Towards an Economic Organization Theory of the State

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Introduction

A basic theme in the neo-institutionalist literature is the recognition that "institutions do matter". Broadly conceived, institutions are the humanly created constraints on the interaction between individuals (North, 1990). They are the rules and norms – formal or informal rights and obligations – which facilitate or regulate exchange by allowing people to form stable and fairly reliable expectations about the actions of others (Furubotn and Pajovich, 1972; Coase, 1988; Moe, 1990; Powell and DiMaggio, 1991).

Can or should neo-institutionalist concepts and models be applied to the public sector allowing us to look at it with a different perspective? How can we make sense of the neo-institutionalist theories about interests and institutions if we are primarily interested in the public sector?

Public Institutions and Interests

Whenever human interaction involves considerable transaction costs due to the intertemporal nature of the interaction as well as the complexity of the agreements involved, principal–agent problems arise. The principal–agent relationship is constitutive of state institutions, in particular public policy-making in democracy. Public policy or the making and implementation of policies in the public sector involves the problems typical of principal–agent relationships within the private sector. At heart of the policy process and the implementation stages is the attempt of the population as the principal to *monitor* the efforts of politicians and bureaux as the agents to live up to the terms of the contract agreed upon. Public contracting stretches from the election arena over to the parliamentary theatre to the bureaucratic setting.

Starting from the interests that people or various groups bring to political institutions in an effort to further these by various state activities is a promising approach to the conduct of public sector analysis. Within such a framework it is vital to separate the rules or the public institutions from the egoistic, altruistic, personal and collective interests which figure in public institutions. Here,

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we have a clear alternative to the traditional public administration framework focussing on the ambiguous public interest concept.

The new institutionalism argues that public institutions are not neutral in relation to the policies that they operate. Public institutions matter, it is claimed by both the major contrary interpretations within neo-institutionalism, viz. the sociological version of institutions as more than the sum of its parts (holist version) and the economic version of institutions as rational responses to individual interests and their aggregation into collective action (atomistic version).

Neo-institutionalism may be generalized into an alternative framework to the traditional public administration and welfare economics approaches to the public sector – an economic organization theory about the state and local government. In a democracy the interests of the citizens in relation to the state have the same status as the principle of consumer sovereignty in a decentralized economy. However, the principle of citizen sovereignty has to be accommodated to the principal–agent problems involved in governing a state. Due to the transaction costs involved in collective action a voluntary exchange approach to the public sector including the provision of public goods fails. The state offers taxation as the solution to the free rider problem in collective action (Olson, 1965). At the same time the necessity to employ an involuntary exchange mechanism (hierarchy) for managing human interaction creates *the* two principal–agent problems in political life: the first refers to the monitoring of the politicians by the citizens, whereas the second deals with how the politicians are to monitor civil servants implementing public policies.

Within any institutional setting there is bound to be serious problems of ambiguity about the rewards to be given to the agent, about the desired actions to be taken by the agent, about the causal link between actions and outcomes, as well as about what the consequences of the environment for the feasibility of public policy-making and implementation. Several public choice models may be stated in terms of the principal–agent framework (Lane, 1993).

Market Failure and Non-Market Failure

Market or politics is the classical problem in political economy, be it the old brand focussing on resource allocation and income distribution with economists Smith, Ricardo or Marx, or the new brand dealing with the interaction between the polity and the economy, e.g. with public choice scholars Tullock, Buchanan, Olson and Frey. How are we to choose between markets or the state? The traditional theory about market failures used to offer systematic criteria for this crucial problem of choosing institutions.

Welfare economics states that various kinds of market failure in itself constitute sufficient conditions for the making and implementation of public policies (Nath, 1969; Schotter, 1985). There exist four types of market failures, or situations where the allocation mechanisms of the market cannot be used to allocate resources. It may be either a technical or economic failure in the sense of physically unfeasability in general or more specifically inefficiency. The four kinds of market failures are: (1) Externalities, positive or negative; (2) Economies of scale; (3) Information imperfections; (4) Justice in the distribution of income and wealth.

The market failure theory argued that the demand and supply of public programmes including resource allocation, income redistribution and public regulation could be derived from citizens' preferences and available technology. Two functions, basic to the welfare economics approach, may be given as follows (Wolf, 1988).

