

INCENTIVES AND CONSTRAINTS IN THE PUBLIC SECTOR: THE BEHAVIOR OF THE RENT-SEEKING BUREAUCRAT

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Abstract: The aim of this paper is to analyze the incentives and constraints that a typical bureaucrat face in his or her daily activity and to present some conclusions related to the most likely behavior of bureaucrats. We begin by analyzing the behavior toward advantage seeking. We then apply the hypothesis of rent-seeking behavior to the activity of bureaucrats. After discussing the main differences between the incentives and constraints of the managers of privately owned enterprises and bureaucrats, we conclude that the activity of rent-seeking characterizes the activity of bureaucrats. Finally, we identify the rule of law as the best institutional arrangement for discouraging the rent-seeking activity of bureaucrats.

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Rent and rent-seeking

Economic rent is defined as the surplus that a factor of production gets above the minimum amount of money needed to keep it in its current use. All factors of production have alternative uses in which they can earn more or less than in their current use. The opportunity cost of using one factor of production is the best alternative use that must be forgone. In order to prevent it from moving from one use to another, a factor of production must earn a sufficient amount of money (i.e. by definition the economic rent).

Capital, land, and labor have all alternative uses. Their owners will seek the most productive use for their property. For instance, a parcel of land can be used for agriculture or it can serve for developing a residential area. The owner of the parcel must earn enough from cultivating the land in order to prevent him from transferring its use for buildings. In other words, the owner must earn enough in economic rent.

The owners of labor-power can also earn economic rent. If an engineer can earn in the current employment a salary that is greater than the one in the best available alternative, he or she earns an economic rent. The analysis of the economic rent earned by the owners of labor-power is complicated by the non-monetary advantages that people obtain from different jobs, advantages that influence their decisions. The size of the economic rent obtained by the mentioned engineer can be substantially different in the actual use of his or her work-power. In other words, the economic rent for the

owners of labor-power is given by the sum of monetary and non-monetary gains in the actual use over the gains in the best available alternative.

Seeking and keeping the economic rent define the behavior of the people as resource owners. Economic rent is a very pleasant thing for the individual that gains it. However, it is under a permanent threat from the competition. To describe the behavior aimed at obtaining and keeping economic rent, economists use the term rent-seeking. Resource owners will engage in rent-seeking and rent-keeping activities when they believe that the anticipated benefits are greater than the anticipated costs. For example, employees that realize that in the current occupation gain economic rent will resort to strikes or some other means of pressure if they are at risk of losing their jobs. In terms of rent-seeking behavior, we can define a strike as the most powerful means that employees can use in order to keep the economic rent they gain in the current employment.

Capital owners can also gain economic rent. The competition makes market prices to be closely related to the opportunity cost. This way, the economic rent is diminished. It can be regained through finding new ways to satisfy the consumers, technological improvements, and better management. To the degree that the consumers are willing to pay a price that covers the opportunity cost, wealth is created. People's behavior aimed at gaining rent through creating benefit is called profit-seeking. For an entrepreneur, the rent the plane through political means is just as good as their end of day and through markets. In addition, it has a net advantage: the government can protect the rent through obstructing the competition.

Let us take the case of an automobile manufacturer. Studying the incentives and constraints that the managers face in their rent-seeking behavior can help us create a proper image. The enterprise gains profits that stock owners and managers think as appropriate. However, profits are declining due to increased competition from foreign producers. If the enterprise does not adapt its production to the consumers' demand, profits will continue to decrease and will ultimately turn to losses. If the rules of the game in the economy allow it, the managers have a strong incentive to seek protection from the politicians through some form of entering barriers (for example, through the introduction of import duties). Since the economic case in favor of free international trade is strong, economists explain import duties based on the rent-seeking behavior: some producers are successful in convincing politicians that sector X of the economy needs protection from foreign competition.

The structure of incentives and constraints (i.e. the rules of the game) is the main element that models the behavior of entrepreneurs in their trying to engage in rent-seeking as opposed to profit-seeking. Therefore, there are two opposite ways of action for a resource owner seeking the most profitable productive destination for his resources: rent-seeking and profit-seeking. The difference between the two is given by the wealth that is created in the economy. The entrepreneurial way of obtaining and keeping the rent is the one that produces wealth in the economy (Cowen & Tabarrok, 1999). The political way does not produce wealth; it merely transfers the benefits from one person to another.

