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Public Output and Private Decisions

Conceptual Issues in the Evaluation of Government Activities and Their Implications for Fiscal Policy

Thanos Catsambas

We need to know more about individual citizens' responses to macroeconomic choices — about the political economy of public economics.

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This paper — a product of the Country Operations Division, Europe and Central Asia, Country Department II — is part of a larger effort in the department to develop background conceptual frameworks for operational activities. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Anita Correa, room H11-107, extension 38549 (February 1993, 9 pages).

In this essay, Catsambas explores theoretical concepts behind the current debate on government growth, public sector inefficiency, and the role of fiscal policy with a view to raising the most important issues relevant for fiscal policy. He examines theories of public sector growth, the evaluation of benefits from government spending, and the response of the private sector to government activities.

Three principal reasons have been suggested to explain public sector growth: conscious government choices, political pressure from interest groups, and the self-interest of bureaucracies. One may ask: Is the growth of the public sector a response to public demand or the result of government waste and inefficiency? In terms of the agent-principal theory, bureaucrats who are supposed to serve as agents for citizens may not necessarily do so — which is where waste comes in. If bureaucrats are interested in the nonpecuniary benefits of their bureaus, they will have an incentive to maximize their activities and budgetary allocation rather than their operating efficiency.

In discussing the evaluation of public programs, Catsambas focuses on the "true" benefits, as perceived by citizens. Would a well-to-do citizen, who could afford private security guards, make the same evaluation about public security that a poor citizen would make? In general, what considerations affect a person's desire for a given amount of public spending, and what are the important parameters that analysts should take into account in their investigation?

Catsambas also explores the issues behind the private sector's response to government activities and argues against a mechanistic approach to the interaction between the private and the public sector. Unless decisionmakers are relatively certain about how citizens evaluate government actions, citizens may respond in a way that nullifies the government action.

Catsambas concludes that more empirical work is needed on measuring citizens' response to public sector activities. And fiscal policy, especially on expenditures, should be modeled on a disaggregated basis to isolate hypotheses about potential private sector responses to individual public programs.

PUBLIC OUTPUT AND PRIVATE DECISIONS:

Conceptual Issues in the Evaluation of Government Activities and their Implications for Fiscal Policy

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1. <u>Introduction</u>

In the sphere of economic theory two major developments have marked the evolution of economic reasoning in the past two decades: First, the integration of macroeconomics with microeconomics, or, alternatively, the increasingly deeper investigation of individual behavior as a prerequisite for macroeconomic analysis. Second, the renewed interest in the fundamental principles of political economy, especially in the area of public economics. Examples of the first development would be the theory of rational expectations, which explains economic behavior under perfect rationality and perfect foresight, and the principal-agent relationship, which seeks to explain economic behavior when the actions of individuals are interrelated in a world of costly and imperfect information. An example of the second development would be the theory of public choice, which has gained wider recognition since 1986 as the area for which the Nobel Prize in Economics was awarded that year.

In the sphere of economic policy, particularly fiscal policy, attention in the recent past has focused on the growth of the public sector and the effectiveness of fiscal measures within the context of stabilization policy. Combining elements of classical macroeconomic theory with strands of recent theoretical advances, researchers have attempted to analyze, first, the reasons behind the observed growth of government and, second, the circumstances under which fiscal policy does or does not have a desirable impact on macroeconomic activity.

This essay discusses the conceptual issues behind the current lively, and sometimes controversial, debate on government growth, public sector inefficiency, and the role of fiscal policy. It does not provide cut-and-dry answers to policy questions--if only because many issues remain unanswered and a lot of research is still going on. The purpose of this article is to provide a guided tour in some of the most advanced areas of current economic thinking and to explore their implications for future policy guidelines.

1/ Views expressed in this paper represent the opinions of the author and, unless otherwise indicated, should not be interpreted as official World Bank views.

