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DESIGNING INDEPENDENT BUREAUCRACIES: ECONOMIC DEVELOPMENT, THE CORE, AND CREDIBLE COMMITMENT

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ABSTRACT

Economic development requires that entrepreneurs and investors be assured that the investments they make and the wealth they accumulate are not subject to expropriation by government. Unfortunately, in many countries, public agencies serve as the instruments by which political elites engage in corruption and other forms of extracting rents from the economy. A fundamental problem facing political actors, therefore, is how to design institutions and policies that credible commit to a stable system of guarantees of property rights and contract enforcement. Political actors must be constrained from using public managers to impose socially inefficient policies. The transformation of public managers from instruments of rent-extraction to instruments of credible commitment is a fundamental hallmark of the emergence of an effective political economy.

How political elites, who exercise a monopoly on the legitimate use of power, can be induced to implement bureaucratic reforms that support credible commitment is not fully understood. Principal agent theory and the new public management favor greater accountability of public managers to elected officials or eliminating public agencies altogether through deregulation or privatization. Neither greater accountability nor privatization, however, necessarily serves to constrain political elites. We argue that public agencies can play an essential role in credible commitment of the state. We make the case that institutional designs that provide a degree of public agency autonomy are essential if property rights are to be protected, contract enforcement ensured, and stable “rules of the game” are to be shielded from political predation. Using the game theory concept of the “core,” we show that public agency autonomy is a natural by-product of the competition between elites in democracies that exhibit multiple veto players. In addition, we show that transparency requirements and constraints imposed by professionalism and Weberian legal-rationality help ensure that public managers themselves do not engage in corruption or become rent-extractors. Contrary to most recent analysis of public agencies, then, a primary institutional design problem is how to induce public managers to serve the public interest without being fully responsive to elected political officials.
I. Introduction

Since the beginnings of the state, the possibilities for redistribution in favor of those with political power have been immense. Indeed, the state is defined by anthropologists by its capacity for redistribution of wealth. With the invention of agriculture, storage of agricultural produce became essential, both for seeds for the next season and to budget consumption against the seasons and bad weather. Storage and protection of agricultural wealth became both a public good to be supplied and a political resource for the political elites who controlled the wealth. It could be disbursed to pay for loyalty and withheld to punish disobedience. Hierarchical disbursement meant that military and civil functionaries—very quickly, bureaucrats—could be organized and motivated to protect the regime (Diamond, 1999).

The public managers could be mobilized for the provision of public goods, such as irrigation systems, roads and defense. They could be organized to provide for a system of justice, defining property rights and enforcing contracts. They could also be mobilized to guarantee the extraction of rents from all sorts of economic activity that the existence of a stable political system allowed.

The problem, as North and Weingast (1989) pithily noted, is that any state which is strong enough to protect a country from external enemies and internal dissidents, is also strong enough to redefine property rights and contract enforcement at any time, in the interests of the political elites. This means that the same bureaucratic machinery that was capable of providing public goods was also the means of hierarchical extraction
A shoe-maker could be put out of business because his competitor got to the political elites first and procured a monopoly for shoe-making. A trader was always at risk that the people he did business with could purchase protection from political elites more cheaply than they could pay their debts. A road contractor could be put out of business because a different contractor used influence with political elites to get the profitable contracts with fewer kickbacks. Contract enforcement was a risky proposition, dependent on paying more for justice than one’s suppliers and customers.

As North (1981) has argued, since the time of the Pharaohs, the self-interest of political rulers and their allies have made them the enemies of economic development. Rulers always need money, for defense against enemies as well as for personal consumption; and at any given time, the temptation to sell justice, dispense monopolies, accept bribes for contracts, force interest-free loans, and so on, overwhelmed the motivation to provide a level playing field for economic entrepreneurs and investors. Property rights and contract enforcement were always politically contingent, and political risk depressed the motivation for investors and entrepreneurs to accumulate wealth and grow the economy.

Economic development, North argues, occurs only in those political economies in which the access to political power by political elites is limited—that is, where the state is credibly constrained from the extraction of rents. The purpose of this paper is to inquire whether public managers may play a special role in economic development by advancing credible commitment. We claim that a political system is not credibly constrained unless and until its public managers are constrained from acting as agents of political elites. We argue that, the transformation of the bureaucracy from rent-extraction machine to
neutral, expert enforcers of the rules of the game, is the sine qua non for credible commitment in the state. In England, Germany, and the United States, reform of the institutions of public management has meant the creation of protective barriers for bureaucrats from their political masters. Only when this occurs, and the economic role of the state is largely routinized in the hands of a professionalized bureaucracy, are investors and entrepreneurs assured that the rules of the game will not change tomorrow to their detriment.

Our argument is that public managers can aid in credible commitment by being transparently not the agents of key political figures. If the tax bureaucracy is responsive to key legislators, then clearly interests that hope to get tax breaks need only bribe those legislators. If the central bank is responsive to the chief executive, then the counter-inflationary influence of the bank is only as strong as the executive’s will to resist the temptation to dispense inflationary political benefits, to expand his influence in office, or simply to enrich himself in office.

We argue that principal agent models and the new public management literature do not offer adequate solutions to the problem of providing credible commitment for economic development. We show instead how multiple veto points in a political system create a core set of policy choices for public managers, which are independent from political leaders’ choices. When combined with transparency and other constraints, this independence increases the credibility of socially-efficient policy choices by the government. In the sections that follow we provide descriptions of rent extraction in different countries, discuss principal agent models and the new public management
approaches to economic development, and provide an alternative approach based on Madisonian checks and balances.

2. Political Elites, Patronage, and the Extraction of Political Rents

Consider a metaphoric game between an investor and a ruler. The investor has $1 worth of gold, hidden in her mattress, and the ruler has nothing. She can either take her gold out from her mattress and invest it in the ruler's economy or leave the gold there. If she does invest it, the investment generates $10 worth of benefit. The ruler can either steal the $10, leaving the investor with nothing, or tax the investor $5, leaving the investor with $5. In the backwards induction equilibrium of the game, the investor, anticipating that the ruler will choose $10 over $5, leaves her gold in her mattress. The problem is that the equilibrium of the game is Pareto suboptimal: both investor and ruler are worse off than if the ruler could be counted on to constrain his self-interest.

