I. Where we are at this point.

A. The median voter model serves the public choice literature in much the same way that the model of perfect competition serves the economics literature.

B. The median voter model demonstrates central tendencies in democratic decision making.

i. It predicts what democratic public policies tend to be in policy areas in which voters are reasonably well informed and electoral competition is open and fairly intense.

ii. The median voter works very well as a "first approximation" for broad policies (which are likely to be known to voters) and it provides an explanation for the relatively narrow range of policy positions taken by candidates (parties) from the dominant political parties (coalitions).

C. However, there are policy areas in which median voter interests do not seem to be advanced by public policy.

i. For example, food subsidies tend to raise the cost of food for the median voter, making her (him) worse off rather than better off than other policies that can be imagined.

ii. In many cases, farm programs advance the median voter's interest less than "no" policy would.

iii. Many of the details of tax law and regulatory law appear to benefit particular industries and occupations, rather than advance median voter interests.

D. To explain these exceptions to the median voter model, a more or less separate public choice literature on the politics of interest groups emerged during the 1960s and 1970s.

- It explored how special interest groups can affect public policy choices and move them away from the median voter's ideal.

II. The systematic part of the interest group literature begins with Mancur Olson's book, the *Logic of Collective Action* (1965).

A. Olson's book explores the implication of public goods and free rider problems for politically active groups.

i. He notes that free-rider problems exist for all interest group activities, but especially for those that benefit large groups.

ii. Smaller groups have smaller free rider problems and so are more likely to organize and lobby for policies that advance their interests than are large groups.

iii. Most of the subsequent literature was influenced by Olson's book work--although not all of it.

- Most of the subsequent research on interest groups is more narrowly focused than Olson's quite general analysis of collective action--and not all of it took account of the free rider problems associated with such activities.

B. The political economy of interest groups as applied to economic regulation was developed by University of Chicago economists with an interest in industrial organization. The first contributions to this literature took Olson's argument very seriously.

i. Stigler's theory of regulation (1971) is sometimes called the "capture" theory of regulation, because he argues that regulated industries get exactly the regulations that they want.

- Individual firms have relatively large and clear interests and tend to lobby for regulations that favor themselves. Individual consumers in contrast have relatively small net benefits at stake (individually) and so tend not to organize to resist such regulations.
- The regulations that firm's lobby for often create entry barriers that reduce competition and long run supply, increasing the profits of firms already in the industry and, in some cases, reducing the number of firms in an industry.

ii. Even uniform regulations tend to raise production costs for small and medium sized firms more than they do for large firms, because of economies of scale in reporting and keeping records.

- These ideas and empirical work supporting them led to Stigler being awarded a Nobel prize in 1982.

C. Another normative and game theoretic strand of interest group research emerged at about the same time that Olson's book was published.

i. Gordon **Tullock**'s (1967, *Ec. Inq.*) argued that the efforts of most interest groups should be considered a deadweight loss, because their efforts reduce rather than increase social net benefits.

ii. These losses are in addition to the "dead weight triangle" types of losses focused on in public finance and monopoly theory.

- (These "triangles" are sometimes referred to as Harberger DWL triangles after the USCA economist that estimated the magnitude of those losses for the U. S.)

iii. The losses associated with expenditures to obtain special privileges came be to be called "**rent-seeking losses**" (a term coined by Anne Krueger [1974]).

iv. The activities that generate such losses have come to be referred to as **rent seeking activities**.

a. The basic idea is that competition to be beneficiaries of policies that produce rent (economic profits) often reduce social net benefits rather than increase them, and so those resources should be regarded as a waste or dead weight loss.

- In the limit all the profits to be gained through such policies may be consumed in the contest to win the political contest of influence necessary to obtain them.
- In effect the profits from rent seeking are competed away, not by lowering prices, but by spending more effort seeking rents.

b. Mueller and Cowling (1978) undertook an empirical analysis of the dead weight loss of rent-seeking by would-be monopolists in the U. S. and U. K.. They estimated that the rent-seeking losses were many times greater than the static losses, about 5% of GDP.

D. Another strand of interest group theory treats the bureaucracy (government employees) as an interest group that attempts to maximize their net advantage at the expense of voter-taxpayers.

