

Thinking about Bureaucracy: Mises versus Niskanen

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In this paper, I oppose the Misesian insight on the problem of bureaucracy to the theory of Niskanen. Assuming that bureaucracy is merely a symptom of a more serious disease – namely socialism – the Misesian perspective is an analysis of the economic, political, and psychological consequences of the incentives and constraints that bureaucrats face. Niskanen's analysis focuses on the characteristics of the political environment in which bureaucrats act. Applying the Public Choice theory to the study of bureaucratic behavior, Niskanen shows that bureaucrats have a strong incentive to try to maximize the bureau's budget.

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Ludwig von Mises: Bureaucracy as an Effect of Interventionism

Ludwig von Mises is considered the first scholar to study the productive behavior of bureaus from an economic point of view.

Mises presents his theory of bureaucracy in his famous book published in 1944¹. Mises believes that the bureaucracy is a symptom of

¹ "[T]he main thesis of Professor von Mises is that bureaucracy is merely a symptom of the real disease with which we have to deal. That disease is excessive State domination and control... Published on the day after F. A. Hayek's *The Road to Serfdom*, Professor von Mises' *Bureaucracy* once more calls attention to the ironic fact that the most eminent and uncompromising of defenders of English liberty, and the system of free enterprise, which reached its highest development in America, should now be two Austrian exiles." Hazlitt, Henry. "Bureaucracy Defined." *New York Times Book Review*. (October 1, 1944), 5;

the rapidly spreading disease: the rise of state intervention in the economy. The normal consequence is the spreading of a new type of management for the centralized allocation of resources: bureaucratism. The disease is not bureaucracy, says Mises, but socialism. The private enterprise and the government bureau are two separate worlds. Different incentives and constraints that managers as opposed to bureau chiefs face lead to different types of behavior. Bureaucracy is merely an instrument that the government uses for conducting the activity of its bureaus. The management style and performances of bureaus cannot be compared to the ones of private, profit-seeking enterprises. There is no point in criticizing the activity of government bureaus. The only way to go is to restrict the purpose and scope of government. In Mises's view, the economic education of the public will lead to a diminished support for big governments and so forth to diminished bureaucratism. In other words, the ideological war is permanent and its results determine the economic policy.

The main characteristics of bureaus as defined by Mises are:

- Bureaus specialize in the supply of those services the value of which cannot be exchanged for money at a per unit rate;
- Bureaus cannot be managed by profit goals and the economic calculation;
- In the absence of profit goals, bureaus must be centrally managed by the pervasive regulation and monitoring of the activities of subordinates.

The economic calculation and government bureaus

Every new business proposition is based on the estimation of profit and loss. New projects are subject to a thorough examination in order to determine the chances that they offer. Every stage of the project is

ascertained by accounting. The accounting offers a guide for the management of the entire business and of every part. Every manager is responsible for the efficiency of his department. Following his own interest, he has a strong incentive to promote the best interests of the enterprise. The supremacy of the consumers, shows Mises, enters every department of the enterprise. The profit motivation is the main principle of the firm's management.

Lacking the profit motivation, the bureaucratic management is the management that must follow rules and regulations set by a higher division. The performance of every organization depends on the decisions that medium and lower managers make every day. They are free to make decisions. The decision-making mechanism is also comprised of central decisions that medium and lower managers must put into action. The position of a bureaucratic organization is different from the one of a profit seeking enterprise. The aim of any bureaucrat is strictly obeying the rules and regulations. His freedom to act according to his own preferences is limited by those rules. In Mises's words, the bureaucratic management is the management of those activities that cannot be led by economic calculation. The objectives of the public administration (as a typical example of bureaucratic organization) cannot be measured in money terms.

In public administration, there is no connection between revenue and expenditure. The price of a public good supplied by the state is not determined by the market. That does not mean that the public goods have no value for the consumers. The performance of a governmental agency cannot be easily measured. The consequence is that the behavior of the bureaucrats is very different from the behavior of the executives in private enterprises. The value created by a government agency cannot be determined. The main feature of a bureaucratic organization is therefore the impossibility to measure its performance. This fact has major consequences for the management. First, it is difficult to find proper standards that can be used to assess the performance of every individual and department. Second, it is difficult to

measure the costs and the benefits of the agency. Third, different branches of the central and local government can have public expenditure programs with different and incompatible aims. Due to the impossibility of measuring costs and results, applying a system of rewards and sanctions, both to individuals and to the group, is impossible.

