Consequently, Eswarm and Kotwal conclude that with the introduction of the passive owner the problem of moral hazard 'takes a different form but remains unsolved' (1984: 581). Their assessment of the danger of the residual claimant's moral hazard to efficiency is that it is potentially 'more devastating' than the problem of moral hazard of members of the production team. Equally important, in their three page long article, Eswarm and Kotwal pointed to a possible solution to the problem of the efficiency of a system of interactive social production – breaking the budget-balancing constraint *credibly*, i.e. to ensure (not assume as Holmstrom did) that the residual owner does not intervene into the team production process.

Continuing Eswarm and Kotwal's analysis sixteen years later, Miller argued that the only way the owner can stay aloof from the production process is by constraining herself ahead of time of any actions that can affect the team production (such as giving a bribe to a team member)

¹⁸ For the purpose of this dissertation the notion of 'moral hazard' refers to the existence of 'an incentive to take actions that are destructive to efficiency' (Miller 2000: 290).

¹⁹ Group punishment scheme sets the team members' payoff at x -level of the team's collective output. If, however, the output falls short of the x , no one member of the team is paid and the benefits created by the team are taken by the residual claimant.

(2000: 298). Only by denying the residual owner any opportunity to act, is the efficiency of the team achieved. Paradoxically, Miller argues, self-constraint ahead of time is also the only way that the owner can ensure sustainable maximization of profit for herself. It is so because team members have every reason not to trust any incentive scheme offered by the owner because of her persistent moral hazard, and anticipating opportunistic actions on behalf of the owner (such as bribing), the team members either would not accept the contract in the first place (Miller 2000: 297) or, in a more accurate account of reality, would converge on the zero-effort Nash equilibrium at t_2 if the owner reneges at t_1 (Miller 2000: 298). In other words, the fundamental problem of the organizational design of firms from a macro-efficiency point of view is credible commitment – believable containment of the residual owner’s authority to act on her profit-maximizing motives.

There are different organizational solutions to the problem of credible commitment in firms. Thus, a historical example, brought to the literature by Abraham and Prosch (2000), shows how at the end of the XIXth century Carl Zeiss Stiftung – sole owner of a famous German firm Carl Zeiss – set up a severance pay scheme as a ‘hostage’ that constrained it from arbitrary firing of employees.²⁰ Drawing on Tomas Schelling’s delegation to agent research (1960), Miller claims that one of the most efficient ways to commit the owner to the efficiency of the firm credibly is to delegate the owner’s authority (to make compensation decisions) to someone whose motivations are different from those of the owner. Having extensively studied the strategy of conflict, Schelling showed the value of an agent whose preferences differ from those of her principal for the avoidance of a nuclear war (1960). Miller claims that ‘the role of budget breaker calls for an agent of Schelling’s sort’ (2000: 300) – someone who is clearly not committed to the owner’s short-term profit maximization and points to the managers in paternalistic American firms such as Kodak or AT&T as such agents. It is the managers of those firms, not the owners, who make compensation decisions for employees. At the same time, their own compensation is not directly

²⁰ As any high-tech enterprises, Carl Zeiss, which specialized in optics, required from employees costly assets specific investments – optic-related knowledge and skills. Carl Zeiss Stiftung – the sole owner of the firm – had the opportunity to maximize its short-term residual by firing employees who made job-specific investments. Knowing that the owner can fire them any time, employees were reluctant to invest to optic-related knowledge and skills, which had little applicability outside the firm. To encourage employees to make that assets-specific investment, the owner established a ‘hostage’ for itself – severance pay for dismissed. If in pursuit of short-term profit the owner decides to fire an employee, it punishes itself by paying a severance fee to the laid off worker, thus reducing the size of its residual. Therefore, severance pay was an institutionalized form of the owner’s credible commitment to honor the compensation contract and therefore the long-term efficiency of the firm.

linked to the achievement of short-term profits for shareholders, but to the longevity of their employment in the firm and seniority of their position or what labor economics calls ‘deferred compensation’ (Lazear 1979). These personnel and compensation arrangements determine the managers’ preferences – they make managers visibly committed to long-run performance instead of quick profit maximization that is the shareholders’ motives. The structure of managers’ preferences makes their promise to respect the compensation scheme agreed with the employees credible from the employees’ point of view and, therefore, a Pareto-optimal Nash equilibrium outcome – that otherwise would have been inaccessible for the firm – is achieved.