III. Olson's *Logic of Collective Action* (1965)

A. Olson argues that interest group efforts to influence policy via coordinated voting, lobbying, campaign contributions, etc. are all public goods for the group's members.

i. When a policy is influenced it, all members of the group benefit, whether they have contributed to the collective effort or not.

- Thus, there tend to be free-rider problems associated with most collective action and with the efforts of most interest groups.

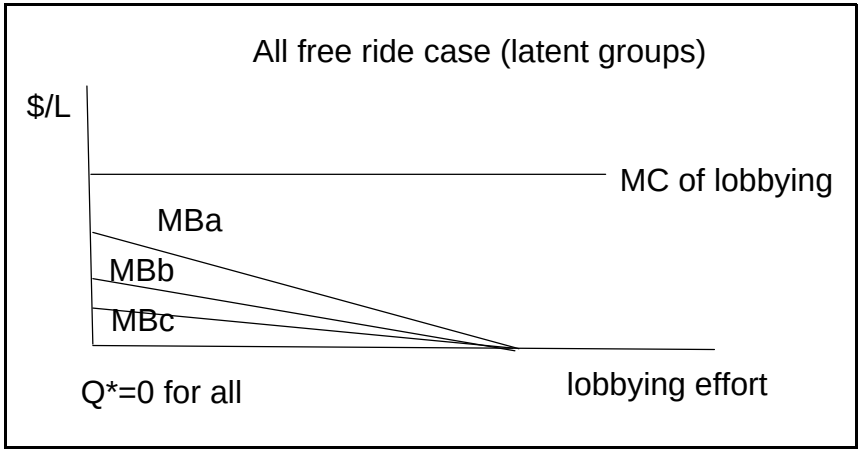
ii. Olson's theory can be used to predict the types of groups that are most likely to engage in lobbying.

iii. It also provides insights about how groups may over come the free rider problem by organization themselves.

B. Olson argues that this public good or free rider problem is the most important impediment to collective action.

C. Olson argues **that n the absence of an organization, large groups will not lobby to advance their interests.**

i. **Such groups remain "latent" and so do not, for example, lobby for particular policies or make conditional campaign contributions, etc.**



- **It should be noted, however, that many of the general interests of large groups tend to be advanced by electoral politics.**
- **The median voters most basic economic interests are his or her interests as a consumer.**

ii. **Small groups are also easier to organize, because there are fewer people or firms to incentivise and monitoring costs tend to be smaller. Small groups with intense interests are the easiest to organize of all.**

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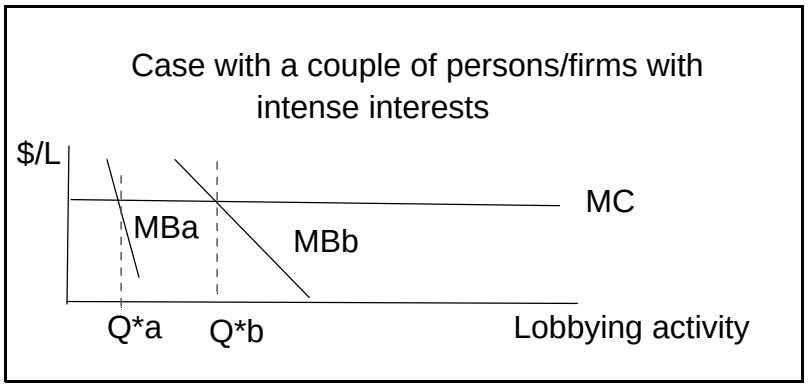


iii. **These choice settings can also be represented with game matrices that illustrate incentives to participate in activities that may affect the kinds of policies adopted by governments.**

a. **The first game matrix illustrates the behavior of members of a "latent" group--groups with large memberships and relatively small individual stakes in the laws under consideration by the legislature. Note that just as in a pure public goods problem, free riding is the dominant strategy for each and neither contributes to their group's lobbying activities. The Nash equilibrium is thus in the upper lefthand cell.**