The demand for public programmes would be an aggregation of the demand for each single public programme, which would be affected by the number of externalities (X) in various markets, the extent of monopoly (M) in the private sector, the information imperfection (I), the need for public goods (G), the perception of inequalities (E), the tax rate (R), and the unit cost for a public programme (P). The factors X, M, I, G and E would increase the demand for public programmes whereas the factors R and P would decrease it, all other tings equal. This is a most general model for determining the demand side of the public household.

The supply of public programmes would depend on the factors that enter the supply function of single public programmes to be aggregated into a total supply of public programmes. These factors include: how accurately a public programme may be measured (V), the extent of monopoly in the public programme (m), how clear the technological relation between input and output is for a programme (T), the unit cost (P), the tax rate (X) and national income (Y). The factor would decrease the supply of public programmes, whereas all the other factors stimulate the supply of public programmes.

In these two models a number of conditions for public sector activities are identified, but each of them is conducive to difficulties that were overlooked in welfare economics. Looking first at the demand side there is the tendency to a too high a demand with regard to both the number of and comprehensiveness in public programmes. Different factors in combination drive up the demand for public programmes: emphasis on market failures from groups that directly benefit from these programmes, the competition between political elites leading to an underestimation of the costs and an overestimation of the benefits, as well as the basic public sector divergence between consumption and payment.

These imperfections on the demand side result in information deficiencies that are conducive to micro- and macrofailiures. Microimperfection means that benefits and costs are not tied together, which in its turn implies a fundamental asymmetry in that the benefits tend to be concentrated in small groups strongly organized whereas the costs are diluted onto the silent majority. Macroimperfection occurs when shifting political majorities employ the public budget for redistribution at the cost of a minority, or when minorities combine into temporary majorities favouring their special interests. These two demand side imperfections drive up both the number and size of public programmes beyond what is economically optimal.

At the supply side of the public sector there are several factors that increase the cost of the public budget: the systemic difficulties in identifying and measuring the marginal cost of outputs, the use of public monopolies, uncertainty in the production technology as well as the nonexistence of standard evaluation criteria for effectiveness and efficiency (Wolf, 1988:35-99).

Combining these types of imperfections there is a high likelihood for politics (non-market) failure, including: (1) The disjunction between costs and benefits; (2) Redundant and X-inefficient costs; (3) Internalities or costs derived from the presence of private interests in public programmes; (4) Externalities or costs for others derived from public programmes; (5) Distributional inequities caused by public programmes.

Public sector equilibria will be indeterminate due to micro- and macro-failures on both the demand and supply side of the public sector; yet, whatever the equilibrium quantity would be it would tend to be too high at an exorbitant cost due to X-inefficiencies (Leibenstein, 1966), contrary to welfare economics prediction. Welfare economics lacks a theory of how interests interact with the public institutions meaning that opportunistic behaviour is rewarded. It is particularly weak in the analysis of the economic organization of the state, viz its institutions for resource allocation, redistribution and regulation.

Institutionalist Approaches

What is the essence of the new or neo- institutionalist approach? There is disagreement among the neo-institutionalists about what social phenomena are to be called "institutions". Matthews (1986) distinguishes between institutions as property rights, as conventions, as types of contracts and specifically as contracts about authority or governance structures like the firm or the bureau. Williamson (1985:15) concentrating on the latter approach, states "Firms, markets and relational contracting are important economic institutions", whereas North (1990) stresses the importance of distinguishing conceptually between the rules of the game (institutions) and the strategies (organization) the players in the social game find it advantageous to adopt (1990:5).

In the economic version, there are three levels of analysis. At the first level, the actors pursue their interests within a given institutional framework. The institutions are the rules of the game which shape the interaction between the actors. The rules of the game and the interests of the actors determine the social outcomes of the interaction. Institutions serve here as a source of explanation for outcomes (Barzel, 1982).

At the second level, the institutions are no longer a source of explanation, but are themselves to be explained. The focus is on understanding the processes by which institutions are formed. Economic neo-institutionalism recognizes that an individual may pursue his/her interests in a better way by making an effort to change the institutional constraints he or she faces rather than simply adapting to the institutional structure as if it was unsusceptible to change. The producer operating within the constraints of perfect competition may for instance try to collude with others or seek favourable regulation by the government in order to avoid threatening competition. In other words, actors may seek to alter the rules of the market game. Likewise, in the political sphere, groups that find the institutional arrangements, the rules, in their disfavour, may seek to change those rules. Such a rule conscious strategy could be directed towards both explicit and implicit institutions, comprising the legal order in a broad sense as well as operating rules of the game such as corporatism, iron triangles and policy-networks.

