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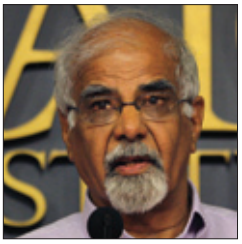

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Principal-Agent Theory and the Welfare State

BY MARK PENNINGTON

The recent financial Armageddon often gets blamed on shareholders failing to discipline out-of-control corporate managers. This "principal-agent" problem is seen as the cause of excessive CEO pay, as well as irresponsible risk-taking by greedy bankers and financiers. There is more than a grain of truth to these arguments, but we must not be fooled into believing that weak corporate governance lies at the heart of contemporary ills. The problems that shareholders face in overseeing irresponsible managers are nothing compared to the difficulty that voters face when reining in out-of-control politicians. If we want to deal with the fiscal crises unfolding in the United States and Europe, we must address the biggest principal-agent problem—the one at the heart of the modern welfare state.

CONTROLLING POLITICIANS: THE MOTHER OF ALL PRINCIPAL-AGENT PROBLEMS

In the 1930s, during the shift away from owner-managed capitalism, experts began studying what became known as the principal-agent problem. At the time, large numbers of relatively small investors were pooling their capital and employing professional managers to operate companies on their behalf. Unfortunately, this fragmented ownership meant it might not be worthwhile for any particular owner to spend his time and money monitoring management's actions. Because improved company performance was now shared by all the owners, each owner could hope to rely on other shareholders to monitor accountability and thereby free ride.

If most shareholders reason this way, then managers can get away with paying themselves too much, building luxury office complexes, and running up enormous travel expenses. This is the crux of the principal-agent problem.

With private industries, principal-agent relationships create inefficiencies within the market. But these distortions are limited because individual owners retain the

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At Cato University this July, SEN. RAND PAUL (R-KY) sat down to dinner with Cato founder and president EDWARD H. CRANE. In his keynote address that night on Capitol Hill, Paul spoke about the culture of spending in Washington and offered reasons to be optimistic about the country's future. **PAGE 14**

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"exit option": they can sell shares in poor performers and buy shares in better ones, or invest their wealth in alternative structures such as owner-managed firms, cooperatives, or firms with concentrated ownership. In short, owners have a number of other choices.

Controlling politicians in the welfare state is a problem of an entirely different magnitude. Citizens can't withdraw their support from government programs without facing threats of fines or even imprisonment. When individual voters (principals) cannot reasonably "exit" relationships with politicians (their agents), they often become trapped in inefficient structures.

Holding politicians accountable in a welfare state requires considerable time and effort. Unfortunately, in a large democracy, the chance that any one voter's efforts to monitor government programs will affect the taxes they pay and the outcome that they experience is vanishingly small. Rather than being informed and active citizens, voters find it rational to be ignorant about the political issues around them and the impact policies might have. Even a civic-minded person may not find it worthwhile to become an informed voter when the chance of personally influencing outcomes at the ballot box is infinitesimal. One might hope that the press would take more of an interest in such matters; but given that their readers have only minimal interest in political affairs, the tendency of the media is to concentrate on political trivia rather than the deeper, underlying issues.

Studies in the United States and Europe confirm the existence of massive voter ignorance, irrespective of educational achievements and social class. In the United States, for example, as many as 70 percent of voters can't name either of their state's senators, and the vast majority cannot estimate rates of inflation or unemployment within 5 percent of actual levels. It is this rational ignorance of public policy that enables politicians to maintain policies that injure voters' interests. The ability to rely on a steady stream of tax revenue creates a "soft budget constraint." This, in turn, enables politicians to act opportunistically—either to their own benefit or those of special interests—rather than for the public good. In the latter case, politicians tend to opt for policies that concentrate highly visible benefits on organized groups (such as farmers) while dispersing the costs widely, across the unorganized groups who ultimately pay the price—taxpayers.

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The democratic process does, of course, provide cultural and institutional constraints that limit the form and character of political opportunism. In most developed democracies it is considered unacceptable for politicians to receive salaries that are comparable to the compensation packages of corporate managers in the private sector. It is worth keeping in mind, however, that political opportunism can manifest itself in other, nonfinancial ways. It may include a preference for "on the job leisure" for politicians and bureaucrats, or the use of discretionary power to advance causes close to a politician's or bureaucrat's heart. In general, this opportunism may simply emerge as a widespread indifference to the need for efficiency when spending other people's money.

PRINCIPAL-AGENT PROBLEMS AND THE CRISIS OF THE WELFARE STATE

Consider welfare payments. Most voters favor mechanisms that provide security to people in the event of unemployment, disability, and other misfortune. At the same time, these voters have an interest in ensuring that this support is limited to genuine need—and that it functions by actually reducing poverty, rather than perpetuating it. In an ideal world welfare recipients would only claim benefits as necessary. In the real world, however, they may behave opportunistically by failing to seek employment or making illegitimate claims. Similarly, in an ideal world, politicians and bureaucrats in charge of administering welfare programs would be motivated to reduce such abuses. But in the real world they may prefer the benefits of political convenience and an easy life rather than the arduous work of rooting out fraud.