Free Riding in a Lobbying Group

		Bob	
Al		**Free Ride**	**Contribute**
	Free Ride	**2, 2**	**4, 1**
	Contribute	**1, 4**	**3, 3**

b. **The second case illustrated with a game matrix is one for a "privileged" group. In this case, the groups are smaller and their individual interests are much greater than in the former case. Thus, each member has a sufficient reason to contribute to their group's activities, but may still benefit from free riding. There are two Nash equilibria to this game (in the absence of a formal organization) and significant lobbying takes place.**

Contributions of or Lobbying by a Privilege Group

		Apex	
Acme		**Free Ride**	**Contribute**
	Free Ride	**1, 1**	**4, 2**
	Contribute	**2, 4**	**3, 3**

c. **The last case illustrated with a game matrix is one in which a latent group and a privileged group are rivals--which is to say groups with quite different interests in the policy of interest. For reasons indicated in the first and second diagrams and first and second game matrices of this section of the notes, the latent group (in the absence of a formal organization) will devote fewer resources to lobbying than the privileged group and so "lose" if resources determine the outcome.**

Lobbying Group by Opposing Latent and Privileged Groups

		Bob	
Acme		**Free Ride**	**Contribute**
	Free Ride	**2, 2**	**2, 3**
	Contribute	**3, 4**	**4, 1**

d. **In this last case, the payoffs change a bit more than in the previous cases. Generally, the latent group is best off free riding**

if the privileged group lobbies but is better off lobbying if the privileged group doesn't. Thus there is a single equilibrium to the game in this case, in which only the privileged group lobbies for change.

iv. **Small groups with intense interests are thus often able to have their way on legislation (at the margin). And the rules that are adopted often make members of latent groups worse off by rasing prices for privately sold goods or increasing their tax burdens. This effect is most likely in areas in which a rationally or naturally ignorant voter remains uninformed, because this reduces the incentives of elected officials to take account of voter interests.**

a. **For example, firms may get protection in a form that generates profits for themselves but higher prices for consumers.**

- **The tariff protection provided US sugar growers is one such case.** It raises the price of sugar and sugar products in the US for consumers.
- Of course, this requires rational ignorance on the part of voters in the policy areas of interest. (Explain why.)
- Small ideologically energized groups may have similar effects.

b. Small politically active groups are often able to get preferential government policies adopted which benefit themselves at the expense of other larger groups.

v. **Large groups require some sort of organization** to be able to lobby.

a. Such groups are often organized for other purposes, as with farm cooperatives and labor unions.

b. However, once organized, they can be used to raise money for lobbying on behalf of their members.

- Groups that lack other reasons to organize tend to remain unorganized and thus "latent" in Olson's terms.
- Lobbying will rarely be the primary aim of organizations with large numbers (thousands or millions) of members.

D. This asymmetry in the ability of small and large groups to organize and lobby for or against policies implies that the benefits received by small groups are often less than the costs imposed on the large unorganized or poorly organized group.

- It is such cases that regulatory policies generate dead-weight losses.
- Many entry barriers, for example, increase an industry's profits but reduce social net benefits by reducing supply and increasing market prices.
- Many tax privileges increase tax burdens for others in society, and through effects on tax rates (they increase) increase dead weight losses from taxation.

E. Olson also analyzed various methods that groups might use to help overcome their free-rider problems.

i. He noted that organized groups generally provide benefits that are directly related to active membership.

- To get such benefits, they have to pay their dues, participate in lobbying and rallies, etc..

ii. Such conditional benefits provide incentives to join the organization and pay their dues.

a. These conditional benefits are normally pure private goods, often produced with economies of scale, but perfectly excludable.

- Providing such services reduce incentives free ride on the groups l activities.

b. Olson calls such conditional benefits **selective incentives**.

- For example, farm coops provide many services to farmers in addition to lobbying for preferential farm policies.
- Environmental and senior citizen groups often sponsor trips, newsletters, and so forth.

iii. Keep in mind that interest group activities are only part of the process that generate public policies in democracies.

a. Electoral competition still matters--especially on broad policy issues understood by voters.

b. The "dark side" of interest group politics affects policies only at the margin in well functioning democracies like those of the US, Canada, and Western Europe.