The rent-seeking bureaucrat

Without any doubt, the term *bureaucrat* has a pejorative meaning. No one thinks that his or her job is related to bureaucracy. In the eyes of the public, the bureaucrat is thought to be indolent, indifferent, without initiative, and always ready to take bribes. Nevertheless, we will employ the following hypothesis: the bureaucrat is no

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different than the business people or managers. One does not need special characteristics in order to become a public servant. In fact, there are numerous cases in which politicians employ trustworthy managers to run a government bureau. The bureaucrats are no better or worse than their equivalent working for private corporations. The bureaucrats are employed by the government administration or by various regulation agencies. The official denomination of such employees is public servants, but in economic theory, *bureaucrats* and *bureaucracy* are the common terms used. Analyzing the set of incentives and constraints of bureaucrats is essential in determining their behavior. The bureaucrats have a strong incentive to serve the interests of the politicians that supervise their bureau.

There is a fundamental distinction between private company and a government bureau: unlike the private company, a government bureau does not seek profits. The purpose of the bureau is to supply a good or service in exchange for a budget that the state periodically grants it. The consumers do not buy the goods or services that the bureau supplies in the regular sense, so the value that consumers assign to those goods and services cannot be determined. That does not mean that the goods or services are of no value. It simply means that the value of the good or service cannot be identified. Some bureaus may charge consumers a user fee in exchange for the service supplied, but usually this does not cover the costs incurred.

In the case of bureaus, since there is no profit drive, efficiency is a futile term. The efficiency of privately owned firms is the result of voluntary actions of individuals. The activity of government bureaus is based on state financing, i.e. it obtains its revenue through coercive means. However, efficiency cannot exist in lack of voluntary behavior. The outcome is that there is no precise tool to be used to assess the degree to which a bureau reaches its targets. A bureau cannot be assessed as being more efficient than other that supplies the same service in a different area. Accordingly, bureaucrats cannot be rewarded with higher payments for their success nor can they be punished for failure.

Given the fundamental distinction between the incentives of bureaucrats and managers, one may ask the following question: what are the goals of a bureaucrat? The answer given in the last century by Public Choice school theoreticians is that the fundamental goal of a bureaucrat is to try to maximize the budget of his organization. A high budget is advantageous to the bureau chief and to the lower level bureaucrats. The goals that the bureau chief may have can always be better attained with a higher budget, *caeteris paribus*. Among the goals of the bureau chief, we can enumerate reputation, transfer to a larger or better bureau or other government position in the future, getting a good job in the private sector, and being elected to a political office. Lower-level bureaucrats also favor a large budget. A large budget means an increase of personnel. Consequently, the demand for supervisors is likely to increase. The chances for promotion are higher in a large organization. A large budget could also mean a better working environment for lower level bureaucrats. They may have more machines, a larger office, and a more modern equipment to work with. Lower level bureaucrats are thus likely to favor a bureau chief that promises to augment the size of the bureau.

As shown above, the bureaucrat is a rent-seeker. They tend to gain advantages in the current occupation that is higher than the best available alternative; they will spend resources to preserve that gain. The existing literature on this subject points that they can influence the political decision-making process to their own benefit.

The rule of law as a set of constraints in the public sector

The political way of seeking competition advantages (i.e. rent-seeking) does not produce new benefit for the economy; it merely redistributes the value that has already been created. Since in many cases it takes the shape of restrictions imposed to the free competition, rent-seeking behavior leads to market distortions. These distortions, especially when they influence the exchange rate and the price of various goods and services, lead to increased difficulties for individuals to plan for the unsure future and increase chances for error (Ikeda, 2003). The prospect of obtaining economic rent through political means modifies the incentives and constraints that people face. An increasing number of people will engage in rent-seeking, reorienting scarce resources from market competition and consumers' satisfaction to seeking advantages from politicians in their capacity of rules makers. Over time, this activity will undermine the trust in law and private property.

Hence, rent-seeking activity leads to wasting scarce resources. The institutions of an economy are essential in determining the size of rent that is possible to extract through political means. As a rule, the greater the benefits over costs, the greater the incentive to engaging in rent-seeking. Conversely, the lesser the benefits, the lesser the incentive for rent-seeking. Enforcing private property rights and, therefore, individuals' economic freedom, as well as a limited government tends to reduce the level of rent-seeking. The rule of law represents an institutional arrangement that protects private property rights and individual liberty. The rule of law protects individuals from arbitrary government intervention and therefore constitutes a guarantee for limited government and individual freedom. Legal rules that favor some competitors over others in specific markets are clear violations of the rule of law by breaching the principle of the universality of law. In fact, as Public Choice theories have proven, the excessive regulation of the contemporary economies is a consequence of the rent-seeking activity in a democracy (Gunning, 2003). An economy that is strictly characterized by the rule of law is an economy without rent-seeking activity.

If successful, the rent-seeking activity is a clear breach of the principles of the rule of law. Legal regulations that stem from rent-seeking tend to privilege some competitors at the expense of others. Self-oriented competitors are interested in capturing politically generated rents and they will spend resources in order to be among the winners. Rent-seeking and rent-keeping are fundamental motives for interventionist economic policy in modern-day democracies.

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