This is an example in which moral hazard resides with the ruler; the ruler’s self-interest is the direct cause of inefficiency. And as we shall see, the ruler has need of an agent, or trustee, who can be counted on not to act on the ruler’s self-interest; we claim that this is a systematic and fundamental problem in politics, and that the most important role of the bureaucratic agent is to constrain the self-interest of ruling political elites.

The ruler-investor game is a game-theoretic version of the problem analyzed by North and Weingast (1989). Using the example of the predatory behavior of the Stuart kings, they argue that the inefficient equilibrium was maintained consistently throughout the era of the Stuarts, and was indeed illustrative of a problem with all forms of authoritarian government. The Stuarts redefined property rights and contract enforcement after the fact, with their control over judicial appointments, their use of the
power to establish and protect monopolies, and their ability to tax those with wealth through more or less coerced loans.

The problem persists as long as rulers have the power to prey on economic actors. Or to say the same thing in another way, the problem persists unless and until rulers are credibly constrained from preying on investors and entrepreneurs—and constrained so visibly that investors and entrepreneurs know that if they enter into a contract with the king, or with someone who might bribe the king, their contractual rights will be enforced by an independent judiciary, supported by an independent parliament.

In most times, and in most places, political elites are not so constrained. As North (1981, p. 25) writes:

From the redistributive societies of ancient Egyptian dynasties through the slavery system of the Greek and Roman world to the medieval manor, there was persistent tension between the ownership structure which maximized the rents to the ruler (and his group) and an efficient system that reduced transaction costs and encouraged economic growth.

The worst kleptocracies, such as Idi Amin in Uganda, Mobutu Sese Seko in Zaire, and Ferdinand Marcos in the Philippines, systematically send tax collectors out to take two chickens from every household that has three. Kleptocrats can accumulate monumental wealth from even the poorest of economies, with a sufficiently fine-grained bureaucratic extraction machine. But even in the typical, rather than the worst, such autocracies, the bureaucratic agents of the state have the capacity to accumulate wealth for themselves and their superiors by systematically exploiting the monopoly power of the state to license and regulate economic activity.
Publicly-Regulated Private Cartels and Other Legal Rents

Private actors face incentives to seek government rents. Industries that are enduring severe competition see their profit margins shrink, and many firms go out of business, such as is occurring in the airline industry in the U.S. currently. These firms have an incentive to form a cartel in which they secretly collude on prices and prevent other firms from entering the market. These privately-organized cartels, however, are highly unstable because individual members face a “prisoners’ dilemma.” Any one firm can gain enormous profits if it can get away with not following the cartel rules by lowering prices and seeking to gain market share or by raising prices and not cooperating in trying to keep a competitor out of the market. As long as the other firms adhere to the cartel rules, the “cheating firm” gains financially. Since every individual member of the cartel faces the same incentive to cheat, the private cartel is unstable (Hammond and Knott, 1988).

One way to solve this problem is for the firms to seek public regulation that guarantees through legal statute that the cartel’s rules will be followed. In setting up price and entry regulation, many firms already-established in the industry favor such regulation because it protects them from competition. Even in economically advanced countries, during most of the twentieth century, major sectors of the economy fell under this kind of inefficient regulation, including airlines, trucking, telecommunications, banking, investment, agriculture, and heavy industry (Hammond and Knott, 2000). In general, there is a mutually-reinforcing public and private interest in rent seeking that leads to inefficiencies in many sectors of the economy. And the capacity of the state to
intervene on behalf of protected firms diminishes investment and entrepreneurial activities by other firms in the industry.

Whether rent seeking is thought of as corruption depends on the legal system and the nature of the rent seeking activity. Most legal systems in democratic countries support the theory and practice that compensation to politicians and other public officials should be based on salary pay scales that are roughly related to each group’s marginal contribution to producing the public good. The pay scales are relatively modest and reflect the public service aspect of these positions. The legal system may sometimes define rent seeking as illegal corruption and at other times as legal activity, even when the activity causes inefficiency in the production of public goods. But inevitably, the end result of these transactions is to raise uncertainty about property rights and contract enforcement. When one economic actor bribes the government to get a school construction contract, other entrepreneurs may not find it worth their while to invest in their own construction businesses. When one retailer bribes the government to get access to a new shopping mall built with government cooperation, other retailers are more uncertain about their ability to compete effectively. When a manufacturer encourages a regulatory agency to issue regulations that raise entry barriers for competitors, investment patterns are distorted and entrepreneurship discouraged.

Erecting Barriers to Entry

The cartelization of industry generates excess profits as long as the cartel can be maintained. The constant threat to these profits, and to the political and economic forces behind the cartel, is the entry of competitors. So a crucial aspect of rent extraction is
erecting barriers to entry, to allow the privileged competitors to make profits, and share
them with their political allies.

The most graphic description of entry barriers is found in Hernando De Soto’s
*The Other Path* (1989), which documents the role of tax officials, health officials,
building inspectors, tariff officials, police, and other bureaucrats in the systematic
protection of political elites. Since the “official” economy protects political elites, then
competitors must be licensed to do business. De Soto’s researchers found that simply
setting up a new garment business in Peru requires 289 days and 11 permits. The
researchers were asked for bribes ten different times, and had to pay bribes on two
occasions to keep the process going. The total cost to setting up the one-worker firm was
32 times the monthly living wage. The same was true for getting clear title to a home, a
shop, or a car. As a result, many Peruvians live and work in an economy that is
informal—and totally without the protection of the state for property rights to the hut they
live in, the taxi they drive to make a living, or the shop where the mother sells a few
simple craft items. Nor are the police or the courts available to enforce contracts
between actors in the informal economy. The incentive to invest in businesses, enhance
their homes, or even provide minimal maintenance for their taxi cabs is absent. A great
deal of economic activity is directed simply at day-to-day consumption, because the risk
associated with investment and entrepreneurship is too great.

In transition countries, rent extraction has become even more appealing to
political elites because of the rapid modernization of the economy and society. The
process of reorientation to a market economy in post-Communist countries has produced
an increased interest in material values, unemployment and other hardships of the
economic transformations, and a decrease in legal financial gains for civil servants and elites (Anusiewicz et al. 2001, 81). In Russia, several public officials and political figures were accused of corruption in the export of oil in the early 1990s, including the acting Prosecutor-General Aleksei Ilyushenko (Holmes 1997, 138). In Hungary, the most significant corruption case was that concerning the members of the privatization board including the Minister for Industry, Trade and Privatization, Tamas Suchman. They were forced to resign in 1996 when evidence surfaced about a $ 5.1 million consultancy fee paid to a lawyer (Holmes 1997, 139).