Political actors know that the institutional structure matters and act accordingly by pushing for institutional change when the institutions are unfavourable to their interests. The institutional structure that results over the years, however, may not reflect explict design or any single actor's interests, because opposing interests, opportunistic behaviour and uncertainty increase complexity (Weingast, 1989; Weingast and Marshall, 1988).

The third level is concerned with the nature of meta-institutional decision-making. This is the constitutional stage, where problems with regard to the rules for the making of institutional choice are discussed and sometimes resolved. It is an eminently political arena not fully recognized as such in the neo-institutionalist literature – the arena where the basic rules of the state are laid down – see Jellinek (1966) and Kelsen (1961).

The economic approach to institutions, no matter what level of analysis, is characterized by a view of institutions as constraints on individual choices. There is a clear distinction between the interests of the actors on the one hand and the institutions that regulate their interaction on the other. Most interests are exogenous in this perspective, as they are not to be explained with reference to institutional phenomena, but the actors may develop institutional interests, i.e. rational expectations about which institutions best serve their interests.

The sociological version of the new institutionalism looks upon institutions as more than constraints on choices. The identities and conceptions of the actors, perhaps even the notion of an actor itself, are formed by the institutional structures. The distinction between interests and institutions is not underlined. In sociological neo-institutionalism, institutions seem almost to assume the role as actors, which could lead to reification or the fallacy of misplaced concreteness. In this perspective, interests are endogenous, as the individuals' conceptions are formed in the institutional context they live within. What, more specifically, is the relationship between institutions and interests?

Sociological Institutionalism: Holism

March and Olsen claim for their institutions a major place because they help solve a fundamental social science problem: what makes social life orderly and social systems workable? The two alternative models fail in this respect. The neo-classical decision-making model employs the economic man assumptions explaining social order as the outcome of purely rational self-interest maximization whereas the sociological model points at impersonal forces in the social structures that stabilize individual behaviour. What kind of an entity is an institution according to March and Olsen (1989)?

These explanations of the possibility of social order failing March and Olsen claim that phenomena like rules, laws and norms make social systems possible. What sets institutions apart from interests is that as rules these entities constitute meaningful phenomena in the sense that it is crucial how the rules are interpreted by the participating actors. Institutional rules constrain behaviour because they suggest the reasons and not the causes for action. Thus, their concept of an institution requires a special mëthodology or epistemology.

The standard social science concepts of causality and reduction to self-interest or sociological functionalism have to be replaced by hermeneutic concepts. Understanding the so-called "Sinn" of the rules of a social system immediately provides the rationale of action in it – logic of approriateness (March and Olsen 1989:23-24). No reduction takes place making public institutions a dimension of its own. But how can we explain or predict the behaviour in public institutions without resorting to the concepts of interest and preference?

As examples of political institutions March and Olsen mention the state, the legal order and the legislature or a parliamentary assembly; yet, would not these social systems consist of sets of various institutions? With March and Olsen "institution" denotes not only rules but also technologies and cultures; yet, an institution as a system of rules and instituion as the behaviour that is orientated in terms of its rule with e.g. organizations are very different social antities.

The March and Olson sociological version does not uphold the distinction between institutions and interests. They claim that we cannot separate the set of interests from the set of institutions; second, they state that institutions come before or determine interests in all kinds of positive or negative social interaction.

Institutions come before interests; institutions shape the wishes and wants of individual persons, the preferences. Already this position is risky, but March and Olsen move to the metaphysical doctrine of organic holism (Nagel, 1961), i.e. public institutions constitute a social reality that involves more than simply the acting persons.

March and Olsen argue that the emergent properties of institutions as organized social systems give public institutions a life of their own, a destiny that even the social researcher finds it difficult to unravel. It is not clear that the holistic conclusion follows from the starting-point that institutions may explain social order. Let us try another version of neo-institutionalism that reverses the relationship between institutions and interests.

Economic Neo-Institutionalism: Transaction Costs

The neo-classical theory describes individual choice and action as based upon stable preferences and a rational consideration of alternatives and their consequences where the alternative yielding the highest level of expected utility is chosen. The process of choice takes place within a given institutional structure of fully defined and enforced property rigths. This basic choice model is retained within neo-institutional economics, examining how various institutional arrangements influence outcomes, and how institutional arrangements themselves such as the firm or the bureau arise as the outcome of interaction between various actors rationally pursuing their interests (Alchian and Demsetz, 1972; Matthews, 1986:903).