2. The growth of Government

Much attention has been given to the question of public sector growth in recent years.[2] In this century public expenditures in nearly all countries have grown faster than national income and, in many cases, the growth of government has accelerated after World War II. At the same time, there have been large disparities in levels and rates of growth in government across countries. Why has government expenditure grown relatively faster than GNP? Why does the size of the public sector begin to grow at a more rapid rate at a particular point in time? What explains the differences observed among countries?

Many authors have tried to answer these and similar questions with varying degrees of success. The main obstacles have been conceptual issues related to the nature of government activities, and difficulties in measuring public sector output. Nonetheless, three principal reasons have emerged as possible explanations of public sector growth: (a) conscious social choices of governments, (b) pressures from interest groups, and (c) the role of the bureaucracy.

By the term "social choices " we mean the conscious decision by Governments to provide an increasingly larger amount of goods and services through the Government budget. Until the early 1970s the expansion of public sector activities took place within a stable economic environment and against the background of historically unprecedented rates of economic growth. The primary concern of Governments, especially those of newly formed nations, was to improve living standards and consolidate gains in social equity. The principal issues during the decades of the 50s, 60s and early 70s were how to rank national priorities and how to divide the growth dividend. However, very few people questioned the desirability of state expansion. It was not until the two oil crises of the mid- and late-70s that the external financial constraints led many countries to re-evaluate the role of the public sector.

By the term "pressures from interest groups" we mean budgetary decisions that are based not on economic but, rather, on political criteria. Unlike the private arena, where profit maximization and the promotion of marketable skills are the basic criteria for decision-making processes, governments respond to ballots and political influence. The existence of interest groups--from small business associations to powerful petroleum conglomerates--may influence adversely the efficiency of government production. If legislation is influenced by pressure groups, there is an obvious suspicion of "pork-barrel" spending on special interests at the expense of prudent fiscal management.

Finally, the "role of the bureaucracy" in the growth of the public sector has been receiving increasing attention since the publication of the influential book by Niskanen

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2/ Jack Diamond [1989] provides a concise treatment of a basic theoretical model, which is empirically tested in the Group of Seven countries. Among the many works in this area, classic texts include the contributions by Niskanen [1971] and Buchanan and Tullock [1985]. A recent analysis with many theoretical insights may be found in Schultze [1992].

[1971], which formalized the behavior of government bureaus in organizing the production of goods and services. According to his analysis, bureaucrats have no incentives in running an efficient operation, since they cannot keep the "profits" that accrue to their own bureaus. On the other hand, the prestige and often money income itself are positively associated with the size of the bureau. Based on such considerations, Niskanen argues, bureau heads try to maximize the size of the organization which they control, usually at the expense of efficiency considerations. Such behavior, if actually descriptive of reality, may imply spending a much larger amount than necessary to provide a given amount of output, since bureaus intend to maximize revenue, rather than profits from their sales.

3. Waste in Government: The principal-agent relationship

This reasoning of bureaucratic behavior, which in its earlier form was described by Niskanen, was given a new thrust under the approach known as the **principal-agent** relation in the literature of economic theory. In its simplest form, the agency relationship involves the presence of two individuals, of whom one depends on the action of another. The individual taking the action is called the *agent*. The affected party is the *principal*. The principal determines a rule that specifies a pay-off for the agent as a function of the latter's action. The problem acquires interest when there is uncertainty about the outcome of the agent's action and when the information available to the two participants is costly and unequal.[3]

Information asymmetries play a pervasive role in the principal-agent relation and its implications for economic efficiency. Agents typically know more about their tasks than their principals and, therefore, may have an incentive to hide or distort information so as to serve their interests best. For instance, if the decision to contain government spending centers on specific programs, it is usually the bureaucratic experts supplying the program themselves who can define the cost of obtaining a given level of output. If the Bureau has (collectively or individually) a vested interest in retaining a high level of cost, its monopoly nature would help it achieve its goal, because the legislature usually has no other supplier of the goods and services with which to compare costs.