IV. How Do Interest Groups Affect Public Policy?

A. There are a variety of perfectly legal methods by which interest groups can affect public policy.

B. First, and probably most important, is persuasion.

i. Interest groups may attempt to persuade the public (voters), their representatives, or regulations that the "best" policy just happens to be the policy that generates large transfers to the groups of interest.

ii. To persuade voters and politicians, they can sponsor TV and internet advertisements, blogs, books, and reports on the projects that they favor.

iii. In effect such campaigns selectively reduce information costs to induce voters and government officials to become more familiar with data or arguments that support their preferred policies.

C. Second, in a democracy or dictatorship, such groups may provide direct and indirect support for those in power in exchange for preferential public policies, subsidies, and/or tax breaks.

i. In democracies electoral can be done with "single issue" voting, public protests/support, and with campaign contributions.

ii. In dictatorships, support may be provided with "gifts" to persons in authority, organized public demonstrations of support, and by helping out with censorship and the discovery and repression of political opponents.

D. Third, there are also many illegal methods of influence: bribery, threats of violence, extortion, blackmail, etc. of relevant policy makers.

- [All these methods are routinely used, although not to the same degree in every country.]

E. Thought questions:

i. Name several groups that appear to be effective at influencing public policy.

ii. What methods do they seem to use?

iii. Does the general flow of direct and indirect transfers look like Olson's analysis suggests?

iv. What is the optimal size of an interest group?

v. Is free-riding necessarily a social problem in this case from the point of view of the Pareto criteria?

vi. Draw an Olsonian lobbying diagram in which one of the interested members of a group is a billionaire.. Show the "high demander provides" equilibrium, and discuss the relevance of this model for contemporary US politics.

V. Elections, Interest Groups, and Campaign Contributions

A. During electoral contests, interest groups often provide campaign contributions of various kinds: money, labor, assistance with travel arrangements, etc.

B. The tradeoffs faced by a candidate who can use campaign resources to influence his probability of being elected is within the following diagram.

i. The diagram uses "iso-probility" lines.

- Iso-probability curves characterize combinations of policy positions and campaign resources that generate the same probability of being elected.
- They are thus analogous to indifference curves for politicians running for office.

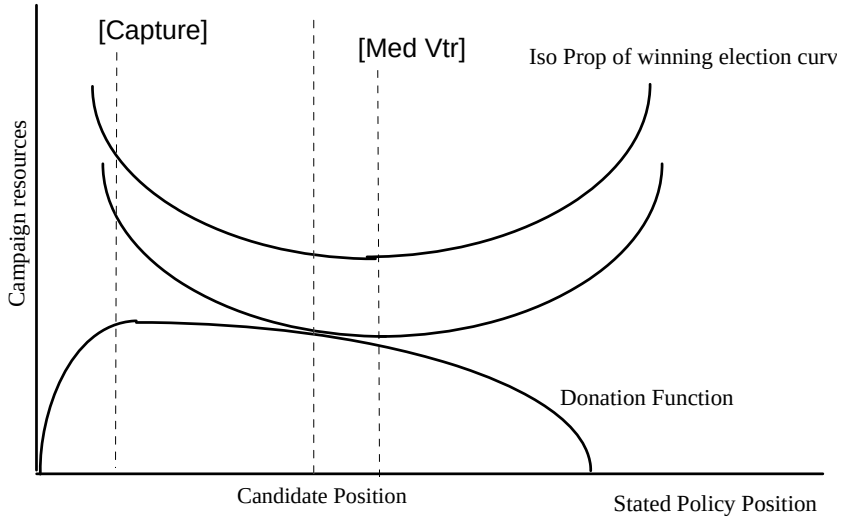
ii. The shape of the iso-probability lines is one way to characterize the importance of campaign resources.

- The lines may be horizontal, in which case only campaign spending matters. In such cases voters can be easily persuaded to accept the arguments of candidates and interest groups.
- They may be u-shaped, in which case both policy positions and campaign resources matter.
- They may be vertical in which case only campaign positions matter and campaign resources are irrelevant. (This takes us back to the

median voter model. The highest iso-probability line in this case is the one passing therough the median voter's ideal point.)

iii. When they are u-shaped as drawn below, candidates face a tradeoff between satisfying the median voter and securing sufficient resources to run a creditable campaign.