In the light of Holmstrom’s approach, the primary role that managers play in corporate governance of paternalistic firms is to put the owners’ short-term profit maximization – efficiency-retarding – motives out of action. Personnel and compensation arrangements, such as seniority-based promotion and deferred compensation play a key role in ensuring that managers’ preferences differ from those of shareholders and therefore efficiency is enhanced.²¹ In addition to this, managers are insulated from shareholders’ efficiency-retarding interests by what Miller calls a ‘managerial discretion doctrine’, e.g. a legally entrenched principle that not only ‘makes it difficult for shareholders to sue managers for bad decisions (2000: 304) but also keeps them free from ‘direct control or supervision of anyone, including the firm’s shareholders’ (Blair and Stout 1997: 20).

Managers are in fact the third set of actors, acting as a solution to a commitment problem by owners. As the logical extension of Eswarm and Kotwal’s conclusion that with the introduction of the passive owner the problem of moral hazard ‘takes a different form but remains unsolved’ (1984: 581), it is plausible to argue that the introduction of the third set of players relocated moral hazard to the managers. The question then is, what keeps managers from diverting resources from

²¹ It should be noted that managers are not free from the possible illicit pressure of owners that can alter the structure of managers’ incentives and induce efficiency-retarding actions from them similar to how bribing one team member by an owner induces an inefficient outcome for all. Say, the owner can offer a share of a quick profit to a manager, who would bribe a team member who would engage in a marginal amount of shirking that would result in the team not reaching x -level of joint output and, therefore, bringing the owner a substantial quick return. Contrary to the situation with bribing a member of the production team, the corrupt manager is easily identifiable. This carries considerable costs for the manager: she will most likely be fired after the deal is revealed, lose her retirement arrangements and have considerable difficulties in finding another job. Therefore, the owner’s offer to a manager should be such as to compensate for all the possible losses associated with the breach of agreement and trust. The amount of manager’s compensation in the ‘quick return’ scheme seems being prohibitively large for the owner to make such an offer to the manager in the first place.

both owners and employees? Although Miller points to several mechanisms that may block unilateral, possibly selfish, actions of managers,²² his overarching conclusion is in line with that of Eswarm and Kotwal's – there is no system that can 'perfectly reconcile the conflicting self-interests of individuals in interactive social organization' (2000: 290).

3.2. Credible Commitment in States: Tying the Ruler's Hands

Miller's core innovation is his claim that the key problem of efficiency in team production – credible commitment of the residual claimant – is identical to the problem of public goods production by the state (2000, 2001). It is so because in both cases the problem is arising from 'the dominant strategy individuals face to free ride when actions are costly to observe' (Falaschetti and Miller 2001: 392). Moreover, theorists of both the state and firms independently from each other 'identify a necessary condition to sustain efficiency in collective endeavours – namely, the existence of an external agent' (Falaschetti and Miller 2001: 393). Thus, just like Holmstrom justified the need for a residual claimant in team production, social scientists argued – as early as Hobbs (1968[1651]) – that an external agent is necessary to sustain efficiency in public goods production. The role of this external agent, however, is quite different in Hobbesian and Holmstrom's analytical frameworks.

The role of the Hobbesian external agent – sovereign or Leviathan – is to supply incentives (mostly a threat of punishment) to free ride-minded individuals to work towards group objectives in return for a share of benefits created by the production of public goods. Thus, Hobbesian Leviathan is not only an external but also *active* agent, who acts on individuals' motives to free ride when their true preferences are costly to reveal (see Miller and Hammond 1994). In other words, only by backing the sovereign by force and the capability to punish an efficient social order is possible. On the other hand, as the discussion above showed, Holmstrom saw the value of the external agent for social efficiency in its passivity. Thus, to be efficient a system of interactive social production requires an external agent who is simultaneously an active actor (capable to punish free riding) and a passive owner of the residual. This inconsistency or 'logical impossibility' is, according to Miller, the root cause of our failure to find a perfect design of

²² Joint fiscal responsibility of owners and managers for the firms as a whole, 'political constraints' - the ability of employees and suppliers to make the managers' life difficult (via strikes, slow-downs, lawsuits and such like) which makes it rational for managers to keep 'the entire array of stakeholders cooperative and contented' (2000: 305), representational opportunities of the employees on advisory councils or even the board of directors and employee stock ownership (306) – and the power of professional norms (307).

governmental institutions that enables sustainable prosperity for all members of a society (Miller 2000: 289-290).