New institutional economists, e.g. Oliver Williamson have gone a step further by introducing the concept of bounded rationality in an alternative model of individual choice. Williamson's (1975) conception of the term "bounded rationality" is that of Herbert Simon, refering to the limited capacity of man to have information about all the alternatives and consequences of action, to process that information, and to communicate within the limits of language. With this model of choice, Williamson adresses the same basic question that other neo-institutional authors work with: how does an institution emerge?

The new economic theory of the state – new institutional economics or neo-institutional economics – argues that political institutions may be chosen rationally by means of deliberations about which rules are appropriate for patterns of interaction in society. Instead of treating institutions and interests as given, the institutionalist approaches in economics attempt to endogenize what has traditionally been regarded as exogenuous. Various strands in economics and organization theory lead up to the development of a theory of institutions that is highly relevant to the interpretation of the public sector (Bromley, 1989; Hargraves Heap, 1989; Eggertsson, 1990).

Basic in the application of the neo-classical decision model onto organizations is the concept of transaction costs in this litterature. Within a defined system of property rights it may be conceived as all the costs involved in the transfer of sets of property rights. More specifically, transaction costs are conceived as all the costs involved in establishing, monitoring and enforcing a contract. The costs of negotiating a contract include the costs of searching for contractual partners, aquiring information and concluding an agreement.

Economic organization theory departs from the neo-classical economic model which assume that the costs of transacting when engaging in exchange are zero. Ronald Coase argued that the initital assignment of property rights does not affect resource allocation outcomes in the economy when transaction costs are zero, although it may have distributional consequences (1960). Formulated more generally, when the cost of transacting is zero, institutions, e.g. systems of property rights do not affect allocative outcomes. The implication is that the neo-classical model does not recognize the importance of transaction costs and thus fails to pay adequate attention to the existence of institutions.

Coase (1937) sees institutions as governance systems that regulates contracts. The governance system that minimizes the costs involved in establishing and enforcing contracts will be chosen by the contractual partners. As a matter of fact, this basic hypothesis is equally or even more relevant for political institutions, because the issues brought to the public agenda are social problems with high transaction costs involved – issues which could not be resolved by private contracting in a simple voluntary exchange approach.

Williamson (1975; 1986) looks upon a hierarchical system in a comparative institutional framework as an arrangement that in certain organizational contexts is the most transaction cost efficient way of handling exchange. The basic question is under what circumstances a firm should organize an exchange internally or through the market assigning governance structures to the most cost efficient framework with the aim of reducing the costs of transacting.

Williamson points out two human factors and two environmental factors which when combined help explain the relative higher cost of writing and enforcing contracts in the market compared to internal organization. The human factors are bounded rationality and opportunism whereas the environmental factors include uncertainty and the small numbers problems.

Bounded rationality refers to the limited ability of man to receive/process information as well as to communicate it. Individuals are not typically capable of handling large amounts of information making it difficult to foresee all contingencies in a complex and changing envirnonment. Opportunism refers to self-interest behaviour through deliberate manipulation of information about attributes of the object of exchange as well as one's own preferences and intentions. "Uncertainty" should perhaps rather be termed "complexity". The environment of organization is complex and changing offering risks but also opportunities. Small numbers means that only a few actors participates in the exchange.

The combination of bounded rationality with uncertainty means that writing contracts that cover all contingencies that may occur over a long period of time is impossible. Any attempt to approach the goal of rational decision-making will tend to be very costly. The market solution to this coordination problem would be an incomplete long-term contract or recurrent short-term contracts.

However, both these alternatives are subject to the problems that appear when opportunism is paired with the small numbers condition. This condition secures that competitive pressures do not eliminate the potential gain of opportunistic action. Incomplete contracts may leave room to behaviour contrary to the intention of the contract when unforeseen contingencies arise. The need for adjustment and amendment of the contract leads to the consideration of short-term contracting. Short-term contracts invite the strategies involved in the negotiation between bilateral monopolists. Each party has an incentive to realize the gain potential by engaging in cooperation, but also to capture the largest possible proportion of this potential in exchange.