The profit motivation is essential for determining the incentives and constraints that managers face. The management that aims to achieve profit is the management that serves the interests of the consumers. The managers that are successful in satisfying consumers are rewarded with greater income. The bureaucratic management is the management that aims to obey hierarchical orders. In bureaucratic organizations, successful managers are those who best follow orders. Therefore, the connection between consumers' satisfaction and the success of managers is no longer valid.

William Niskanen's view: the Budget Maximizing Bureaucrat

William Niskanen is considered the first modern economist to study the problem of bureaucracy from an economic point of view. Niskanen assumes the Public Choice methodology in his study of bureaucratic objectives and behavior¹. Public Choice theorists have been interested in applying the method of economics to the political processes in order to better understand the collective decision-making process and the implementation phase of any economic policy measure. Until the Public Choice revolution, the implementation phase of economic policy had received little attention². Mainstream economists simply assumed that bureaucrats assigned with carrying out specific measures act in a faithful and unbiased manner. The outcome of the

¹ James McGill Buchanan and Gordon Tullock inaugurated the field of Public Choice in 1962 with their book "The Calculus of Consent: Logical Foundations of Constitutional Democracy". An excellent introduction into the domain of Public Choice and the main policy recommendations that Public Choice theorists make can be found in James D. Gwartney et al. (2005);

² The phrase *Public Choice revolution* is used by Pierre Lemieux (2004);

proposed economic policy could not be different from economists anticipated. The government intervention for correcting the cases of market failures seemed a reasonable idea. After the integration of the study of bureaucracy into Public Choice and because of this, alongside with the study of politicians' incentives and constraints, the role of government as a corrective mechanism had to be reconsidered.

Niskanen presented his theory in a series of articles, the first and most famous of which being "The Peculiar Economics of Bureaucracy" published by the American Economic Review in 1968. Niskanen's article relaunched the debate about the problem of bureaucracy. Niskanen's theory has been criticized and completed by numerous articles since than¹ (4).

The main elements of the initial framework in which Niskanen places his theory are summarized below:

- Bureaus are nonprofit organizations that are financed by a periodic appropriation or grant;
- Bureaucrats are similar to the officials working in other organizations;
- There is a bilateral monopoly in the activity of bureaus and sponsors;
- The relationship between the bureau chief and the sponsor is characterized by an information asymmetry;
- The aim of any bureaucracy is to maximize its budget.

Let us take a closer look at each of these elements.

¹ Niskanen (1994: pp. 269-283) makes a reassessment of his theory at more than twenty years since it was initiated and summarizes the main elements that had to be modified.

Definition

Niskanen uses a definition of bureaus that is different from the one of Mises. For him, bureaus are organizations with the following two characteristics:

- The owners and employees do not appropriate any part of the difference between revenues and costs as personal income, and
- Some part of the recurring revenues of the organization derive from sources other than the sale of output at a per unit rate (Niskanen, 1994: p. 15).

The focus of Niskanen's analysis is on government bureaus, but his definition covers as well other organizations, public or private. The people working in a bureaucracy are called bureaucrats, and the head of the bureau is called bureau chief. Thus, the terms bureaucrat and bureaucracy have no normative meaning. Public Choice theorists also define the sponsor as being the politician who hires and oversees the bureau chief.

Incentives and constraints

In the analysis of the bureaucrat's behavior, Niskanen employs the hypothesis that the bureaucrat is no different from the business people or managers in privately owned enterprises. One does not need special characteristics in order to become a public servant. If the analysis of the bureaucrat's behavior leads us to the conclusion that he acts differently than the manager, this fact cannot be the result of different characteristics of the two. The key element that we have to consider is the difference between the incentives and constraints that business people and bureaucrats face.

The bilateral monopoly of political demand and bureaucratic supply

Most of bureaus have only one buyer for their service, usually a group of political officials. They are completely dependent on the politicians in their activity. The demand for the output comes from the political sponsor, rather than from the consumers of the service. Most bureaus are monopoly suppliers of their service. The political organization is also dependent on the activity of bureaus to supply a certain service. Therefore, the bureau and the political sponsor are dependent on one another. The service that a bureau offers is usually a promised set of activities and the expected output of these activities for a budget (Niskanen, 1971: p. 25).

The information asymmetry

Niskanen assumes that there is asymmetry information between politicians and bureaucrats. There are two types of information in any transaction: information about supply and information about demand. Each part involved in a transaction has an interest in knowing the other's part intentions. The bureau chief is in a better position regarding the access to relevant information than the politician who supervises his activity. The bureau chief usually knows more about the politician's demand than does the politician about the costs of supply. The bureau chief can easily learn about the politicians demands for bureau services since the legislature's meetings and the government's policies are typically open to the public. The politicians have limited ability to keep their demand for bureaucratic supply of services secret. On the other hand, the politician cannot learn easily about the costs of supply of a particular bureau. No one can know better than the bureau chief the opportunity for incurring some costs. Therefore, the bureau chief has an incentive to be secretive.