The question is then: “Why an active Leviathan cannot be at the same time a passive owner of the residual benefits”? The application of Eswarm and Kotwal’s analysis suggests that the production of public goods inevitably creates a temptation for powerholders to use the power of the state to maximise their residual, which is inconsistent with the overall social efficiency. Thus, a Leviathan’s property to be active, purposefully designed with efficiency-enhancing intent, can also play an efficiency-retarding role. A tendency of those who control the power of the state to maximize rent at the expense of the overall efficiency has been noted by other authors (Buchanan and Tullock 1962, Miller 1989, North 1981, North and Weingast 1989, Olson 1984). An early work of Miller (1989) showed how in the beginning of the 19th century in America the local ruling party organizations forced middle and small enterprises to pay large bribes by threatening the firms to enact a legislation that would be detrimental to the firm’s investment. Confiscatory extortion of the party machines meant ‘greater costs in recourses, uncertainty, and threat to property rights’ (689), a combination of conditions that discourages economic agents from participation. In a more general manner, North notes that throughout the history of humankind there has been a “persistent tension between the ownership structure which maximized the rents to the ruler (and his group) and an efficient system that reduced transaction costs and encouraged growth. This fundamental dichotomy is the root cause of the failure of societies to experience sustained economic growth.” (1981: 25).

Further application of Holmstrom and Eswarm and Kotwal’s research implies that in order to achieve efficient social order powerholders must be deprived of opportunities to act on their residual-maximizing motives. One way to do it is to diffuse the political power among multiple actors. In their seminal work North and Weingast (1989) showed how the enactment of a set of constitutional checks on Stuart kings²³ or ‘tying the king’s hands’ during the Glorious Revolution in the XVIIth century resulted in increased activity of economic agents, which eventually lead to a ‘remarkable’ economic effect (803). A recent theoretical contribution to the literature (Falaschetti and Miller 2001, Henisz 2000, Keefer and Stasavage 2003) has demonstrated that multiple veto players rather than a unitary agent have a greater capacity to produce credible

²³ The Crown’s authority was considerably diminished, parliamentary supremacy established and the ‘independence of the judiciary from the Crown was assured’ (1989: 816) by which ‘the beginnings of division or separations of powers’ was created (818).

commitment against opportunism.²⁴ Falachetti and Miller underline the welfare-enhancing nature of a constitutional design that maximizes ‘the transaction costs of putting together a decisive coalition’ (2001: 405) that eventually discourages powerholders’ moral hazard. A developed party system seems being an important element of such constitutional design (Aldrich 1995, Alesina and Spear 1988, Cox and McCubbins 1994, Gehlbach *et al* 2008). As long-lived entities political parties care about their reputation, the argument goes, and therefore they control individual powerholders from imposition of their rent-seeking preferences and renegeing on campaign promises. The delegation of authority to independent agencies has been identified as another institutional mechanism through which governments can enhance the credibility of their commitments. A growing body of research showed that politicians delegate when they want to increase a policy’s credibility at the stage of its implementation (for instance, see Horn and Shepsley 1989, Keefer and Stasavage 2003, Shepsley 1991). This argument is in line with a separate body of literature – on central banks – that has long underlined the role of independent central banks in cementing the credibility of government commitments in monetary policy (see Rogoff 1985).

Since both problems of efficiency – in teams and states – have the same root cause, then the introduction of Schelling’s agent into the production scheme might be as beneficial for the overall societal efficiency as it is for the firm as a whole. Miller argues that civil service is an important element of a system of organizational solutions to the problem of credible commitment in modern states.

3.2.1. Civil Service as a Solution to the Problem of Credible Commitment in Modern States

Miller claims that civil service provides ‘an enormous and beneficial shield for bureaucratic decision-making, protecting it from much of the day-to-day political influence...’ (2000: 316). Having said this, however, he provides a rather large picture of how civil service enhances efficiency. The aim of this section is to show how individual components of civil service type of bureaucracy shield bureaucrats from the day-to-day political intervention. Before we proceed, however, we shall clarify the notion of civil service.

²⁴ It is important to note that unlike other authors Falaschetti and Miller argue for the diffusion of hierarchical authority within a single actor rather than creating multiple external actors. Diffusing authority within a single agent equates to creating ‘a team whose members must act collectively to benefit from opportunism’ (2001: 401).