Even though a small numbers condition do not obtain at the outset, this condition tends to evolve as the contractual partners invest in transaction-specific capital and acquire transaction specific skills. This process makes maintenance of the contractual relation all the more important for the parties to the contract, as the consequences of termination become severe. Market contracting becomes risky as the pay off resulting from hold-up strategies increases.

The relative advantages of relying on internal or vertical organization instead of market contracting consist of the attenuation of incentives by subgroups in an organization to behave opportunistically, as their behaviour can be monitored more closely and an incentive system be designed to further the interests of the organization. In addition, disputes may be more easily settled within an organization than across markets. As for bounded rationality, the advantages include the possibility of a step-by-step approach to problem solving in the exchange process, as well as a process of convergent expectations serving to reduce uncertainty.

Minimizing the costs of transaction arises thus as the goal in the choice of institutions. Coase argued that allocative outcomes will tend towards efficiency through voluntary exchange if transaction costs were negligible. Voluntary exchange can be trusted more extensively if the state minimizes the transaction costs, e.g. by creating or clarifying property rights. Developing this argument from private sector organizations to public sector organization, the state could be interpreted as a rational device for handling transaction costs. Taken to its conclusion the economic theory of public institutions ends up in economic constitutionalism (Veljanovski, 1982).

Neo-institutionalism in economics implies a theory about the role of the state in defining the basics of contractual arrangements, depending on existing technologies and natural endowments. As technologies or endowments change, there is initiated a process towards new equilibrium contracts in which the state may play a profound role in minimizing transaction costs by institutional innovation. Group interests whether in the form of self-interests or broad collective interests not only enter public institutions as the building blocks of public decision-making and implementation. Such interests affect the derivation of public institutions prior to ongoing policy-making.

Economic institutionalism whether based on the rational or the bounded rational decision model deserves attention in political theory. On the one hand, the new institutionalism may constitute a framework for the analysis of the public sector. On the other hand, neo-institutionalism harbours its own theory of the state which should be discussed as critically as the sociological institutionalism above.

A New Framework for The Analysis of The Public Sector

The neo-institutionalist and new institutional economics approach can be formulated more sharply with particular relevance to the analysis of hierarchial decision-making in the public sector by utilizing the principal–agent model.

The principal–agent model starts from a contractual perspective. Agreements establish a hierarchical relationship between the contractual parties where one part in return for a compensation agrees to follow the directions of the other. One party, the principal, is given the right to instruct the other, the agent, whereas the agent promises to work for the promotion of the interests of the principal. Such relationships are established when it is impossible to specify all the details in a contract, and at the same time it is risky to leave room for discretion. Such agreements are expressed in the public contract between the electorate, politicians and bureaucrats (Moe, 1984).

Public contracts, pervading the state and local governments, involve the principal's task to design a governance system which gives the agent incentives to act in accordance with the principal's interests, that is to act as the principal would have done had he/she had the capacity and competence to do it him/herself. The contractual perspective highlights the possibility for contractual failure and implies a search for mechanisms to be established in order to control whether the agent lives up to the terms of the contract, and for sanctions to be employed to enforce the contract.

The governance problem is non-trivial except under exceptional circumstances. First, there must be conflict of interest between the principal and the agent. If the agent anyhow wants to do what the principal wants him/her to do, there would be no reason to create institutional constraints on the agent's choice of action. Second, the agent must have information that is relevant to the principal which the principal can not obtain without incurring costs. If the principal has the same information base as that on which the agent acts, and if he could monitor the actions of the agent easily, then the principal can easily design and enforce a short-term contract. Asymetric information in combination with conflicts of interest creates the potential for two different types of governance problems in the public sector.

Adverse selection may arise at the time when the contract is established when the agent has information about the services the agent will render which is inaccessible to the principal. The agent may misrepresent the fundamentals of contract negotiation to obtain better contract terms than he would otherwise have been able to secure. When the principal comes to realize this, he/she may design terms according to the expected performance of the would-be agents discouraging better-than-average candidates and encouraging worse-than-average candidates. The degradation of the quality of the candidates may continue resulting in an outcome similiar to Akerlofs (1970) description of the market for "lemons".

Moral hazard may arise even though the principal has the same information as the agent at the time when they bargain over the contract. The problem is that the principal is unable to observe the actions taken by the agent, and consequently has to base his evaluation of the agent's contract performance on the results of those actions. If the result depends on unobservable random variables beyond the agent's control, the principal can not make reliable inferences about the activities of the agent by monitoring the results of those activities alone. It allows the agent to disobey the terms of the contract without being revealed. Adverse selection arises when the agent has hidden information while moral hazard arises when the agent can hide his actions.