At a more fundamental level, it is possible to conceive of principal-agent relationships where agents favor different principals from those whose interests are supposed to serve ! If the government is the agent and the citizens are the principal, the agency relation may produce detrimental results for the *intended* principal, if the agent actually caters to the *wrong* principal: regulatory agencies may cater to their industries instead of consumers, Ministries of Defense to their contractors instead of citizens. Along the same lines, if the citizen-*principal* is unable to devise and implement appropriate incentives for the

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3/ The concepts of the principal-agent approach, as well as some specific examples used in this section, are drawn from Pratt and Zeckhauser [1985].

government-*agent*, the latter may lack the motivation (let alone competence) to structure itself so as to produce efficiently.

Such considerations, and many other similar issues that the theory of public choice attempt to address, could possibly provide the answer to some characteristic examples of excessively large outlays in the provision of public services. One may well wonder: *is the observed rise in the national income share of the public sector the result of a conscious response to private demand, or does it simply reflect inefficiency and wastage in government?* Could it be the case that the increase in government activity does not reflect a higher flow of services in any meaningful sense, but is simply the accounting result of production inefficiencies? In many cases the beneficiaries of government programs would be utterly surprised to find out the actual cost of a governmental service compared with their own perception of the benefit. In other words, there may be a large discrepancy between an individual's own evaluation of benefits and the cost of provision of the relevant good or service. Since public output is usually measured by the inputs used in its production, excessive costs may also provide the wrong signals for the allocation of resources during the budgetary process. The transmission of individuals' demand for public services may thus be frustrated in two ways: first, by the failure of the market mechanism; and second, by the conscious manipulation of government by bureaucrats to their own benefit. The question therefore arises: What are the criteria in assessing government activities? How could one measure the importance of public programs to the eyes of the citizens?

4. The evaluation of public output

These questions are not new in public finance. Economists have tried for decades to devise a scientific method for evaluating government spending. The difficulties in measuring individual preferences for public programs arise because there are no markets, no sales, and no prices in the realm of the government sector. Analysts would have to depend on some indirect expression of personal preferences to assess the contribution of government output to an individual's utility function. But this is not only a measurement problem. When we are asked to comment on a government activity, we are likely to take a stance derived not only from our interpretation of the actual economic role of the state as a supplier of goods and services, but also from our value judgements concerning the proper political role of the state in such matters. In other words, the evaluation of public output frequently includes elements of both *positive* and *normative* economics. It is not surprising, therefore, that many public finance experts remain skeptical about the feasibility of such an evaluation. In the words of a noted researcher in this area, "the analyst who tries to evaluate government spending is embarking upon a quest for fool's gold."[4]

Yet the importance of assessing individual preferences for government activity cannot be underestimated. Within the framework of an agency relationship, one may identify

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4/ See W. Irwin Gillespie [1979].

different levels of interaction: on the one hand, the agents-*politicians* are interested in knowing the wishes of the principals-*voters* in order to slant budget expenditures in a way that meets the wishes of a majority. On the other hand, the agents-*bureaucrats* are also interested in the preferences of the principals-*citizens* in order to gauge the behavior of their own bureaus against the wishes of the population. If, as noted earlier, there is a discrepancy between the principals the bureaucrats are supposed to serve and those they actually serve (as, for example, in the case of a regulatory agency and the respective industry), any major deviation of the Bureau's behavior from the majority's wishes is certain to put the agents-bureaucrats in the spotlight. We therefore observe two direct and one indirect level of interaction between the principals (citizens-voters) and their agents (politicians and bureaucrats): directly the politicians are expected to favor those projects that are likely to generate a working majority within a well-defined political process. Also directly, the bureaucrats are expected to rank highly those government activities that explicitly or implicitly would enhance their own pecuniary or nonmonetary benefits. At the same time, indirectly the bureaucrats are constrained by the political process, which reflects the influence of the electorate through the direct agency relationship between politicians and voters.

