Joint Economic Committee Republicans
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Government's Incentive to Expand:

Private-Cost Minimization and Public-Cost Maximization.

Two recent reports released by the Joint Economic Committee (JEC) demonstrated that an excessively large government undermines economic growth and retards wage growth.[1] There are several reasons why excessive government diminishes economic well-being. One important reason for the negative effects of excessive government is the different incentives facing bureaucrats, politicians, and entrepreneurs.

Private-Cost Minimization

In the private sector, competition insures that every entrepreneur must minimize costs. The benefits of goods and services used by consumers tend to equal the costs of producing those goods and services. Entrepreneurs cannot raise costs without providing additional benefits to consumers. If an entrepreneur's costs are greater than competitors, the entrepreneur will rapidly go out of business. Thus, entrepreneurs must continually monitor their costs to guard the health of their enterprise.

Competition among entrepreneurs spurs innovation and creativity. If an entrepreneur discovers an innovation that lowers costs, these lower costs will force other entrepreneurs to find cost-lowering innovations or go out of business. Likewise, an entrepreneur who can provide additional benefits to consumers, i.e. higher quality goods, while maintaining costs, will rapidly gain profits. Competitors must match innovative entrepreneurs.

Competition and the profit motive encourage entrepreneurs to constantly strive to improve quality and reduce prices for the consumer. This relentless search for cost savings facilitates economic growth. When people get the same goods for fewer resources (i.e. costs) or higher quality goods for the same cost of other inferior goods, they are wealthier.

Profits signal to entrepreneurs which goods to produce, innovations to imitate, and prices to set. Without profits, entrepreneurs do not have the information necessary to make informed decisions. Falling profits, or profits lower than other firms, signal that the entrepreneur must make changes to produce higher profits.

The economy of the former Soviet Union demonstrated what happens when profit incentives are absent. Managers were given bonuses based upon total tonnage of glass produced. So managers produced lots of very thick-paned glass that was not transparent. Central planners recognized they needed to change the incentives, so they paid bonuses for total number of panes. Managers produced very thin, brittle glass. Government planners could not create incentives that would encourage managers to produce the type of glass consumers demanded. Only profits generated by satisfying consumer demands can perform this vital role.

The incentive to produce profits is completely absent in the public sector. The lack of a profit motive means people in the government sector have different incentives. What are these incentives? They are difficult to define. Bureaucrats have various incentives such as job security, power, or prestige. Because their incentive structure is murky, determining the motivation is difficult. However, it is unlikely that bureaucrats will have the incentives to produce low-cost/high-quality services in the manner demanded by taxpayers.

Public-Cost Maximization

In the private sector, entrepreneurs must hold costs down to remain competitive. In the public sector, incentives lead bureaucrats to provide their services at maximum cost. Bureaucrats, even with the best of intentions, naturally tend to assume that the size of their bureaus measured in money, staff and power, affects its ability to be effective. Thus, there is a natural tendency to maximize an agency's budget, staff and power to ensure agency effectiveness. This budget maximization does not take into account all the competing private use of these resources. Since bureaucrats have specific inside information on the quality and costs of their services, often their bureau's interest in large budgets will be accommodated.

The major source of information for the budget process is prior years' budgets. Because budget decisions rely on historical budgets, bureaucrats' future budgets depend on maintaining a high-level of spending. If bureaucrats are successful in reducing costs, they will likely see their budget decreased, a disincentive which has an effect contrary to bureaucratic power and prestige enhancement. Lower budgets will make it more difficult to provide bureaucratic services while maintaining high staff and administration expenses.

Without the guidance offered by prices and profits, bureaucrats have no real way of determining the point at which their decisions impose more costs than benefits. Bureaucracy means that criteria such as budget maximization, administrative power, seniority, administrative convenience, and similar considerations dominate bureaucratic decision-making.

Another problem in the public-sector incentive structure is that it obscures information. In the example of glass production in socialist economies, managers cannot know how they can provide the appropriate type of glass because they do not profit. Without profits, bureaucrats do not, and can not, know if their services are valuable at the price offered.