Public contracting in the state and local governments results in a double principal–agent relationship in a democracy. One the one hand there is the relationship between the population as the principal and its agents in their capacity of rulers of the population. On the other hand the rulers may wish to employ a staff to be active in the implementation of the policies of the rulers, which implies that the latter become the principal of the former.

Population as principal, politicians as agents

Public contracting resulting in principal–agent structures in state and local governments is characterized by ambiguity, moral hazard and adverse selection. The fact that democratic state institutions rest upon a principal–agent structure in no way prohibits that the agent may reverse the relationship and regard itself as the principal. No benevolent assumptions should be made about the conduct of state activities. The possibility of reversing the principal–agent structure of the state having the population serve the interests of the state makes it all the more urgent that institutional mechanisms be found that limit the range of opportunistic behaviour. However, there are transaction costs involved in restricting the degrees of freedom of the agent.

Strictly speaking, the referendum model involves the smallest possible margin for the agent to act on behalf of the principal. The population would decide each issue by means of a single majority vote to be implemented by those occupying state authority positions. This assumes that the activities of the agent are completly observable by the population and that each issue can be decided and implemented on its own terms. The transactions costs involved in monitoring the actions of the agent on such a close basis would be staggering.

If each and every policy would be clearly separable to be voted on completely on its own merits, then the scope for opportunistic behaviour would be diminished. However, this would require control over the agenda that would prohibit arrowian cycles and preference manipulation (Tullock, 1988). As long as the agenda may comprise more than two alternatives and as long as the simple majority rule is employed within a choice setting with more than two choosing actors or groups of actors, then there is the potential for mismatches between the preferences of the individuals in the population and the winning alternatives. How can the electorate in a liberal democracy constrain its public agents – politicians and civil servants – to act according to the contract between them agreed upon in various settings: in the constitution, on the election day or in the employment relation? By the institutions of party government?

Making the agent in the political body the automatic implementer of the wishes of the population is not a practical solution to the problem of governing the public sector. Typical of the democracies of the world today is the distance between the electing body and the elected, which gives rise to all the kinds of principal–agent problems as they are encountered in the analysis of the private sector (Ross, 1973; Williamson, 1986; Mueller, 1986). How could the population as the principal interact with the set of political parties and politicians as their agents given that there is uncertainty about what action the principal wishes the agent to take as well as that the action of the agent cannot be perfectly or costlessly monitored? By Schumpeter's elite competition?

Asymmetrical information, moral hazard and adverse selection enter the basic political contract between the electorate and the politicians. Firstly, there is ambiguity about whether the actions taken by the agent under the circumstances were the correct ones or the desired as well as whether the outcomes are acceptable to the principal to call forth the rewards, demanded by the agent.

On the basis of their information advantage the politicians may argue their case by pledging that the actions desired by the principal were not feasible under new circumstances or that the outcomes were the only ones feasible in that situation. Or the politicians may argue that the actual divergence of the desired outcomes from the actual ones do not involve any brake of the election contract, because there is bound to be moral hazard about what actions are to be taken given the election promise of bringing about a desired outcome. Moreover, there exist opportunities for manipulation of the ambiguous terms of the political contract by politicians who wish to engage in irresponsible behaviour or political symbolism meaning that there is a danger of adverse selection of some politicians.

Politicians as principals, bureaux as agents

Policy-making in a democracy is subject not only to the hazards the ambiguity of the contract between electorate and politicians presents. The degree to which policies enacted in a democratic choice setting actually coincide with the wishes of the electorate depends also on the contract regulating the relationship between politicians and the administrative and professional bureaux in the civil service. Its tasks, briefly stated according to the principal–agent contract, is to furnish policy makers with the information required to make sound decisions and to implement the policies of their political principals. The contractual problems involved in managing the public sector comprise both policy enactment contracts and policy execution contracts. This basic distinction is not to be identified with the troublesome conceptual pair in traditional public adminisrration: politics versus administration (Appleby, 1949)

Contracts have to be made between the state and civil servants stipulating what the state expects in return for remuneration. Due to the transactions costs involved in hiring and monitoring public officials, the state typically employs the bureau model for handling various state activities. In accordance with Williamsons's prediction, vertical intergration is chosen ahead of voluntary exchange. Basic to the operation of the bureau is a principal–agent relationship between politicians on the one hand and civil servants be these administrators or professionals on the other hand.