The notion of civil service has been interpreted differently in the academic literature. Some scholars treat the concept of civil service as public bureaucracy, i.e. a collection of all civilian non-elected posts within the government. Moreover, some authors of this group do not make any reference to the organizational design of public agencies they study (see Van Rijckeghen and Weder 2002), while others make a distinction between politicized (patronage) and de-politicized (meritocratic) civil services (Gaidushek 2007, Meyer-Sahling 2004, 2006, 2007). Another group of scholars treat civil service as the dominant organizational structure of the American public bureaucracy through the 20th century. For instance, Tolbert and Zuker note that ‘prior to the recent wave of reforms (President Carter’s reform of 1979 - MN) civil service structures ... were nearly universal in the United States’ (Tolbert and Zuker 1983). Similarly, Patricia Ingraham states that ‘The prevalence of civil service was as such that it was a synonym to human resource management system’ (2003: 49). Since a key characteristic of the organizational design of the U.S. public agencies is the removal of staffing powers from politicians’ hands, some researchers use the notions of civil service in the sense of a fully de-politicized public bureaucracy (Frant 1993, Krause *et al* 2006, Lewis 2007), which constitutes in our opinion, the third approach. Thus, Howard Frant refers to civil service as a type of personnel policy where ‘important decisions about hiring, firing and promotion are ... not under the control of the chief executive’ (1993: 990). The idea of a *degree* of de-politicization or the amount of authority over personnel decisions inherent in the interpretation of civil service as a fully de-politicized bureaucracy, suggests that de-politicized bureaucracies may vary with regard to the degree of political influence over personnel policy decisions. Jan-Hinrik Meyer-Sahling argues that relevant legislation ‘defines the specific set of personnel policy instruments, which ministers can choose to use as control measures in order to achieve bureaucratic compliance...’, and a combination of the instruments available to politicians in hiring, firing and promotion eventually defines a degree of politicians’ freedom to ‘determine the outcomes of personnel policy’ as stipulated by law (2006: 696).

Although there is no direct evidence that Miller recognizes civil service as a fully de-politicized bureaucracy, the logic of his argument implies that the greater the degree of de-politicization of public bureaucracy the higher the probability of the occurrence of stable socially beneficial outcomes. Therefore, for the purpose of this dissertation we employ the notion of civil

service as an analytic concept, meaning a *fully* de-politicized public bureaucracy or a type of bureaucracy in which politicians wield the lowest amount of authority over personnel decisions.

A good starting point for the understanding of the welfare-enhancing effect of civil service is to look at the civil service's opposite – a politicized bureaucracy or patronage. Patronage is an organizational design of public bureaucracy, in which patrons have their 'hands free' with regard to the personnel decisions. As powerholders can hire, fire, promote or demote any of their bureaucratic subordinates at any time, these powers provide politicians with an effective instrument of influencing the work of non-elected governmental officials. Thus, patronage-entry to bureaucracy – in which a political superior appoints her bureaucratic subordinates at will, choosing among a handful of candidates, one way or another affiliated with the superior – enables powerholders to establish firm control over of bureaucratic behavior from the onset. In her MA thesis, devoted to recruitment practices in one of the Russia's regional governments in the beginning of 2000s, the author discovered that bureaucrats hired at patron's will felt that they should do as the patron tells because, in words of the respondent OAV, 'it is because of him that I am working here and if I don't carry out his orders today I won't be working here tomorrow' (Nistotskaya 2001: 32).²⁵ A very personalized mode of entry to the service as well as a credible threat to dismiss or demote a bureaucrat, or to postpone her promotion allow powerholders a high degree of control over their bureaucratic personnel. In words of Howard Frant (1996), organizational design of politicized bureaucracies provides 'high-powered incentives': the bureaucratic personnel is well 'attuned' to the preferences of the political masters and is prepared to put an extra effort into the work. However, the same high-powered incentives would make bureaucrats not only to work longer hours but also to bend the implementation of the law in response to informal pressure of opportunistically minded powerholder. Not responding to the powerholder's demands would most likely have adverse consequences for the bureaucrat, since politicians are capable to punish a defiant bureaucrat. Therefore a rational strategy for the bureaucrat would be to fully succumb to the demands of the powerholder, including illicit ones. Because moral hazard of the residual claimant is a structural characteristic of any system of interactive social production, it is plausible to expect that the magnitude of such pressure on bureaucrats would be high and, therefore, the welfare-undermining effect would be large.

²⁵ In addition respondents felt compelled to 'pay back' the favor of employment to the patron, which could be explained by the fact that in the 1990s the exchange of favors remained an important element of the socio-economic fabric of the Russian society and a deeply entrenched behavioral norm (see Ledeneva 1998).

In civil service bureaucrat obtains her post in a bureau not through personal connections to the patron, but on the basis of her professional credentials and in a competition open to the general public. This, has been rightly said, brings increased competence to public agencies and *esprit the corps* (Rauch and Evans 1999). However, more importantly from our point of view, meritocratic recruitment eliminates the very phenomenon of patron from the bureaucratic worldview. Paraphrasing the words of the respondent OAV from our 2001 research, ‘I am here not because an individual patron wished this, but because I saw a vacancy announcement in the mass media, submitted my application, and my knowledge and skills got me through the entry examination’. One can say that meritocratic recruitment eliminates the environment of personal loyalty and the high-powered incentives built into it. Instead it can be seen as the foundation in a ‘lifelong commitment to a firm’ (Miller 2000: 316) inherent in the civil service organizational design.