Such examples are easily found in third world countries as well. In the early 1960s, the ruling class of the All People’s Congress came to power in Sierra Leone. Between 1965 and 1992, this ruling class under the leadership of President Siaka Stevens forged a corrupt state system that resulted in the impoverishment of the whole country (Olowu 2001, 108).

Resource Management

A central problem for many third world countries is the exploitation of a commons. Nations with tropical rain forests have an asset that, like oil, can be used to spur economic growth. Or, it may be used to enrich those granted logging rights, and their political allies. In the latter case, over-rapid extraction results in “timber booms”, which ultimately have a harmful effect on a nation’s prospects for economic development (Ross, 2001).

In Malaysia, Indonesia, and the Philippines, timber booms have resulted in rapid deforestation, flooding, and social disruption. Those who have accumulated wealth, as usual, have taken their earnings and invested it in safer political systems, leaving much of
the population paying the costs of the boom. In the Philippines and Malaysia, at least, the building booms were resisted by strong professional forestry departments, which tried to restrict logging to sustained-yield levels, based on the best science in the field. However, in both cases, the attempts of professional bureaucrats to protect the commons were undermined by politicians with close relationships with logging firms, both legal and illegal.

**Bureaucratic Patronage: The Common Thread**

The exploitation of tropical forests in the Philippines, bribes to obtain licenses in Peru, tax schemes in Sierra Leone, all have a common thread. The implementation of these plans requires that crucial agents of the state be mobilized and motivated to participate. These problems are universally solved by creating a patronage bureaucracy.

Most narrowly, a patronage bureaucracy means that positions are filled due to the influence of political sponsors. In Great Britain in the first half of the 19th century, these sponsors were most notably the landed gentry (Shefter, 1978). In the U.S. after the Civil War, the most influential sponsors were city bosses and their allied ward leaders. (Knott and Miller) In Latin America, patronage is controlled by influential individuals in various political parties and factions (Geddes, 1994). In more authoritarian regimes, the sponsor may be anyone with sufficient influence with the dictator or the dictator’s key supporters.

But the effect of patronage extends far beyond the simple act of appointment. Because the patronage bureaucrat knows that he can lose his patronage position as easily as he earned it, he is a malleable tool of the political elite who sponsored him. Losing the job would be especially painful because the value of the position is often based more
on the possibilities of corruption than the official wage, which may be nominal. Indeed, in many cases, the applicant for a patronage position may be willing to pay the patron much more than the nominal annual salary for the appointment.

Once in office, the patronage appointee is, in modern parlance, the perfect “agent” of the politicians who appointed him. The recruitment was based on an eagerness to participate in whatever the rent extraction schemes are in place: selling timber permits, collecting bribes for business licenses, operating illegal businesses with police protection, or selling tax concessions. The interests of the political “principal” and the patronage worker are nearly perfectly “aligned”. The political patron may worry that any particular subordinate will keep too large a share of the rents, but this problem is normally under control because the principal knows how much to expect, based on the revenues of other bureaucrats. Any bureaucrat who fails to produce up to the norm can be easily replaced.

But the loyalty of the patronage worker extends beyond being a willing agent of rent extraction schemes. More fundamentally, the patronage worker provides political support to maintain the status quo. In electoral systems, the patronage bureaucrat may be expected to make financial contributions and deliver votes. In more authoritarian regimes, the bureaucrat may supply vital political information, suppress dissidents, and support allies.

The patronage bureaucrat is thus the means for keeping political elites in a position of political power, as a means to continue the extraction of rents. A political system based on patronage is thus famously difficult to change. Individual members of a political elite may gain or lose power, but the system—the patronage system—goes on
and on. And in the process monopolies are maintained, tax systems subverted, entrepreneurship discouraged, and investment driven away.

As Geddes has shown so well in her compelling study of Latin American patronage, the system may persist despite a general awareness of the efficiency costs. No one segment of the political elite wants to give up his own patronage power, whether others are or are not willing to. Patronage takes on the nature of a prisoners’ dilemma, in which social inefficiencies are inadvertently maintained by the self-interested actions of the participants.

3. Conventional Solutions

Solutions to political rent seeking usually call for increased accountability of public bureaucracies to elected officials and the centralization of authority in political parties. The other approach is to support privatization of government activities and deregulation. Neither of these approaches, we will argue, takes sufficient account of the role of public agencies in economic development.

Principal Agent Theory

Principal-agency theory indicates that the principal’s problem of motivating and controlling subordinates is easiest to solve with three conditions: (1) the principal has an extensive array of incentives with which to motivate the agent; (2) the agent has no particular informational advantage with regard to the principal; and (3) the principal is unified, rather than divided and contentious. All of these conditions are met in many such autocratic regimes. In rent extraction systems such as that in Peru, the problem with
public managers is not their unaccountability to political elites. On the contrary, the accountability of bureaucrats to elites is a measure of the problem.

Accountability of bureaucrats to political elites by itself does nothing to constrain the rent-seeking of those elites—on the contrary, it is the means by which political elites implement rent-seeking strategies. Bureaucrats typically pass a proportion of their bribes upward, or pay politicians “up front” for their influence in securing patronage appointments with a high potential for corruption. When politicians make lucrative deals for contracts, licenses, or favorable information with economic actors, they depend on their control over bureaucrats to implement the deal. Whether corruption is initiated on the street-level or at the corporate boardroom, it depends on bureaucratic accountability to political elites. And, on the contrary, a credible commitment to property rights and contract enforcement requires the transformation of bureaucrats from faithful agents of rent-seeking politicos to insulated professionals. Economic development requires a departure from a degree of non-responsiveness on the part of bureaucrats.

New Public Management

One of the watchwords for the new public management is accountability. While accountability is supposed to be to the public, in practice accountability is to elected officials. In many state governments in the U.S., governors and legislators are demanding more accountability of higher education to the elected officials. In several cities mayors have taken over the school system, and in Illinois and Michigan, the governors have proposed to gain more control of statewide school boards. There is also a movement in several states to change judicial elections to appointments and bring judicial decisions under legislatively mandated sentencing guidelines. While accountability is a positive
goal, the institutional means for implementing accountability have a major impact on whom public managers are accountable to and for what purposes.