Candidate Policy Position Tradeoffs



iv. A broad array of intermediate type "ii" shapes are possible--as in the case drawn--with various tradeoffs between policy positions and campaign resources as illustrated.

- As they become flatter, campaign resourses become more important.
- As they become steeper (narrower and more vertical) campaign resourses become less important.
- The equilibria of all such intermediate cases are between the median voter and capture equilibria, as in the above diagram.

v. If only campaign resources matter, then the iso-probability lines are horizontal, and candidates will attempt to maximize campaign resources.

- In that case, the equilibrium policy position will be the one labeled "capture."

vi. If only policy positions matter, then the iso-probability lines are vertical, and the median voter model in its pure form obtains.

- In that case, the equilibrium candidate position will resemble that labeled "Med Vtr."

vii. Perhaps, surprisingly, there is quite a bit of statistical evidence that near vertical or tightly u-shaped iso-probability curves are the most common in the U.S. and that candidate positions are more important than campaign resources "at the margin."

- (Note that successful candidates may still have more money to spend than losers, but this reflects the donor's interest in gain favor from the persons holding high office.)

C. Footnote/Appendix for interested students--Difficulty of moving beyond the one-sided case illustrated

i. The illustration can be used to determine a Nash-type reaction function insofar as the donation function and the probability of being elected functions are both determined (as drawn) by specific positions on the part of the other candidate(s).

ii. Unfortunately somewhat ad hoc assumptions have to be introduced to demonstrate the existence of an equilibrium.

iii. In the Stochastic voting models it is assumed that voters have an exogenous bias favoring one of the candidates. This generates an equilibrium where the favored candidate departs furthest from the median voter position , secures the most resources, and wins the election. (The other candidate in such models often locates at the median voter position, but loses none the less.)

iv. In models that do not assume such a bias, an equilibrium only exists when donors are symmetrically distributed about the median voter. That equilibrium was a median voter equilibrium.

v. (In other cases, the one most likely to lose can always gain a 50% chance of winning by taking the same position as the other candidate, yet once this happens the other generally can find a better position, thus there is no equilibrium, but a range of possible positions (as in musical chairs) that candidates might take in a given election. This result surprised me.)

VI. Normative Aspects of Interest Group Politics: Rent-Seeking Losses

A. Gordon Tullock (1967, 1980) pointed out that many of interest group activities are costly and socially unproductive.

i. To the extent that the policies lobbied for are transfers programs, or programs with a positive dead weight loss, **it may be said that all the resources used to get those programs adopted are wasted**.

ii. These resources could have been used to produce new goods and services or efficiently enhancing services, rather than to produce new or increased dead weight losses.

iii. Instead, the resources are consumed in conflict that tends to reduce the size of the "social pie."

B. To an economist, a "rent" means "compensation above one's opportunity cost" or expressed a bit differently: rewards greater than necessary to attract resources to their current uses.

- Rents in this sense tend to be just another word for profits.
- Many rules that prevent competition in one way or another may be said to generate rents or profits for the persons receiving preferential treatment.

C. Tullock argued that not only are resources wasted in the pursuit of monopoly privileges, protective tariffs, and tax preferences, but that **the waste may be very large**.

i. He argues that in a perfectly competitive market for political influence, the rate of return on rent-seeking activities should fall to that of other possible uses of a person or firm's resources.

ii. In this case, all the "profits" from rent seeking tend to be consumed by the process of competing for them.

iii. Winners still profit, but the overall rent-seeking contest consumes resources that are approximately equal to the profits won.

- For example, in a standard monopoly diagram, there is a rectangle of profits obtained by controlling output to keep prices up.
- That profit will be competed away as would-be monopolists all attempt to secure such privileges for themselves from government.
- [Draw the classic figure illustrate rent-seeking costs involved in Monopoly and Tariff policy. Label both the Harberger DWL triangle and the Tullock rent-seeking losses rectangle.]

iv. Not all rent-seeking contests have this property (which came to be called "exact dissipation," but many do.

D. The game matrix below illustrates how a contest between two persons can escalate toward the "exact dissipation" result.

i. In the contest characterized in the game matrix, the "rents" are simply taken from the other player, but at a cost.