Mistakes and Incentives

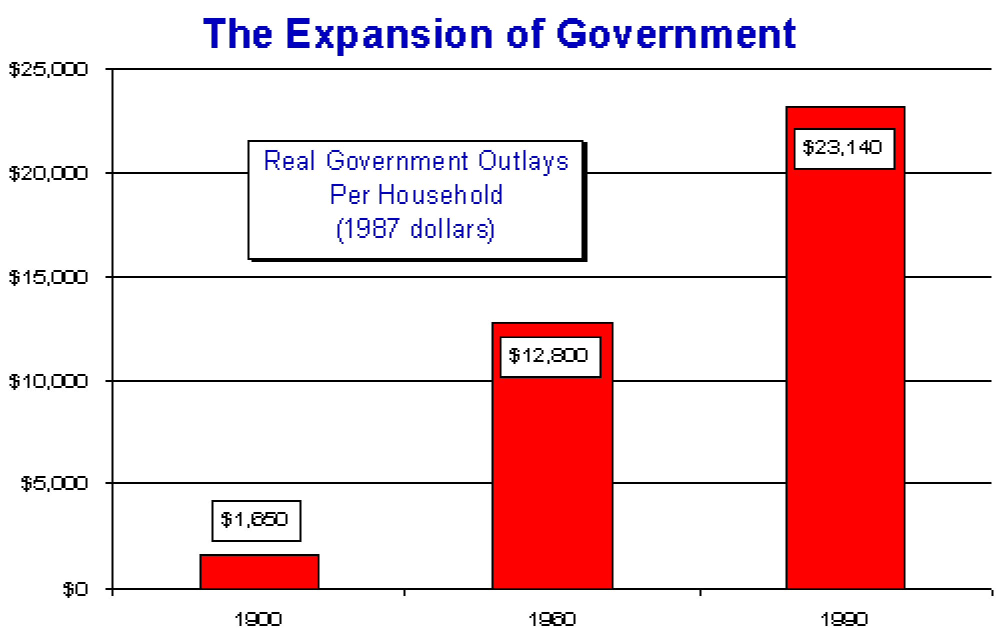
Adjustment to error reflects the different incentive structures of the public and private sectors. Mistakes are inherent in human endeavors. Every bureau or enterprise must deal with mistakes. However, in the private sector, the mistakes that matter are the ones which reduce profits. If these mistakes continue, the enterprises will fail and resources will cease being wasted in failing activities.

In a government agency, there is no way to determine which mistakes are costly and which are unimportant, since there are no profits to inform decision makers. To insure taxpayers' resources are not wasted, officials must develop rules and procedures that define appropriate behavior. However, rigid rules have a serious down side. Rules stifle innovation and initiative. They drive up costs as they force public servants to spend resources and efforts in compliance. The failure of the Federal Aviation Administration (FAA) and the Internal Revenue Service (IRS) to upgrade their computer systems is a prime example of the burdens of rigid rules and procedures.

Bureaucracy is in a difficult position. Without profits to guide behavior, grave mistakes are avoided by setting elaborate rules and procedures. Unless officials proscribe rules and procedures, taxpayers may suffer as mistakes are not corrected. However, rigid rules also impede creativity, innovation and flexibility. Clearly, it is a problem inherent in the public sector. To avoid the costs of bureaucracy, it is incumbent upon a society, which desires to increase economic well-being, to reduce the size and scope of government.

Conclusion

The different incentive structure facing public bureaucrats and entrepreneurs explains why the size of government has expanded (the figure below shows how pronounced this shift has been). Public sector growth is slowing economic growth and reducing economic well-being. When the effect of incentives is understood, it becomes apparent that reducing the size of government is very important in order to improve the economic health of America's families.



Source: Steve Moore, *Government: America's #1 Growth Industry*, Institute for Policy Innovation, 1995.

When the government expands, innovation is stifled. Resources are wasted through inefficiency. In the private sector, inefficiency dooms the enterprise to failure. Every day businesses fail throughout the country because they cannot provide services in the manner demanded by consumers. However, it is rare that a government program is ended. The reason is the incentive structure in the public and private sector.

The public sector is stifling initiative and entrepreneurship throughout the world. Government is growing ever larger at the expense of private consumers, workers, and producers. The result is anemic job growth and poor economic performance. The United States has been spared the worst of government excess yet our large government is hurting American families. Improvements in economic welfare demand a smaller government.

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Endnotes

1. *The Impact of the Welfare State on the American Economy*, Joint Economic Committee, (Washington, DC: December 1995) and *The Impact of the Welfare State on Workers*, Joint Economic Committee, (Washington, DC: March 1996).