Another important building block of the bureaucratic commitment to larger long-term policy goals is the prospect of a life-long employment integral to many forms of a de-politicized bureaucracy. The argument that prospects of a long-terms career cause bureaucrats to internalize the goals of the organization – not of their political master – was well-established well before Miller (see Wilson 1989).²⁶ The prospects of a life-long employment are credible because bureaucrats can be fired only for a gross misconduct (as bribery conviction), on the decision of the court or the bureaucratic self-government organization (such as civil service commissions, Corps and such like). This implies that life-long career prospects not only make bureaucrats less ‘attuned’ to the powerholders’ preferences but also less responsive to the their day-to-day oversight, which is exactly what we aim at designing an efficient system of interactive social production.

Just like during recruitment politicians wield no decision-making authority, seniority-based promotion – another central characteristic of the civil service type of bureaucracies – leaves no room for political intervention into personnel issues. The specificity of seniority-based promotions is that they occur in an almost automatic fashion as a function of the bureaucrat’s longevity in the service. Since seniority-based promotions do not presuppose a residual decision-

²⁶ A standard politico-economic account views politicians as being primarily motivated by re-election (see Alesina and Tobellini 2007)

maker, a politician's promise to promote a bureaucrat or a threat to demote her is not fully credible (Frant 1990). Similarly, a pay system in civil service is grounded to the bureaucrat's longevity in the organization and her rank. It is governed by an administrative procedure and a residual decision-maker is not required. Therefore, neither politicians can relocate officials along the bureaucratic ladder, nor influence their level of remuneration. This implies that bureaucrats are much less sensitive to the day-to-day oversight by their impotent bosses.

It should be noted that Miller does not argue against the overarching control of politicians over public bureaucracy: in a democratic state elected officials are legitimate masters of non-elected ones. Politicians' responsibility is, however, not in the day-today oversight of bureaucracy but in reaching agreement on a package of public goods and policies that would be implemented by the bureaucracy (2000: 318). This implies that social welfare is not threatened when politicians exercise their control as a collective actor and ensure that bureaucracy carries out public policies that reflect the preferences of the citizens as a whole (aggregated, although imperfectly as Arrow's (1950) impossibility theorem teaches us, by the legislature) and not of individual constituencies or individual powerholders.²⁷ Social welfare is, however, threatened when politicians push for narrow (i.e. of favored constituencies, including log-rolling) or selfish interests in public policies; and that is precisely what civil service guards against.

To sum up, Miller's adaptation of Holmstrom's and Eswarn and Kotwal's research to states highlights the value of a fully de-politicized bureaucracy in preempting politicians' moral hazard penetrating public policies. It provides a rigorous positive explanation for a century old normative claim of Max Weber about the superiority of his 'ideal-type' of bureaucracy, featuring attributes of a de-politicized type of bureaucracy (Weber 1946).²⁸ Informed by this, we showed how individual features of civil service buffer bureaucratic policy-making from regular influence of opportunistically minded politicians: meritocratic recruitment, seniority-based promotion and a pay scheme, together with prospects of a long-term career make bureaucrats irresponsive to the

²⁷ Despite the Arrow's impossibility theorem, following Aron Wildavsky we assume than democratically agreed policies have a welfare-enhancing – rather than faction- or self-enrichment – intent. 'A promise underlines public policy: if the actions we recommend are undertaken, good... consequences rather than bad ... ones actually will come about' (Wildavsky 1979: 35).

²⁸ Prior to Miller the value of civil service were mostly seen in terms of its ability to mitigate the moral hazard on the part of bureaucrats by expanding time-horizons of public managers, committing them to larger and long-term policies, and generating behavioral norms conducive to more efficient operation of governments (Evans and Rauch 1999, Rauch 1995, Rauch and Evans 2000).

preferences of individual powerholders, providing instead incentives for bureaucratic commitment to long-term policy goals.

3.2.2. Standard Operating Procedures and Professionalism as Other Solutions to the Problem of Credible Commitment in Modern States

In addition to civil service, Miller argues, there are two other institutional mechanisms through which politicians can be credibly committed to a social welfare intent of public policy: standard operating procedures (SOPs) and the power of professional norms.

‘Standard operating procedures’ refer to a set of written rules and procedures that a bureaucrat is required to follow performing her official duties. The control role of SOPs has been appreciated by political scientists since at least McCubbins *et al* (1987), who showed SOPs as an instrument of political control of the bureaucracy. The point that Miller makes is that SOPs are like a double-edged sword: they help ‘to identify and punish both the use of arbitrary power by bureaucrats... and elicit pressure from outside interests’ (2000: 318). He brings a dramatic example from a recent American history – so called the Keating Five scandal of 1987-90 – to show how, justifying their decisions by the reference to SOPs, four civil servants were able not to succumb to the pressure of five powerful US senators (including the Republic nominee in the presidential race of 2008 John McCain), who demanded a special treatment for the business of one of their major political contributors – Charles Keating of Lincoln Savings and Loans. William K. Black, one of four civil servants who were called to Washington D.C. to meet the senators, said that the meeting was ‘a show of force’ as the civil servants had to face ‘one-twentieths of the Senate in one room’ (Nowicki and Muller 2007).