A second tenet of NPM—privatization—certainly plays a role in limiting the possibilities of government rent extraction. The major deregulation and privatization movements of the past two decades have led to widespread increases in socially efficient activities (Glaeser and Goldin, 2004). However, not all public agencies can or should be privatized. If the agency is simply providing an easily measurable service, such as garbage collection, then there seems to be little reason why privatization is not a benefit. But if the agency is providing a credible commitment to property rights, contract enforcement, the rule of law, and a level playing field, then it needs to be in the transparently public domain. A private corporation that would offer to provide the “services” that such a public agency provides would be less credible than the public agency because the public would assume a profit making corporation would be open to bribes and would sell to the highest bidder. Further, the corporation could hide behind its private status to reduce transparency.

In general we would expect privatization or deregulation to produce a net efficiency gain when the issue is price controls or restrictions on entry into a market. The case for privatization is not so clear when key activities of the state are concerned with the economic infrastructure, including labor relations, monetary policy, anti-trust policies, legal and financial policies, and the environment. In these cases, the need for credible commitment distinguishes between those agencies that should be privatized versus those that should necessarily remain public agencies.
4. Delegation, Public Management, and Credible Commitment: Possible Constituencies for Bureaucratic Insulation

The conventional solutions just discussed do not in any way prepare us to understand the bureaucratic transformations that have occurred in those nations which most credibly defend property rights and contract enforcement. Neither current public management theory nor principal agency theory would prepare us for the dramatic insulation that characterized reform movements in those nations.

But this standard story about credible commitment does not mention public managers. We argue that investing key decisions in autonomous public managers, and thereby making those decisions subject to the forces of professional expertise and bureaucratic routine, is the primary means by which investors and entrepreneurs can be sure that the state will not be subject to the vagaries of future rent-seeking. Governments are credibly committed to property rights and the rule of law when investors believe that a group of professional bureaucrats (making and enforcing rules) are insulated from political control, and delegated with the authority to make key decisions affecting property rights and contract enforcement (Majone, 1997; Miller, 2000).

Credible commitment of the ruler is established by the agent's non-responsiveness to the ruler's interests (North and Weingast 1989). The hallmark of modern democratic government is, ironically, bureaucrats who are not responsive to the aspirations and interests of political elites.

Bureaucratic reform consists first and foremost of ending the responsiveness of bureaucrats to political elites by ending (or limiting) the patronage system. This requires what Shefter (1978) has called a “constituency for bureaucratic insulation”. At first glance, it may be difficult to discern who would be in this constituency, and how
they might succeed in an attack on patronage; after all, the operating assumption of any patronage system is that anyone can be bought. The patronage system has enlisted the self-interest of a critical coalition to maintain itself, and as the Tammany Hall boss George Washington Plunkitt wrote, “Reformers are only morning glories.” It would seem to require stupidity on the part of the leaders to allow reformers to succeed.

Admittedly, most attempts to reform patronage systems do fail. But we will examine cursorily three famous successes of civil service reform over patronage.

*Autocratic Transformation: The Case of Germany*

The easiest type of reform to visualize is in a non-competitive political system. In Latin America, as Geddes pointed out, politics is highly competitive, and this is what gives patronage its value to each of the competing political elites. But imagine a political system in which the form of competition is between a centralized ruler and decentralized nobility—with patronage largely in the hands of the nobility. Then the ruler may well support an end to patronage as a way of weakening his rivals—and obtaining a more effective civil service in the bargaining.

This is Shefter’s (1978) interpretation of the end of patronage in Germany. When Frederick the Great started the modernization of the Prussian army and state bureaucracy in the late 18th century, political necessity required that he give key positions to the aristocracy. “The aristocracy was the class the monarchy could least afford to alienate” (p. 424). Napoleon’s victory over the Prussians at Jena in 1806 gave an advantage to reformers from the aristocracy, including Baron vom Stein, Prince von Harden berg, and Count Gneisenau. They argued that Prussia could no longer afford the luxury of allowing aristocrats control of patronage, and instituted a system of civil service exams, which
would replace the patronage system of appointments. The opposition of the aristocracy was greatly weakened by what amounted to a compromise: the exam system was designed in such a way as to strongly advantage those with a classical education and a university education—which effectively limited appointments to children of the aristocracy and the upper bourgeoisie. Nevertheless, once in place, the civil service system succeeded in creating a corps of bureaucrats and officers who could plan on a lifelong career and “prevented outsiders from influencing the bureaucracy through the hiring, firing, and promotion of civil servants.” As a result, bureaucrats’ incentive to invest in the professional skills that Prussia needed to compete with France increased, even as their responsiveness to ambitious politicians outside the bureaucracy decreased.

By the end of the 19th century, the German civil service so impressed Woodrow Wilson that he wrote a famous scholarly treatise advocating bureaucratic insulation for the U.S. bureaucracy, with the German bureaucracy (but not its autocratic political system) as a model. Wilson wrote that it was in Prussia that “administration has been most studied and most nearly perfected . . . Almost the whole of the admirable system has been developed by kingly initiative” (p. 7).

Civil Service Reform in Great Britain

Civil service reform in Great Britain was later in coming than in Prussia, and the struggle to find a “constituency for bureaucratic autonomy” was more difficult in the British system. In the 18th century, patronage was rampant in the British system. Enough of the patronage was controlled by the king that the king was able to play a political role, at least as a blocking coalition with his forces in Parliament.
By the early 19th century, the king’s control of patronage evaporated, leaving patronage in the hands of decentralized landed gentry. The patronage positions jealously protected by these dignitaries were sufficient to guarantee themselves or close allies positions in Parliament as backbenchers. The problem for the party leaders asked to form governments in the first half of the 19th century was that their ability to govern was limited by back-benchers whose independent political power, based in patronage, made them unresponsive to party discipline.

The emergence of a strong cabinet system supported by party discipline is described by Cox in *The Efficient Secret*. What Cox does not mention is that this party discipline could never have been achieved as long as back-benchers and their allies in the gentry controlled patronage. The foremost element in the political coalition backing civil service, therefore, were party leaders who wanted to deprive backbenchers of the basis for independence. But party leaders did not simply remove patronage from the gentry; it eliminated patronage by putting bureaucratic appointments on the basis of merit exams.