This analysis highlights the primary difficulty in evaluating public output, namely that in a complex dynamic society there are multiple norms and multiple judges. It is nearly impossible to provide an evaluative framework without a set of value judgements. The analyst must first accept a <u>normative</u> model of "what ought to be", before he embarks on an assessment of the results. This would still be but only the first step. Following the choice of norms, the analyst would have to select a series of indicators that best approximate the performance to be evaluated. And at the end, he would have to quantify the indicators in a measurable way. There are many pitfalls along the way, the most important being the determination of a particular indicator by individual values. Technicians (economists, analysts, policy advisors) may find themselves influenced in their choice of indicators by their <u>own</u> complex value judgements regardless of how much they would like to believe that they are making a choice on technical grounds alone.

Thinking in terms of a principal-agent approach helps us at least clarify the issues and appreciate the choices with which we are faced. We can identify the three Musgravian characterizations of budget theory--allocative, distributive, and stabilizational--with the principal actors involved in the decision-making process. Politicians, as agents for the citizens, their principals, are presumably interested in all three effects of public spending. In practice, however, they delegate the allocative function to the bureaucrats, who are also supposed to serve as agents for the citizens, but may not necessarily do so. This is where concerns about waste in government may arise. The law makers may establish overseeing agencies to monitor public programs, but the actual process is left in the hands of the bureaucrats themselves, who are the sole suppliers of government goods and services. As a result, bureaucrats have considerable leeway in deciding the cost of a given level of output.

At the same time, politicians are more concerned with the stabilization and distributional aspects of macroeconomic policy, although with varying degrees of interest, depending on the current concerns of their constituencies. It is clear, however, that given the mutually beneficial aspects of the agency relationship, the politicians are genuinely interested to know the wishes of their voters and how a particular government program is likely to affect their economic welfare. Let us assume that bureaucrats do no deviate from their agency obligations, that they serve the interests' of their original principals and that in so doing they try to achieve a Pareto-optimal production of output. The question then formally becomes: If we abstract from allocative considerations, can we determine the distributional and stabilizational effects of government expenditures, after allowance for the behavioral responses of individuals? In other words, assuming that the government is responsive to the welfare of its citizens, what would be the implications of accepting the norms of the principals in the evaluation of public output? After all, in a democratic society, citizens are the ultimate principals.

5. Public output and private decisions

In accepting the citizens' welfare as a criterion for the evaluation of government activity, we are reverting to one of the oldest problems in public finance. At the same time, we are introducing a new important element, that of behavioral changes as a result of government activity. When individual objective functions are specified, alternative policies can be evaluated in terms of their effects on the individuals' welfare. It is the latter aspect of the analysis that has given new life to an otherwise well-researched area of public economies. We shall use two specific examples in order to highlight the fundamentals of the argument.

As far as income distribution is concerned, the evaluation of government programs by private citizens depends both on the implicit price they will have to pay in the form of taxes and on the substitutability between a public program and a privately available service. A classic example is police protection. How would the citizens of a community evaluate a proposed increase in spending for an expanded police force? Assuming that private individuals rationally expect the increased cost to be covered by additional tax revenue, people with higher incomes (and, presumably, wealth) would evaluate the proposal more favorably than the lower-income population. This conclusion rests on rather weak rationality assumptions, namely that people expect a higher police force to be more effective in protecting their property and that individuals have a declining marginal utility of income so that, the higher the income, the lower the disutility from the taxes they pay. But it also rests on the strong assumption that public consumption is independent of private consumption. For if individuals are able to substitute private protection (in the form of a security system or, in extreme cases, through private guards) for public protection, it is unclear that they would evaluate the benefits of an enlarged police force as highly as before. This reasoning, therefore, casts doubt on an early argument in this area, namely that a higher-income individual would benefit more from a public good and that, therefore, a *higher provision of public goods may have adverse distributional implications*. The example of the police force may obviously be extended to a whole range of nonexhaustive public programs with similar implications.

The importance of such considerations for the effects of government activity on income distribution has led many researchers to attempt to devise ways to measure the perceived benefits from public spending to private individuals. The methods have ranged from (more or less) controlled experiments in the form of referenda, to revealed preference approaches through voting behavior, to direct measurement of behavioral hypotheses. However, the success of such approaches has been doubtful; in the absence of a market mechanism, the unobservability of preferences remains a formidable problem.