Thus, by referring to a prescribed sequence of actions, standards of evidence or timetables, bureaucrats can buffer the policy intent from alterations by opportunistic powerholders. The power of SOPs should not, however, be overestimated, as it is difficult to imagine Mr. Black and his colleagues being sufficiently shielded from an ‘enormous pressure’ and ‘intimidation’ (Keating Economics 2008) of the senators by SOPs, had the senators been able to sack them at will. The strength of the welfare-enhancing impact of SOPs is likely to vary under different circumstances, and the example above suggests that such impact of SOPs is likely to be higher the greater a degree of de-politicization of a bureaucracy.

It should be noted that not all consider the promulgation of SOPs as an efficiency-enhancing measure. Thus, reform movements of the 1990s heavily criticized the prevalence of

SOPs, or a system of accountability through following rules, as inadequate to the needs of societies living in an Information Age and suggested cutting red tape and moving to accountability through achieving results (Gore 1993, Osborne and Gaebler 1992). However, as Pandey and Moynihan noted, the thinking of reformers did not take into account the academic literature on red tape, including a ‘groundbreaking’ theoretical work by Bozeman (1993) and Kaufmann’s (1977) ‘seminal’ work (2006: 130). Meanwhile, Bozeman (1993, 2000) showed that only some SOPs could be qualified as red tape, i.e. ‘have no efficacy for ‘the rules’ functional object’ (1993: 283) and Kaufmann, drawing on a classic interest group pluralism approach, demonstrated that ‘one person’s red tape may be another’s treasured safeguard’ (1977: 4). Taken into consideration that SOPs are either directly enacted by legislative statutes or derived by bureaucratic agencies within the parameters set by the legislation (Schneider 1992), SOPs could be seen as a safeguard of the welfare intent of public policies against narrow or self-serving interests. The Keating scandal illustrates this point well:

The political interests who object most loudly to runaway or unresponsive bureaucrats are often special interest, like Keating, who find that bureaucrats obeying the law as articulated by Congress rather than bending the law in response to informal pressure (Miller 2000: 317).

The third organizational solution to the problem of credible commitment in modern state is, according to Miller, a professionalized bureaucracy. Although the notion of a profession is one of the most contested analytical abstracts in social sciences, scholars agree that professions are a form of work involving a distinct body of systematic knowledge (Abbot 1988, Bledstein 1978, Scarlett 1991). An important implication of the existence of a distinct body of knowledge is that it gives rise to a related professional ethics, which guides and constraints the behavior of the members of the profession. As Asa Kasher puts it: ‘a professional act is the subject matter of the related professional ethics’, i.e. a system of values, norms, principles, rules, policies and solutions (2005: 74-75). Bearing this in mind, a professionalized bureaucracy could be seen as a bureaucracy populated by people whose behavior is guided by professional ethics.²⁹

²⁹ In France and Spain professionals in different governmental agencies are united into profession-based self-regulatory organizations – Corps. In the US federal government there are many profession-based agencies as , for instance, The Federal Reserve System (economics), The U.S. Environmental Protection Agency (environmental science) and such like.

It is clear that as an institution that guides human behavior, professions are quite different from politics. As Mosher noted,

‘There is a built-in animosity between the professions and politics... Professionalism rests upon specialized knowledge, science and rationality. There are correct ways of solving problems and doing things... Politics is to the professions as ambiguity to truth, expediency to rightness, heresy to true belief ’ (1982: 118-119).

Therefore, the role of a professionalized bureaucracy in public goods production is that of Schelling’s agent – it brings about an actor whose motivations are different from those of politicians. Just like civil service commits bureaucrats to long-term organizational goals, professions commit bureaucrats to ‘*correct ways*’ of bureaucratic decision-making, where ‘correct’ is determined by the professional knowledge and ethics. Professional ethics requires a bureaucrat to evaluate a possible political interference into bureaucratic decision-making from a professional point of view, instead of immediately taking them as an ‘actions guide’ (as principal-agent theory prescribes). A dense net of professional norms makes it more difficult for morally hazardous motivations of powerholders to penetrate the public goods production.