Why did the gentry go along with such a system? Two factors were key. One was that the value of patronage was diminishing as suffrage was extended in Great Britain. While a limited number of patronage positions could be a powerful force in a constituency with a limited number of voters, the same number of patronage positions was less of a political force as the number of voters rapidly increased. The gentry who controlled nominations to government jobs would inevitably have to say “no” to job-seekers more often than “yes”, making as many enemies as allies.
At the same time, the proposals for civil service reform supported by party leaders in the 1860s offered a “sweetener” to the gentry. Positions in the civil service were stratified, with top positions all being filled by an exam system that stressed the classical education. This education was primarily available in the “public schools” and Cambridge and Oxford, which were in turn only open to the gentry and the upper echelons of the bourgeoisie. Thus, members of the gentry who gave up the political power that went with control of patronage could nevertheless be assured that their children would continue to end up with the most powerful civil service positions.

As in the Prussian system, biased civil service exams nevertheless broke the political linkages between elites and bureaucrats, and thereby created an incorruptible civil service that was the basis for a bureaucratic guarantee on property rights and credible commitment. One could make an investment in a manufacturing plant in Great Britain without worrying whether a competitor would recruit the bureaucracy to throw obstacles in the way. One could pay one’s taxes without worrying too much that a competitor was bribing tax officials to obtain preferential treatment.

Progressive Reform in the U.S.

In the same article in which Wilson extolled the skills of Prussian bureaucrats, he also argued that they could serve as models for bureaucrats in a quite different political system precisely because there was and should be a distinction between politics and bureaucracy. Politicians could establish a tax policy, but bureaucrats, not politicians, should implement. Reading between the lines, one wonders if Wilson was thinking that nothing good could come of politicians—with their inevitable urge to make friends with favors-- involved in the implementation of a tax policy. At any rate, he is insistent on the
principle of bureaucratic autonomy: “Most important to be observed is the truth already so much and so fortunately insisted upon by our civil-service reformers; namely, that administration lies outside the proper sphere of politics” (p. 10 emphasis added).

During the Progressive period, reformers went to great lengths to break the chains of accountability between agency managers and their political masters. The foremost example of this is civil service reform. Public agency positions placed under civil service were filled by merit examination. In some ways, it didn’t matter whether the substance of the civil service exam was appropriate for the bureaucratic skills that were needed for the job. What was important is that the civil servants who passed the exam and received the job were no longer accountable to political party leaders who had formerly selected people for the job.

Civil service tenure further protected agency managers from pressure from political elites. As a result, political elites no longer felt confident of their ability to seek political and personal advantage from agency managers. At the same time, civil service tenure gave officials a longer time horizon than the next election. This would prove to be invaluable in everything from the management of public parks to the interest rate.

At the same time, Progressive reform stipulated greater transparency for bureaucratic proceedings. Federal bureaucracies were subject to systematic budgeting and accounting with the Budget and Accounting Act of 1921. This meant that favors done for a political elite were more likely to be seen by other political elites, who could object. In this environment, the safest and wisest course for self-interested bureaucrats was to resist doing secret favors for anyone—in other words, following rules and procedure as strictly as possible. Weberian bureaucracy is infuriating, of course, to those
clients who believe they have a perfectly reasonable explanation why standard operating procedure should not apply to them in their particular circumstances. However, the advantage of unbending, impersonal, red-tape-ridden bureaucracy is that it is predictable. A Weberian bureaucrat asked to implement a certain procedure effectively protects and stabilizes the rules of the game in a way that everyone can anticipate for years to come.

Another element of the Progressive reform prescription was professionalism, which acts as a determinant of insulated bureaucratic behavior. Professionalism is an artificial social structure that “invents” a new set of powerful incentives. To be a professional, you must follow professionally mandated norms. Academic professionals know that their career is over if they are found accepting bribes for high grades, or plagiarizing graduate student papers. The small probability of an extreme sanction, and the awareness that other members of the profession have the ability and motivation to monitor you, keep professionals on the straight and narrow. In actions taken by the Securities and Exchange Commission (SEC), for example, the profession of “securities law” is the key to understanding the motivation and behavior of SEC public managers. In effect, the problem of monitoring bureaucratic behavior was “delegated” from Congress (who couldn’t do it well anyhow) to professional peers of the bureaucrats. Congress’s main job is to make macro-level structural decisions about which professions to embed in each bureaucracy and ensure transparency through audits and mandated administrative procedures.
5. Credible Commitment, Bureaucratic Discretion and the Core

The civil service reforms reviewed briefly here seem inconsistent with the emphasis on accountability and responsiveness in the new public management literature and principal-agency theory. No matter how the coalition for bureaucratic insulation was formed, the result was a new disconnect between political elites and bureaucrats, who were constrained more by law, by established bureaucratic procedure, and by professionalism than the requests of mentors or sponsors from among the political elite.

The civil service systems created in Germany, Great Britain and the U.S. have no doubt enhanced the credibility of the commitment of those nations to property rights and contract enforcement. But those nations have undergone a good many changes since the civil service was created. They are all arguably more democratic than they were at the time the civil service reforms were initiated. How can bureaucratic discretion be reconciled with democratic policy-making? Can democratic politicians take back the discretion that civil service reform created?

Investors regard the risk of political and policy change as a negative factor in their investment plans. Nations that promise more stability have an advantage in attracting the economic investment that leads to economic growth. But, paradoxically, democratic nations must allow for the possibility of political and policy change as the inevitable result of responsiveness to a changing public opinion.

The following section argues that pluralism in the number and diversity of the interests given blocking power can actually enhance the credibility of bureaucratic discretion.
Multiple Veto Players: One Dimension

Economic actors want stability, and they fear continual policy change as a result of electoral change. Separation of powers can minimize this problem. For example, consider the simplest Ferejohn and Shipan (1990) model. In this model, there is a one-dimensional policy space. There is a unicameral legislature composed of legislators with single-peaked preferences in the policy space. In addition, one (subset) of the legislators has gate-keeping power; that is, if she makes no proposals, there is no change in policy. If she makes a proposal, then the median floor member can make amendments to enact her ideal point.