Using the bureau as the unit of analysis, adverse selection arises ex ante the policy decision when these units supplies information about the current situation in their area of responsibility, for instance in budgetary requests. Moral hazard can be related to the implementation of public policies. There may be reasons to believe that the potential for moral hazard problems ex post is even greater in public hierarchies than in private hierarchies for which the principal–agent theory originally was developed.

First, often the result, which the principal is supposed to know, is not easily measured in the public sector. Second, the outcomes of public sector activities are in many cases highly dependent on variables beyond the public agent's control making it difficult to evaluate whether the agent has stuck to the contract. Measuring performance and its modes in the public sector is usually directed towards measuring activity levels (efficiency) which are substitutes for measuring the effects of public policies (effectiveness) (Downs and Larkey 1986). Such proxy measures may have undesired incentive effects as public agents may well direct their efforts towards improving their "score" on the measured variable, and neglect real objectives. The two governance problems, adverse selection and moral hazard may well be connected as the potential for moral hazard makes it difficult for the principal to learn that he/she is the victim of adverse selection. The Niskanen theory of the budget maximizing bureau is one way to model the second principal–agent relationship. It emphasizes the asymmetrical information involved in the interaction between politicians and the bureaux, but it assumes a passive political principal (1971). Niskanen's conclusion that the bureau as the agent will always be in a strategically advantageous position in relation to its principal the government has received much attention, but it is far from the only model that approaches bureaucracy as a principal–agent relationship (McLean 1987; Dunleavy 1991). If one assumes more of symmetry, then the conclusion that the public budget will always be much larger or twice as large than the optimal one does not follow.

There is bound to be ambiguity in the double principal–agent relationships in the public sector. Bounded rationality, small numbers problem and strategic behaviour give rise to opportunistic tactics that were not recognized within the traditional public administration and welfare economics approaches. The interaction between interests and institutions is such in the public sector that the public interest concept and its derivatives in the market failure theory has limited applicability when understanding the behaviour of voters, politicians, bureaucrats and professionals.

The very same problems crop up when the state employs public regulation in stead of public resource allocation. Trying to control actors by means of regulatory schemes gives rise to the inefficiency problems stated in the so-called capture model (Stigler, 1988). The generalized model of public regulation in the form of the model of rent seeking points out that there is no way for the government but to pay a rent for the information advantage that those regulated possess (Tollison, 1982). Implementing first-best solutions by means of public regulatory schemes is impossible due to information asymmetry, and second-best solutions are difficult to identify.

Choice of Public Institutions

The neo-institutional literature not only speaks of alternative solutions to contractual problems in voluntary exchange or hierarchy. In addition, there is the meta-contractual model about transactions costs enhancing the construction of efficient institutional solutions. If the raison d'étre for institutions is to economize on transaction costs, then efficiency could enter either by fiat or by evolution, i.e. either through a rational choice of institutions or by means of the invisible hand of competition. The rational or effective solution may be reached through one of two paths: (1) design and (2) selection (Alchian 1950).

There are three main problems with the efficiency model interpretation of the origin of institutions. Firstly, as pointed out by North (1990) no neat supply function of new institutional arrangements can be taken for granted: How to identify the menu of organizational forms that a society devises in responses to changing relative prices? Secondly, the bargaining problem when choosing institutional forms involves high transaction costs which may prevent the parties from reaching an institutional agreement to the benefit of all the affected parties. Thirdly, the problem of inertia (Matthews, 1986:913-915) arises, as complex institutions serving several purposes may prove difficult to change. The natural selection argument concerning the evolution of rational institutions is hampered by the fact that there is no autopilot steering the development of such institutions along the right path. Changes in such rules are made by decisions and not by aggregate changes in a population of institutions. Institutional decisions depends on the perceptions and interests of the affected parties and their relative bargaining strenght. The visible hand may be influenced by competitive pressures, but it is certainly not as efficient in eliminating inefficiency as the invisible hand of competition could be claimed to be.

If efficiency will not come about by the rationality of a selection process, then rationality by design remains the only way. But is really some rational decision model adequate in a choice environment where collective rules and norms is to be decided upon? The rational choice of institutions is the choice which "the collectivity believes, on average, will generate the least ex post regret" according to Shepsle (1989:139n). In this case, the efficient set of institutions would be the intended result of a collective choice process.