If the argument about the power of professional norms sounded quaint in the 1980s – beginning of the 1990s, when the ‘incentive revolution’ was in its zenith, it has gained more recognition recently. For instance, the professional act of William K. Black and his colleagues in the Keating Five case became the subject of at least three recent studies with quite telling titles: *Unsung Heroes: Federal Execucrats Making a Difference*, *The Consummate Professional Creating Leadership* and *The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication* (Ricucci 1995, Bowman *et al* 2004, Tonon 2008).

Similarly to SOPs, the power of professional norms is likely to have a different strength under different circumstances. Since professions and politics are rivalry rather than complimentary institutes, a de-politicised bureaucracy allows for a more consistent application of professional norms than a politicised one. This implies, that the strength of both SOPs and professionalization depends on a type of personnel policy existing in a given policy: the greater de-politicisation of bureaucracy the stronger the welfare-enhancing effect of SOPs and professional norms. Given the importance of the role that personnel policy plays in the bureaucracy-related institutional arrangements that determine social welfare, and also taking into

consideration financial and other limitations arising from the nature of doctoral research, in the remaining of the dissertation we focus on ‘personnel policy regime’ factor.

3.3. Limitations of Civil Service as a Solution to the Problem of Credible Commitment in Modern States

Having provided a plausible explanation how a de-politicized bureaucracy, by creating barriers between those actors of a system of interactive social production with moral hazard and the producers of the benefits, enhances the occurrence of socially beneficial outcomes, the theory also exposes the limitations of civil service as a welfare-enhancing device.

The first considerable limitation is that civil service does not induce the best bureaucratic effort, thereby arguably preventing the achievement of socially-optimal output. Johnson and Libecap (1994) convincingly demonstrated that supervisors are severely constrained by civil service law to sanction inadequate bureaucratic effort and to reward superior one. Similarly, heads of 847 agencies and divisions in 10 American states, surveyed by Elling (1986), ranked difficulty in rewarding a better bureaucratic effort and difficulty in disciplining employees as the first and the fifth most serious managerial problems. Having been shielded in civil service, bureaucrats may become irresponsive not only to morally hazardous influence of politicians but also to their legitimate quests. Weir and Skocpol (1985) reported an interesting example of how in reaction to the Great Depression English politicians, becoming increasingly frustrated with the work of the Labour Department’s bureaucracy, repeatedly took advantage of the loopholes of the British civil service legislation to bring to the Labor Department’ higher positions people from outside the civil service on fixed contracts. The Labour Department soon after become a center of policy innovations and contrasted sharply with the ‘stodgy conservatism’ of other domestic departments (Weir and Skocpol 1985: 127).

To sum up, ‘reduced incentive intensity’ (Frant 1996: 378) integral to civil service does not induce the best possible bureaucratic effort. In a sense, it disables Leviathan’s *active* properties, which are important for achieving social welfare. A better bureaucratic effort is certainly induced if politicians retain a great deal of control over personnel decisions. However, the advancement of Leviathan’s properties as an active agent also enhances its capacity to act more decisively on

its own rent-extracting motives. In other words, designing governmental institutions we face a tradeoff between two corner solutions: an active Leviathan, capable to induce best bureaucratic effort but also to abuse the power of the state for its own benefit, and a Leviathan, who is constrained in its capacity to act on its own profit-maximizing motives but unable to induce the best bureaucratic effort. Although the first design has the capacity to yield the best outcome (an active Leviathan effectively acts on free ride motives of the members of a system of interactive social production, induces best bureaucratic effort but does not act on its own rent-seeking interests), the continuous presence of Leviathan's rent-seeking motives makes such an outcome unstable. If, however, Leviathan succeeds in acting on its self-interests, the worst outcome is most probable – more and more participants withdraw from a system of interactive social production or converge on the zero-effort Nash equilibrium. In the light of this, there is a good reason to settle on a solution that contributes to the prevention of the subversion of public policies from its welfare intent by particularistic or rent seeking considerations and enhances the probability of the occurrence of socially beneficial public policies, implemented may be slowly and not necessarily to its maximum potential.

Another considerable limitation of civil service arising from Holmstrom's impossibility theorem is that moral hazard cannot be fully eliminated from a system of interdependent social production, but merely relocated. This implies that bureaucrats may be carriers of moral hazard as well as politicians. If so, then in civil service bureaucrats seem being perfectly positioned to realize their selfish calculus: on the one hand, they possess significant discretion in rule-making and implementation, which enables them to trade the powers of the state for private gains; on the other hand, civil service provides them with a life-long employment, exempt from effective day-to-day oversight. Indeed corruption is widely perceived as one of the reasons that discourage investment and hamper economic growth (Aidt *et. al* 2008, Del Monte and Papagni 2001, Gaviria 2002, Fisman and Svensson 2007, Mauro 1995).