Imagine that the median legislator is at the zero point, and the committee is to the right of this proposal. Ferejohn and Shipan also assume that there is a bureaucrat who makes policy. In this simple setting, the core of the game is the region between the median floor member’s ideal point and the committee’s ideal point. The bureaucrat can make policy anywhere in this region and it will stick. The majority of the legislature would like to move to the left toward zero, but the committee will not introduce such a bill. The committee would like to move to the right, but knows that any introduced bill will result in a final outcome farther from the agency’s choice.

[Figure 1 about here]

As a result, the final outcome is completely responsive to the agency’s preferences within this range. If the bureaucrat’s ideal point is to the left of the zero, then the outcome is constrained by the median floor’s ideal point. The same is true if the agency prefers a policy to the right of the committee.
This is a marvelous example of democratic control in the large and democratic non-responsiveness in the small. That is, if the agency were to be “out of control”—picking an outcome outside of the core, then the median legislator and the committee have sufficient authority to overturn the agency decisions. Similarly, if there is a revolutionary change in the electorate that causes a dramatic change in preferences of the median legislator, then that will have an immediate impact on policy.

However, as long as the agency’s ideal point is between that of the committee and the median floor member, policy does not change with modest electoral or committee composition changes. If the agency’s ideal point is at .5, the median voter’s ideal point may shift to the left or right modestly without changing the actual policy. The same may be said of the committee’s ideal point as well. The system provides stability, rather than responsiveness to small changes in legislative preferences.

Let us assume that the committee and the median member of the legislature have sufficient political influence to guarantee that the bureaucrat who receives the appointment has an ideal point between their ideal points. That power over appointments is good for policy stability, of course, because it guarantees a bureaucratic ideal point internal to the core, and therefore one unconstrained by either the median legislator’s and/or committee’s ideal point, and one that will therefore not be responsive to minor changes in preferences of either the median legislator or the committee.

The core is the minimum estimate of bureaucratic influence. The core assumes that the median legislator and the committee can agree to an enforceable contract, or act as if they can. If they cannot cooperate, then the bureaucrat’s discretion doubles.

Consider a bureaucratic proposal of X = 1.2. Both committee and floor median could
agree that they would prefer some point to the left—say $X = .6$. To get this outcome, the committee would merely have to make any proposal, allowing the median legislator to build a majority coalition to support it. However, without an enforceable contract, then the committee may fear that its proposal of $X = .6$ will be followed by the median legislator mobilizing a majority coalition to replace that policy with its ideal point: $X = 0$. As a result, without an enforceable contract, any point between $C$ and $2C$ will also be stable. This region, which includes the core, is shown as the “gate keeping equilibrium” in Figure 1. Bureaucrats could choose their ideal point anywhere in this range.

Additional veto points can only serve to increase bureaucratic discretion—not to decrease it. Consider a president (P), who can veto subject to a two-thirds override. If the president’s ideal point is outside the range between M and C, then bureaucratic discretion may be increased. Assume that the president’s most preferred policy is $X = -1.0$ and the legislator at the 67th percentile (counting from the right) is located at $X = -.6$, as shown. Then the bureaucrat can make a policy at $X = -.4$ that cannot be upset by legislative action. While a majority of legislators (including the gate keeping committee) would prefer $X = 0$, the president would veto, and an insufficient number of legislators would vote to override. As a result, the bureaucrat’s impact on the final policy outcome would be as shown in Figure 2. Within the CORE, which extends from the veto point’s ideal point to the committee’s ideal point, the bureaucrat has autonomy. And once again, policy would be protected from minor legislative preference changes.

[Figure 2 about here]
Multiple Veto Players: Two Dimensions

The point of this section is that multiple veto points generate a core, and that the core is a minimum estimate of the bureaucrat’s discretion. The same thing can be shown more dramatically, using the same actors, in the two-dimensional case not discussed by Ferejohn and Shikan.

In Figure 3, there are three legislators with ideal points in two-dimensional policy space: M, Cx, and Cy. If these three legislators were operating with simple majority rule, there would be no core, and the bureaucrat would be able to make no choice that could not be overturned by a majority of the legislature. For instance, if the bureaucrat selected outcome P1, the Cx and M could agree to a vertical move to the X axis.

[Figure 3 about here]

However, gate keeping power by Cx in the X dimension, and by Cy in the Y dimension creates a stable core. The core is the darkened segment of the contract curve between Cx and Cy, in the upper right quadrant, containing both P1 and P2. Consider P1. Although two legislators would prefer a vertical move to the X axis, this would be blocked by Cy. Similarly, a horizontal move to the Y axis from P1 would be blocked by Cx. Since P1 is already on the contract curve between the gatekeepers, there is no move that the two gatekeepers could agree to. As a result, P1 and the other points on the contract curve in the upper-right quadrant are in the core, and in the bureaucrat’s discretionary choice set. (Note that the rest of the Cx-Cy contract curve in the upper left quadrant is vulnerable to a horizontal move to the Y axis proposed by Cx and supported by M.)
Once again, this core gives the bureaucrat a range of discretion. A bureaucrat whose ideal point was at B1 would most prefer policy P1, and a bureaucrat at B2 would most prefer P2. Either of these selections would be insulated from majority coalitions (M and Cx, for example), who could agree to other policies they preferred.

This core is relatively robust to changes in the location of M. However, changes in CX or Cy would in general change the location of the contract curve between them, and would therefore force bureaucrats to adjust policies. As a result, credible commitment to the policies in this core would not be as robust as in other institutionally complex settings, such as those with a presidential veto. The presidential veto added to policies in this institutional setting would create more stability in the region, which would add consequently to bureaucratic discretion, as shown in the next section.