The consequence of the information asymmetry is that bureau chief has the ability to increase the bureau's budget more than it would be optimal even from the politician's point of view.

The budget maximization behavior

Niskanen assumes that the main goal of the bureau chief is to make his bureau as large as possible. In other words, he will try to maximize his budget. A high budget is very beneficial to the bureau chief and to the lower level bureaucrats. The many goals that the bureau chief may have can be better achieved with a higher budget, *caeteris paribus*. Among the goals of the bureau chief, we can enumerate prestige, transfer to a larger or better bureau or other government position in the future, getting a good job in the private sector, and being elected to a political office. Lower-level bureaucrats also favor a large budget. A large budget means an increase in the size of the workforce. Therefore, the demand for supervisors is likely to increase. The chances for promotion are higher in a large organization. A large budget could also mean a better working environment for lower level bureaucrats. They may have more machines, a larger building, and a more modern equipment to work with. Lower level bureaucrats are consequently likely to favor a bureau chief that promises to increase the size of the bureau.

Politicians are also likely to favor of bureau budget that is higher than optimal. The aim of the politicians is usually to be reelected. A bureau chief can help politicians achieve this goal. Some part of the budget of the bureau will be diverted to helping the politician. The larger the budget that a bureau has, and the greater the discretion power that the bureau chief has in deciding how the budget is spent, the more help can the bureau chief offer to the politician. The opposition party in the legislative is likely to oppose the use of funds for helping the ruling party. However, sometimes even the opposition party members have something to win from a larger budget.

The bureaucratic production

Building on the described hypotheses, Niskanen deduces the equilibrium level of output for a bureaucratic organization. The question that Niskanen's theory tries to answer is: how much higher will the budget of a bureaucratic organization be, compared to the consumers' optimum? The bureau's output is higher than the level demanded by the median voter. Therefore, Niskanen's model relates two kinds of optima: political optimum and bureaucratic optimum.

Applying Niskanen's model, the following conclusions are reached:

1. A bureau will supply an output up to twice that of a competitive industry;
2. At the equilibrium level of output, a bureau will generate smaller net benefits than a competitive industry;
3. The politicians prefer an output that depends on marginal costs and on marginal evaluation of the median voter (Niskanen, 1994: 64 – 65).

Mises and Niskanen: common ground and main differences

Analyzing bureaucracy, Niskanen is interested in the productive behavior of bureaus. The main questions that Niskanen's theory aims at answering are:

What is the level of output that bureaus are interested to produce?

What is the relation between the equilibrium level of production from the consumers' standpoint and from the politicians' standpoint?

What are the main features of the environment of bureaus and how does the environment influence their behavior?

What are the effects of different voting rules and tax systems on the equilibrium level of public services in a representative democracy?

The main normative questions that the Niskanen's model tries to answer are:

Should a given public service be supplied by a governmental bureau or by a private firm?

What changes in the bureaucracy and the political institutions should be made to increase the net benefits from the supply of public services? (Niskanen, 1994: 11)

Of particular interest is in Niskanen's view the environment of the government bureaus. This environment is best described by analyzing the incentives and constraints that bureaucrats face. The institutional environment is the starting point of Niskanen's analysis.

Mises takes a similar stand. The objectives presented in his "Bureaucracy" are different though. Mises's analysis aims at comparing the bureaucratic production with the works of private enterprises in a free economy. The essential mechanism in this kind of economy is economic calculation. The activity of bureaus cannot be run by the principle of economic calculation. If there is no economic calculation, says Mises, human rationality is rejected from decision-making; economic chaos will soon follow. There is no point in trying to improve the outcome of bureaus, suggests Mises. The only way to go is to restrict the role and scope of the government. Mises extends his analysis to the political, social, and psychological effects of bureaucratization. This phenomenon implies the control of individuals by the state. Different aspects related to the private life of individuals are subject to state control; mentalities change and the society takes the way of socialism. Bureaucratization is a new form of political order in which the state concentrates the power. These aspects are completely neglected by Niskanen.

In spite of some common points, the perspectives of Mises and Niskanen differ. The source and effects of bureaucracy, as well as the

policy recommendations derived from the two competing theories are irreconcilable.

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