Miller argues that just as civil service constrains politicians from welfare-undermining actions, it does gag bureaucratic selfish calculus. A combination of a system of deferred compensation with high costs of bribery conviction promotes, what Miller calls, 'an unprecedented level of honesty within bureaucracy' (2000: 316). A system of deferred

compensation integral to civil service brings most of the material gains at the end of bureaucratic career.

Civil service is a dramatic instance of deferred compensation. Civil servants... are paid less than their true marginal productivity early in their careers. They are rewarded for making a lifetime commitment to a firm by opportunities for promotion, pay raises, and beneficial retirement plans (2000: 316).

A bribery conviction – dismissal from office, often without a possibility to return to service – carries substantial immediate and deferred material losses. Under a credible threat of dismissal for bribery, a rational bureaucrat may not want to jeopardize her prospects for a long-term and rewarding career by receiving a bribe (unless the bribe is as large as to compensate all current and deferred losses and a possibility to rejoin the service). In the same vein, Evans and Rauch (1999) argue that career prospects ‘reduce the relative attractiveness of the quick return from corrupt individuals’ practices’ since the costs of breaking organizational norms are ‘directly proportional to the expected longevity of membership in the organization and the expected reward to longevity’ (752).

It has been argued that a depoliticized bureaucracy not only mitigates the perverse effects of moral hazard on the part of politicians (and bureaucrats alike), it also contributes to a positive solution of the problem of adverse selection by encouraging the development of human capital and a lasting competence (Evans and Rauch 1999: 752, Miller 2000: 318, 320, 325, Rauch 1995: 970-971), namely:

- meritocratic recruitment enables the selection of least minimally knowledgeable and skillful individuals, e.g. increases the quality of human capital in governmental agencies (Evans and Rauch 1999: 752);
- meritocratic recruitment is a necessary precondition for the rise of ‘the constraining and motivating power of professional norms and expectations’ (Miller 2000: 320)
- prospects of a long-term employment facilitates job-specific investments on behalf of public managers that positively affects the bureaucratic output (Miller 2000: 318);
- the fact that under civil service bureaucratic and political terms of service do not coincide provides a degree of stability (especially at the end of the political term when the attention of politicians is moved away from their lawmaking duties to reelection or a post-political career), continuity and predictability that is appreciated by investors and entrepreneurs (Miller 2000: 322).

Although relevant literature points at several additional mechanisms that may block selfish actions of bureaucrats – including SOPs (Miller 2000), public service motivation (Perry and Wise 1990), improved civic control (Deininger and Mpuga 2004), the role of mass media and international organization – the message of Miller’s synthesis is that moral hazard cannot be fully eliminated from a system of interdependent social production and no organizational solution can perfectly reconcile the conflict of self-interested individuals in interactive social organizations. In a world of second-best solutions, civil service plays an important role in credibly constraining rent-seeking interests on behalf of powerholders and bureaucrats alike that invariably present in a system of interdependent social production.

By limiting the staffing powers of politicians, civil service reduces the number of ‘technical’ points of entry in the day-to-day process of public goods production available to opportunistically minded politicians.

4. Conclusion and Discussion

A theory of efficient system of interactive social production, advanced by Gary Miller, provides us with a rather pessimistic finale that social welfare cannot be perfectly protected from rent-extracting activities of politicians and bureaucrats. At the same time, the logic of a system of interactive social production enables us to understand the nature of trade-off policy-makers face designing public bureaucracies. Miller’s analysis makes it clear that politicians’ moral hazard creates a greater danger to welfare than that of the bureaucracy, and reveals that a greater de-politicization of bureaucracy enhances the likelihood of the occurrence of socially beneficial outcomes.

Miller’s analysis is of special importance for post-Communist countries such as Russia, where ‘double transition’ amplified the politicians’ moral hazard. On the one hand, the change from command to market economy created the abundance of rents, which is considered by the relevant literature as the ultimate source of rent-seeking behavior (Mauro 1998). On the other, this massive change in the ‘rules of the game’ was taking place in the political environment of nascent democracy, where a system of checks and constraints, such as the separation of power and party discipline, was underdeveloped. In such a context the problem of political opportunism is a critical issue in the design of public agencies.

This dissertation subjects Miller's theory to empirical test in a relevant milieu, as in 1995 Russia launched an administrative reform, aiming to convert its state bureaucracy from a *nomenclatura*/patronage to a de-politicized type. The remaining of the dissertation assesses the formal-legal framework governing personnel decisions in Russian public agencies, evaluates a degree of institutionalization of the formal personnel instrument by means of expert evaluation of the practice of hiring, firing and promotion in a sample of Russia's regional governments, and the impact of 'real' merit on small business growth is measured in a series of OLS regressions.

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