*Increasing Bureaucratic Discretion by Presidential Veto*

In Figure 4, the location of the three legislators is identical to that in Figure 3. The president’s ideal point is at (-1.0). The president’s veto can be overridden by a unanimous coalition of legislators. In this case, the core is the entire Pareto set for the legislature. The bureaucrat’s discretion is consequently this entire region. Consider a bureaucrat who sets a policy at B1. The gatekeepers would like to move from that point to their contract curve, but would be blocked by a presidential veto. The president, M, and Cx would like to move vertically to the X axis, but Cy would not introduce the legislation. A move to the Y axis would be supported by everyone but Cx, who would not introduce the legislation. Investors could anticipate that moderate bureaucratic choices over a range of policy issues as wide as the legislature’s preferences all would be safe from majority rule instability.
Threats to Credible Commitment: Lack of Conflict and/or Executive Authority

The only difference between Figures 3 and 4 is the presidential veto, but it enlarges the range of bureaucratic discretion to the legislature’s entire Pareto set. Note that this effect holds if the president and the gatekeepers are in some sense natural opponents, rather than allies. If the president’s ideal point were at P2, for example, the president would be allied with the gatekeepers against M. As a result, the core would shrink back to exactly the line segment shown in Figure 3. The president and gatekeepers could overturn a bureaucrat’s choice at B1, for example. Shared interests between veto powers diminishes the beneficial impact of veto points on bureaucratic discretion and makes bureaucratic choices more susceptible to minor electoral and coalitional changes. This illustrates a very important lesson: as argued by the American Federalists, it is the opposing interests of key institutional actors that generate beneficial effects as regards policy stability and credible commitment.

Another possible threat is increased executive authority. In cabinet departments, the president can easily change policy with a stroke of the pen, or a phone call. If the president (P1) can issue an executive order requiring the bureaucrat to select a particular policy, he would (in Figure 1) select policy Z1. This is the best outcome he could find that would not be overturned by a unanimous (veto-proof) coalition of legislators. There is nothing especially bad about policy Z1, of course. However, a subsequent presidential election could elect a president at Z2, who would issue an order countermanding Z1 and imposing Z2. More autonomous action by any veto point creates the possibility of more instability.
If the policy dimensions are truly important matters, such as monetary policy or degree of protection for institutional investors in the stock market, then these are exactly the kinds of policy changes that threaten the property rights of investors and contract enforcement among economic agents. Presidential “coordination” of policy in vital economic areas introduces the kind of political uncertainty that frightens investors away. Consequently, one might well prefer to insulate these key economic regulatory policies from presidential authority. This has historically been attempted in the United States by the creation of independent regulatory agencies. The Federal Reserve and the Securities and Exchange Commission (SEC) can be legislatively reined in, but are historically protected from the vagaries of presidential politics.

6. Independent Central Banks

Central Banking. As simple as this model of credible commitment is, it corresponds in several ways to our best understanding of the political economy of central banking (Jensen 1997). Elected officials will always find advantage in providing public expenditures, tax cuts, and other benefits to the organized constituents with a stake in those decisions. These benefits, however, generate inflationary tendencies. Investors and other economic agents adjust their actions accordingly, and eventually such governmental actions generate inflation with little impact on unemployment. A government that campaigned on promises not to provide such inflationary shocks would not be believed. Credible constraint of the government is the key to controlling inflation.
The governments that are so constrained are those that have tied their hands by creating independent central banks. Studies have shown that independent central banks have an impact on lowering the inflation rate (Franzese 1999). The central bank’s credibility is enhanced when private economic actors perceive that the bank’s decisions are irrevocable. In contrast, if private actors perceive that partisan administrations influence the decisions of the central bank, then the credibility of a nominally independent bank is undermined.

Even if the government creates a central bank, and grants it independence, could it not take back the authority it handed the central bank at a later point—for example, prior to an election in which it wanted to gain favor by inflationary policies? The answer is that of course it could; the credibility of the bank’s independence depends on the obstacles in the path of reclaiming that authority. The primary such obstacle is the existence of multiple “veto points” within the government, preferably in the hands of opposing political interests, all of which must act in concert in order to reclaim the delegated authority of the central bank. Keefer and Stasavage (2003:417) provide evidence that the mutually-blocking veto points generalize beyond Britain or the United States. Their cross-national research demonstrates that delegation to an independent bank serves to decrease inflation only when a multiplicity of veto checks provides a guarantee that delegation will not easily be recalled by political actors.

The point can be generalized. Credible commitment occurs through a combination of bureaucratic delegation and multiple veto points. Morris (1999), for example, pictures monetary policy alternatives as a one-dimensional space. A variety of political actors, including the President, members of both houses of Congress, and the
Fed chairman, all have single-peaked preferences in that space. A coalition of the president and a majority of both chambers is decisive, so a Fed chairman who enacts a policy that is (say) to the right of the ideal points of the President and the median voter in both chambers can be overturned by the normal legislative procedure. However, there is normally a range of outcomes between the president's ideal point and the ideal points of the more distant chamber median that cannot be upset by a normal coalition. (A slightly more complicated model incorporates legislative over-ride coalitions, with similar results.) Although Morris does not identify them as such, these points are the core of the monetary policy game, the size of which increases with increasing preference conflict between President and the members of the two chambers (Hammond and Knott 1996).

This argument offers an entirely different perspective on the subject of “multiple principals.” In principal-agency theory, the fact that a bureaucracy is subordinate to a number of different principals (President, House, Senate, oversight committees of each chamber) is regarded as a problem because it poses the specter of unaccountability of the Fed to any one principal. But from the perspective of credible commitment, unaccountability is precisely the point. U.S. investors know that the probability that all of the potential veto points acting in concert to limit or redefine the authority of the Fed is close to zero. Bureaucratic choices are allowed to stand unless a decisive coalition of legislators and the president can agree on an alternative policy. Therefore, they can count on a monetary policy that is relatively independent of the inflationary short-term goals of the Fed’s multiple principals.

Investors perceive the Fed as independent of the political ambitions of politicians precisely because it takes the joint action of both chambers of Congress and the President
to reverse its decisions—and joint action is not likely, given their distinct goals and the
likelihood of strategic behavior by the Fed chairman (Keefer & Stasavage 2003). From
the perspective of credible commitment, the loss of control implied by its multiplicity of
principals is not an efficiency loss, as argued by the original advocates of congressional
control. On the contrary, the loss of political control is the prerequisite for effective
performance of the Fed's function.

A natural question to ask is: what constrains officials at the Fed? Clearly, an
unconstrained Fed would be just as much of a threat to the climate of economic
investment as handing monetary policy over to the Stuart kings, or a logrolling committee
of re-election oriented members of Congress. No one can doubt that there are any
number of economic interests who would be willing to pay large amounts of money for
influence at the Fed. So why should we believe that the Fed is more immune to moral
hazard than members of Congress, for example?