- The efforts of both players are consume resources.

A Rent Seeking Contest between Groups A and B (The strategies are effort levels)

	B = 0	B=1	B=2
A = 0	4, 4	2.5, 4.5	1, 5
A= 1	4.5, 1.5	3, 3	1, 4
A=2	5, 1	4, 1	2, 2

ii. The equilibrium effort levels are fairly high (2 each), although not all of the game's "GNP" is consumed by the contest.

- Notice, however, that the total net benefits of the equilibrium outcome is below that of the upper left-hand cell, where no effort in rent-seeking is made.

a. There is a dead weight loss of 4 from this game.

- 4+4 = 8 which is greater than 2+2=4, the difference in net benefits between the upper left-hand and lower right-hand cells is 4.

b. Note also, that there are two Pareto superior moves at the equilibrium: from E=2, E=2 to E=1, E=1 and from E=2, E=2 to E=0, E=0. (3,3) > (2,2) and (4,4)>(2,2).

iii. Unfortunately, under the rules of the game--as implicitly summarized by the game payoffs, the Pareto efficient outcome (E=0, E=0) is not stable--each person privately benefits by engaging in some rent-seeking effort.

E. In many cases, the efforts of interest groups largely offset each other, and so most of their efforts are "wasted."

i. Rent-seeking losses occur because of both the competitive nature of rent-seeking contests and because of the methods used to win.

ii. The losses are larger for some contests than others, because their are more players and/or the method of competition consumers more or less (net) resources.

iii. The game matrix below adds a third payoff that represents losses to those outside the rent-seeking contest. The game characterized is one where those outside benefit as rent-seeking falls. Their ideal is that with no rent seeking. However, that outcome is not stable because rent-seeking is potentially profitable.

A Rent Seeking Contest
between Groups A and B
The strategies are effort levels (or investments)
The payoffs are net benefits (A, B, C)
(C represents net benefits for others outside the game.)

	B = 0	**B=1**	**B=2**
A = 0	**1, 1, 8**	**0, 2, 7**	**-1, 3, 6**
A= 1	**2, 0, 7**	**1.5, 1.5, 5**	**2, 1, 4**
A=2	**3, -1, 6**	**2, 1, 4**	**2.5, 2.5, 1**

iv. In the above game matrix, the Nash equilibrium is, as in the first example, in the lower right-hand cell.

- This contest "escalates toward relatively large rent-seeking expenditures.
- The rent comes from "transfers" from others outside the game.
- (It bears noting that not all rent-seeking contests tend to escalate, but other cases are beyond the scope of this short overview.)

v. In the case illustrated, there are no (simple) Pareto superior moves at the Nash equilibrium, because the interests of the rent seekers and those being exploited differ.

- This follows even though social net benefits are not maximized for the society as a whole.

a. For and overview of this literature, see Congleton and Hillman (2015).

F. Footnote/Appendix, Optional: the mathematics of a Tullock rent seeking contest:

i. Let the contest success function be $R_j^e = R [E_j/ (E_i + E_j)] - E_j$

ii. R is the prize, Ej is the effort of the jth group or individual., the probability of winning the prize is $[E_j/ (E_i + E_j)]$, and the expected net prize is R_j^e.

iii. To find Group j's optimal investment, differentiate R_j^e with respect to Ej, set the result equal to zero, and solve for Ej as a function of Ei and R.

iv. Repeat for group I.

v. The result for "ii" is the "best reply function" for group ii and the result for "iii" is the best reply function for group iii.

vi. The Nash equilibrium occurs when both ii and iii are satisfied simultaneously.

a. This can be solved for with a bit of algebra.

b. However, **a convenient shortcut** is to note that the game is symmetric and assume that a symmetric equilibrium exist (as in the game matrices).

c. In this case, one can simply substitute Ej for Ei in either (or both) of the reaction functions.

d. If you do so, the result will be: Ej=Ei=R/4.

e. The resources wasted at the Nash equilibrium equals the sum of the effort in this case, which is R/4+R/4 = R/2.

f. In equilibrium, rent-seeking contestants "waste" (dissipate) half of the prize in their efforts to win.

vii. Thought questions:

a. To what kinds of activities other than politics might the logic of the rent seeking contests apply?

b. How does rent-seeking differ from ordinary auctions?

c. Is the rent-seeking industry as large as you might expect based on Gordon Tullock's argument? Why or why not?

d. How might one reduce the extent of rent-seeking losses?