More recently, much attention has been paid to the behavioral response of the private sector within the framework of macroeconomic, and in particular fiscal, policy. Specifically, several researchers have argued that some public expenditures may not have the macroeconomic impact usually assumed in conventional econometric modelling. One familiar example is the erosion of real wealth due to inflation. Under inflationary circumstances, interest rates are high because they incorporate an inflation premium over and above the real return to capital. Interest payments on public debt, therefore, do not simply reflect real interest rates; instead, they are also thought to compensate creditors of government for the erosion of their real wealth. As a result, it is doubtful that nominal interest receipts are entirely regarded as income by individuals; they are mostly construed as a compensation for inflation and, to the extent that real wealth has remained unchanged, are likely to have little impact on the spending decisions of the private sector.

Such an interpretation, which is based on a strong notion of rationality on the part of individuals, although an interesting theoretical proposition, is ultimately a hypothesis subject to empirical verification. Additionally, the same price changes that explain the presence of an inflation premium in interest payments, also imply the presence of an inflation tax which allows the government to extract real resources without a change in its real monetary liabilities. On balance, therefore, it is not *a priori* clear what the effect of inflation on stabilization policy really is. Consequently, measuring correctly the interpretation of interest payments by the private sector appears to be a precondition for a meaningful evaluation of fiscal policy.[5]

At a more general level, the effect of public spending on private consumption behavior remains an underexplored area of macroeconomic policy with potentially far reaching ramifications. To the extent that individuals regard public consumption as a substitute for private consumption (as, for example, might be the case of school lunches or health programs), it is reasonable to assume that private spending may be a <u>decreasing</u> function of such government expenditures. This is an important proposition, which may substantially modify the standard results obtained from conventional macro-economic analysis.

One important implication of such a proposition is that the traditional macroeconomic analysis may also be inadequate insofar as the stance of fiscal policy is gauged on the basis

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5/ For an analysis of this and related issues see Catsambas [1988] of only total expenditures (reflected in a global deficit figure) or, alternatively, insofar as public output is regarded as a homogeneous entity. If the reaction of the private sector to government spending depends on the nature of individual expenditures, it is possible that the interpretation of a stabilization program could be misleading, unless not only the total amount, but also the composition of expenditures is properly investigated. In other words, a disaggregated framework of government activities appears to be a prerequisite for measuring the private sector's evaluation of government spending.

The measurement itself is a difficult task as it may not always be possible to disentangle the influence of alternative patterns of public expenditures on private consumption from other exogenous factors. But at the same time, the proper interpretation of the conceptual issues may have such important implications for the conduct of fiscal policy, that an empirical investigation of the problem would probably be an inevitable course of action. Theory alone cannot provide an answer, although it always raises questions.

6. Conclusions

This essay has discussed the conceptual issues associated with the explanation and interpretation of government growth in the past few decades, the evaluation of public output on the part of private individuals, and the effectiveness of fiscal policy under certain behavioral modifications in the presumptive responses of the private sector to public expenditures. The major conclusions may be summarized as follows:

First, the principal-agent approach provides a good explanation for the observed growth of government and suggests that waste in the public sector may be directly related to the behavior of bureaucracy under a system of representative democracy. It also points out the difficulties in using a unique criterion for the evaluation of public output.

Second, if we abstract from the question of allocative efficiency, issues related to the distributional and stabilization aspects of fiscal policy must take into consideration the "true" benefits of public programs, as they are perceived by the recipients. The implication here is that, unless decision makers are relatively certain about the evaluation of public output by the private sector, the latter may respond in such a way as to effectively nullify the specific government action.

Third, the practical implication of this analysis is that more empirical work is necessary towards the measurement of the private sector response to public sector activities. An important corollary of this reasoning is that the modelling of fiscal policy, especially on the expenditure side, should be done at a disaggregated level with a view to isolating the hypotheses about the behavioral responses of the private sector to individual public programs.

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