The answer to this question is an important one. But before addressing it, we will
raise the stakes and argue that the Fed is not unique; virtually every agency that has an
impact on property rights and contract enforcement can be the instrument of moral
hazard, if the bureaucrats are sufficiently responsive to the political interests of elected
officials. In the next section, we will argue that many bureaucracies have been
constructed in such a way as to limit agency responsiveness to the moral hazard of
elected officials.

How do political elites cede authority to bureaucracies? It does not square easily
with our notion of self-interested, power-seeking political elites.
7. Multiple Veto Points and Independent Agencies

In the United States, the competition between institutions in the separation of powers system leads to the creation of delegated bureaucracies (Moe, 1989 and Lewis (1984). Often institutional competition involves conflict among interest groups, parties, and between Congress and the president. When no agreement that completely satisfies one side or group can be achieved, a compromise solution emerges that establishes an independent public agency. The mandates for these agencies are typically rather broad because that is all the conflicting parties can agree upon. The expectation is that the agency will work out the specifics of the policy as an impartial actor that will operate generally within the political core formed by the contending interests by taking professional and legal judgments in deciding policies. While this result is bad for presidential or chief executive coordination, as Moe and Lewis argue, it is good for credible commitment.

Since most democracies do not have a formal separation of powers system, how do these governments credibly commit to independent agencies? This question is at the heart of the comparative bureaucracy problem for credible commitment. The answer is that most democratic systems contain constraints on centralized power and include veto points over political actions. Some of these constraints are institutionally built into the country’s political system and sometimes they are imposed externally.

Historically, the development of a professional bureaucracy often coincides with conflict between the monarch and the new parliament. In the early part of the 19th century in Britain, for example, the Parliament saw administration as the affair of the
Crown and did not want to change the balance of power by granting more patronage power to the executive. The Crown controlled the House of Commons and recruited public service officials by using patronage. After the 1830 elections, however, the Crown lost its ability to form a favorable coalition in the House of Commons. A new system of open competitive examination was launched, and an administration based on departments responsible to the parliament was created. For the first time, the Crown ceased to hold the ultimate control (Fry 2000, 16).

Most parliamentary systems, and especially those that have proportional representation, form coalition governments, the members of which serve as checks on each others’ actions. Any party in power thus needs support of at least some of the other parties and must compromise with these other parties in order to succeed (Milner, 1997, p. 40). In like manner, the vote of no confidence in the parliament serves as a threat in the system to force compromise amongst opposing interests. In some systems, the president (not the prime minister) has the power to dissolve the parliament. In addition, sometimes public agency managers leak information to the news media, which acts as a check on politicians through investigative reporting. Agencies and the public also can use the courts to investigate wrong-doing as well as bring suit against corrupt activities. Thus, although most democratic systems do not have constitutional separation of powers, they have political and institutional features that act as checks and balances over political actions, thus creating a core area of discretion for public managers (See also, Pahre, 1997, pp. 147-174).

In some cases, external constraints influence the creation of independent agencies to regulate the economy. In Turkey, for example, pressure from the International
Monetary Fund (IMF), the World Bank, and more recently the European Union, has been critical in the creation of independent economic regulatory agencies, such as the newly created Competition Commission. Many of these agencies do not receive their funding from general tax revenues. Rather, the regulated companies are required to pay a small percentage of their profits to the agencies, thereby giving the agencies some budgetary independence from the parliament. This independent funding is similar to the FED in the U.S., which receives funding from its government bond operations.

Geddes (1994) found that the few instances of successful negotiation toward professional administration occur when parties are effectively of equal power, and stalemated. This occurred briefly in Columbia and Brazil at various stages in their history. The parties were also remarkably balanced in the United States when civil service reform was enacted in the late nineteenth century. At these times, parties can agree that neither side is giving up a commanding advantage by mutual support for civil service reform.

8. Conclusion: Independence under Constraints

A major advance in reducing moral hazard by government has occurred in the privatization and deregulation of many sectors of the economy which were formerly under price and entry control. These government-sponsored monopolies, franchises, and cartels enriched the participating firms and sometimes the politicians but proved highly inefficient for society. Privatization of government services, when quality and outcomes can be measured, can also reduce moral hazard and increase efficiency. Quangos, public-
private partnerships, and other such arrangements can enhance government credibility in providing services (Flinders, 1999).

The government’s commitment to economic development, however, depends on credible public agencies. These agencies assure credibility over property rights, contract enforcement, rule of law, a level playing field, labor relations, monetary policy, banking and insurance regulation, and many other aspects of the economy. These are key activities which confront political leaders with the moral hazard to divert policy from the public interest to private gains.

A system of checks and balances is the best possible response to the inevitability of moral hazard in economic development policy. In some countries, such as the United States, separation of powers is constitutionally enforced. In most parliamentary systems, it is strategically chosen as part of the political process. Competition among parties, checks and balances between federal and state governments, and checks and balances between interests, the executive, and the courts play a role in preventing moral hazard. In many democracies, the news media play a role in the check and balance system as well.

Public agencies are accountable to the legislature within the boundaries of the core. As the Progressives in the U.S. and the civil service movements in Europe recognized, public agency discretion within the core requires public and administrative law, which gives the court a check on rent seeking. It also requires professional norms, which allows peers in and outside the government to sit in judgment on agency decisions. In addition, civil service rules and ethical standards are designed to provide for human resource protections against political abuse. These checks make agency decision making more transparent and predictable than otherwise would be the case.
There is no structure, and no system of incentives that eliminates moral hazard. There will always be political elites that would like to distort government policies for rent-seeking purposes. There are also blandishments that will seduce professional public managers away from what would otherwise be their best estimate of the public interest as interpreted through their professional lenses. While checks and balances create the possibility of discretion for public agencies to pursue policies in the public interest, the discretion exercised by public managers must be constrained as well, unless it becomes the avenue for rent extraction. No institutional design is a panacea.
Figure 1: Impact of Bureaucrat’s Ideal Point on Policy

Floor Median = M = 0
Gatekeeping committee = C = .5

*core assumes M and C can cooperate.
**gatekeeping equilibrium assumes no enforceable agreements or cooperation between M and C.
Figure 2: Impact of Bureaucrat’s Ideal Point on Policy (with President)
Figure 3: Gatekeeper’s Veto Power and the Core

$C_Y = (-0.6, 1.0)$
Figure 4: Presidential Veto increases Bureaucratic Autonomy
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