VII. Bureaucracy as a Special Interest Group

A. In the median voter model, we treated the process of "government production" as if it took place mechanically and automatically.

i. That is to say, if the electorate votes for a referendum or candidate and that proposal or candidate wins, the promised policy is adopted and the bureaucracy simply implements the policy as promised.

ii. This is similar to the way that we look at production in most economic model of the "firm."

iii. However, the real world is not so simple.

iv. There can be "principal agent" problems in both political and economic settings.

B. Were bureaucrats entirely disinterested in policy and were the "decisions" reached by political decision makers always crystal clear, the bureaucracy might well simply implement what ever policy it is told to--as if it were bureaucrats were ideal programed "robots" or ideally incentivized workers.

i. They would have no interest or ability to do otherwise in such cases.

ii. However, when the "best" policies are not obvious to voters or legislators, bureaucrats may have considerable influence over both the design and implementation of policy.

C. In such cases, analysis of bureaucratic decision making will be required to understand many policy decisions.

i. Bureaucrats may, for example, lobby to influence the policy choice made by legislatures and voters.

ii. A variety of other principle-agent problems may also occur within the public bureaucracy: shirking, etc.

D. Niskanen (1971, 1975) proposes a **Budget Maximizing model of bureaucratic behavior with respect to the legislature.**

- He argues that essentially all bureaus and bureaucrats attempt to increase their budgets.

i. Why would bureaucrats try to maximize their budgets?

ii. Niskanen argues that bureaucrats have a direct personal interest in the size of their organization's budget because:

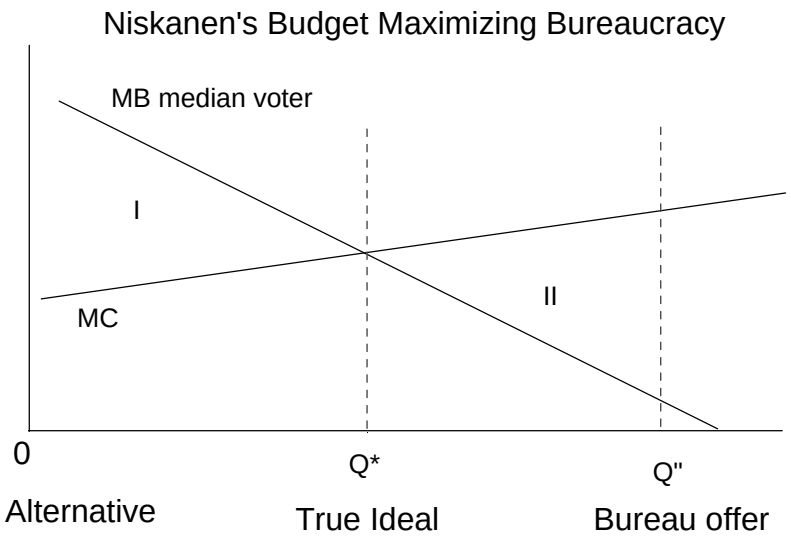
a. Opportunities for promotion tend to increase, and thereby expected salaries, as budgets increase

b. Working conditions tend to improve--computers, office furniture, secretarial support, etc.-- as budgets increase.

c. Non-pecuniary compensation tends to increase as resources become available for travel, dinners, or projects of particular interest to a given bureaucrat.

iii. Moreover, to the extent that public employees are interested in the mission of their agency or bureau, they will gain additional satisfaction by being better able to advance the agency's mission as their budget increase.

- (Even very public spirited bureaucrats generally have an interest in



larger budgets.)

E. The bureaucratic interest in larger budgets would not be significant, if they had no methods by which they might achieve higher budgets.

i. However, Niskanen argues that the bureaucrat's superior knowledge of production methods, policy alternatives, and public demand for specific services, provides them the ability to influence legislative decisions.

ii. They are often regarded as experts. (In many cases they actually are experts, they just happen to be interested in larger budgets).