The social and public choice litterature has shown that outcomes of voting procedures cannot be predicted only on the basis of knowledge of the preferences of the voters. "An outcome X was said to be an equilibrium if there existed no Y preferred to it by a decisive coalition of agents, normally a simple majority of the set of agents (Shepsle, 1989:136). In voting processes, such equilibria generally do not exist when a collective choice is to be made between three or more alternatives. Every alternative X can be beaten by some alternative Y which is preferred to X by a decisive coalition of voters. There is a cycle of preferences for the alternatives. In fact, not only can every alternative be beaten, but any alternative can also be chosen depending on at what point the cycling process is stopped (McKelvey, 1976).

Actual voting processes have not revealed the flux predicted by formal theory, which has lead to the rediscovery of institutions (Shepsle, 1989). Within a given set of institutions, formal or informal rules, equilibria generally do exist. In fact there are often several equilibria. Rules may restrict the agenda, the issues voted upon, the dimensions of an issue voted upon together or separately, the alternatives allowed to enter the voting process and in which sequence, the possible coalitions between choosing participants, etc.

However, groups who find that policy outcomes are unfavourable to them due to a particular configuration of institutions providing constraints may seek to change these institutions. They have institutional interests which are derived from their policy interests (Riker, 1980). What, then, are institutional interests?

Vanberg and Buchanan (1989) decompose the concept of "constitutional preferences" or institutional interests into two components: constitutional theories (cognitive) and constitutional interests (evaluative). An individual's constitutional theories are his/her conceptions about what will be the actual outcomes of alternative rules which may be more or less correct. Constitutional interests on the other hand are the evaluations, based on the individuals' values, of the various outcomes. Since all theories are to some degree uncertain, the individuals are placed behind a "veil of uncertainty" (Vanberg and Buchanan, 1989:54).

If the veil of ignorance is thick meaning that there is a lot of uncertainty about how an individual's interests will be affected by various institutional alternatives, risk averse individuals may choose institutions that "generate the least ex post regret". However, in many cases the veil of ignorance is thin. The institutional choice process is then not much different from the policy choice process, i.e. a process characterized by the lack of stable equilibria.

An infinite regress arises where in the end some choice of political institutions must be unconstrained leading to a lack of a stable outcome of the collective choice process. Following this line of thought, efficient institutions cannot be the predicted outcome of a voting process simply because no equilibrium outcome can be predicted in the absence of institutional constraints. The attempt in the neo-institutionalist approach to salvage the optimality conception by means of the theory of equilibrium institutions cannot be upheld.

Conclusion

Institutions may be interpreted as the humanly devised constraints on social interaction. There is a basic choice between pursuing ones interests within an established framework or making an effort to change this framework. As these courses of action may be regarded as alternative means for the rational pursuit of ones interests, egoistic or altruistic, institutional choice may be analyzed in the same analytic framework as choice within a given institutional structure. This way of considering the relationship between institutions and interests makes interests take precedence over institutions which is exactly the opposite position maintained in the sociological version of neo-institutionalism. Neo-institutionalism in the economic approach to the public sector implies that institutional choice is very important in public policy-making and implementation.

The institutionalist revolution in political science is the most important achievement in this discipline during the 1980s. It has opened up new ways of modelling the public sector, resulting in challenging models of policy-making and implementation in state and local government.

The different neo-institutionalist paradigms bypass the two prevailing approaches to the analysis of the public sector in an era of big government, viz. the traditional public administration framework with its Weberian conceptions of hierarchy, division of labour and public interest motivation on the one hand

and the welfare economics framework with its traditional policy criteria of market failures. Understanding the public sector requires a focus on interests and institutions as well as how they interact in the making of strategies among the actors in state and local government.

The sociological institutionalism of March and Olsen, rejecting each and every reductionist interpretation of the public sector, has a basic holist twist which upsets the balance between the motivational aspects – interests – and the rule aspects – institutions – in public sector behaviour. On the contrary, there is a tendency in the neo-institutionalist approach developing from the economic man decision model, to expect that institutions can be derived from interests in a manner that could satisfy criteria on optimality and rationality.

A clear separation between interests and institutions may be uphold, while at the same time remaining with the confines of methodological individualism. The new institutionalism seems a most promising approach to the analysis of the public sector as it emphasizes the strategic dimensions in policy-making and implementation pointing to opportunistic behaviour, bounded rationality and asymetric information.

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