- It also bears noting that most budgetary requests originate with the bureaucracy.

iii. In extreme cases, bureaucrats can maximize their budgets by making **all or nothing offers** to their sponsors (or oversight committees).

iv. The illustration below characterizes the largest budget that can be acquired by making all or nothing offers.

.

a. If the bureaucrat argues that the "real" choice is between Q" and nothing, an (uninformed) legislator will accept the proposal (Q") as long as area I is larger than area II.

b. **In the limit, the bureau can obtain a budget to produce output Q where area I is approximately equal to area II, and output is twice as large as maximizes the net benefits for the "sponsor" (congressional committee or median voter)**

c. In the case where marginal cost and the demand for the public service under their agency's power are linear, **the maximum budget is twice as large** as the service level that would have maximized net benefits.

F. Implications.

i. To the extent that bureaucrats can use "all or nothing" offers to obtain budget increases, bureaus will tend to have budgets that are larger than those which maximize net benefits for the legislature (ultimately voters or interest groups).

a. This provides a partial explanation for defense spending being "too high."

b. It provides a partial explanation for heathcare support (etc) being "too high."

c. It provides a partial explanation for why environmental regulation tends to be too rigorous.

- (Of course, all these are also affected by interest group lobbying.)

d. [Whether the Niskanen theory is the correct explanation, depends on the actual bargaining that we observe. Are bureaucrats always much better informed than Congress? Or does this vary by policy area? Why?

e. (Can you think of examples of budget maximizing behavior in the public and/or private sectors?)

VIII. Footnote/Appendix Optional: Other Agency Costs

A. Bureaucrats may influence how policies are influenced even if they cannot influence their budgets, because bureaus and bureaucrats normally have some discretion over the implementation of policies for several reasons.

i. First, monitoring can never be perfect.

a. As a consequence, some laws may go unenforced, at least on occasion, because law enforcing agent have only weak incentives to enforce such laws.

b. Similarly, it is often difficult to determine whether a road, cost estimate, or satellite launch is well done (or done as well as possible), without a very careful review of of the bureau's analysis.

ii. Second, discretion over policy might be explicitly delegated to the bureaucracy.

a. The bureaucracy often has expertise--at the very least knowledge of time, place and circumstance--which policy makers lack.

b. Because of this bureaus are often granted some discretion to *interpret and implement* "the policy" in the manner that seems appropriate.

c. In many cases, the actual writing of laws (deciding targets for pesticides and food additives) are delegated to the agencies.

d. Politicians may also delegate decisions to the bureaucracy, not because of the bureaucracy's expertise or comparative advantage, but rather to avoid making public commitments on controversial regulations.

B. In the end, almost all agencies have at least some discretion over the implementation of their assigned duties.

i. In cases where the aims of bureaucrats differ from those of the legislature or electorate, an *agency problem* over the implementation of policy is likely to exist.

ii. That is to say, bureaucrats may implement policies in ways that do not maximize the net advantage of their "sponsors" (the legislators or electorate).

a. For example, public agencies might engage in "Predatory Pricing" (Lott, 1990, J.Pub.E.): That is to say, bureaus may under price their services to drive out private (or public) competition. They can do so, because their production is paid for (or subsidized) by tax payers, rather than their customers.

b. [Illustrate this with a simple diagram.]

c. In cases in which public bureaus have monopoly power, they may be able to manipulating the demand for their services in a manner analogous to interest groups and/or by threatening to close the most valuable services whenever their budgets are under review.

d. [Illustrate this with a simple diagram.]

C. The modern literature on contracts (which emerged well after the literature on bureaucracy began) suggests that there are a wide range of contractual means by which agency problems may be addressed.

i. For example, bureaucrats could be required to post a performance bond which they may redeem upon successful completion of an assigned task.

ii. Wages and salaries could be based on measured output (bridges built, cases handled, money's dispensed appropriately), rather than the quantity of an input (time spent on the job).

D. But, beyond prospects for promotions, such incentives are rarely used within government bureaucracies.

i. Most bureaucrats are paid a straight salary which is largely independent of day to day performance.

ii. [In fact, you might argue that, given the method of compensation, agency problems in the US and Western Europe are surprisingly small. Why?]