In a welfare state taxpayers don't have the option of "exiting" from such relationships. In theory they can lobby politicians to introduce more stringent checks on welfare recipients, but the incentives to do so are minimal. The costs of seeking to persuade politicians to change course are huge. And since effective welfare policies benefit all taxpayers, every voter has an incentive to let others incur these costs and to free ride on any improvements. As this tendency spreads throughout the electorate, welfare programs become increasingly divorced from considerations of efficiency and effectiveness.

Disincentives in controlling poor performance apply not only with respect to welfare recipients and public officials, but also to subsets of voters who demand further taxpayer funding. Self-interest, after all, is by no means confined to material benefits. It may also include emotional incentives where people derive benefits from public displays of support for particular causes. Thus, the pursuit of expressive benefits by "bleeding hearts" eager to display their greater concern for the poor or the disabled may perpetuate ineffective policies. If the costs of supporting failure are not concentrated on the bleeding hearts themselves, they are likely to demand a higher level of support than may be warranted. And, when the decision to reconsider support for a particular program is unlikely to affect either the future of that program or the size of one's own contribution to it, there are few incentives to consider more effective alternatives.

Experience differs across countries, but the lack of effective monitoring in welfare states must account in part for the substantial increase in those claiming various "disability" benefits within developed nations. At a time when general health levels have been

improving, more and more people are replacing work-generated income with disability benefits. In the United Kingdom, for example, between 2001 and 2011 the number of people claiming disability allowance increased from 2.2 million to 3.2 million. This represents almost a 50 percent increase during a period when population growth was no more than 2 percent. Across the Scandinavian countries, with their healthy populations and well-trained doctors, between 10 and 14 percent of the population are on disability benefits. In the Netherlands, 1 million people are dependent on disability payments in a labor market of only 7 million. Even in the United States—which has traditionally taken a more restrictive approach to disability allowances—the proportion of the population claiming benefits has been increasing at a rapid rate.

SOCIAL SECURITY AND MEDICARE

But we shouldn't place too much blame for the expansion of the welfare state on the questionable claims of some welfare recipients and the unwillingness of politicians to deal with this. By far the most significant factor in the current fiscal crisis is the massive growth in entitlement spending—namely, Social Security and Medicare—much of which is paid out to middle-class recipients. When caring for the elderly becomes the collective responsibility of taxpayers, rather than of individuals and their families, there are strong incentives for people to live at one another's expense. Under these circumstances, the most organized gain a disproportionate share of the spoils.

In the case of Social Security the problem is magnified because the "principals"— the future generations of workers who will foot the bill—do not yet exist as a political force and so cannot exert any influence over their "agents." One reason for this, of course, is that some of them are unborn or are too young to vote. Another, though, is that younger voters and potential taxpayers are less politically organized than older voters, who receive most of the benefits. Those who spend most of their time working or in school are the least likely to have sufficient incentives or time to participate in organized politics.

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Retirees, in other words, are better positioned to take advantage of their political involvement.

These asymmetric incentives for political action may best explain why groups such as AARP dominate political calculations concerning the future of Social Security, while the voices of those who bear the expense are seldom heard. The consequences of this imbalance are potentially catastrophic. According to the Congressional Budget Office, spending on Social Security and Medicare is set to reach 12 percent of GDP by 2035. Meanwhile, the CBO found that the 75- year "fiscal gap" (the amount by which the federal government would have to raise taxes to cover the discrepancy between future outlays and future revenues) could reach an astounding 8.1 percent of GDP.

REDUCING THE PRINCIPAL-AGENT PROBLEM: A RETURN TO VOLUNTARY WELFARE

If principal-agent problems are at the root of today's fiscal crises, then the way to address these problems is to shift incentives so that people take greater responsibility for their actions. Fundamentally, this requires introducing "exit" mechanisms so that personal decisions have more influence on outcomes. Although we can debate the legitimate extent of income redistribution, a move toward a more voluntary welfare system based on mutual aid, private philanthropy, and greater individual saving is needed if we are to encourage greater responsibility.

Historically, among the most important mechanisms for poverty relief were mutual-aid associations. As David Beito described in his book *From Mutual Aid to the Welfare State*, "friendly societies," credit unions, and insurance cooperatives were self-governing entities founded by the working poor and financed by small-scale contributions. These associations provided a safety net during difficult times—allowing members to draw "benefits" from a collective fund only if they first contributed. This fund could then be drawn upon should the individual or his family experience misfortune. Though membership was by no means universal, the majority of low-income people relied on voluntary collective action when they sought unemployment relief and security in old age.

Although mutual aid should constitute an important element in any alternative approach to poverty alleviation, so too should philanthropy. The historical record suggests that many services currently supplied through tax-funded welfare agencies have previously been performed by voluntary associations. Even today, in a context where government welfare provision has crowded out many forms of voluntary giving, private welfare organizations such as Habitat for Humanity and the Salvation Army have a far better record of helping to rescue lives than do most official programs.

Privatizing welfare would not eradicate principal-agent problems, but it would significantly reduce their severity. Dealing with poverty by way of mutual aid or charitable donations generates a more direct connection between contributions and results. This connection is most pronounced when giving is one-on-one: when donors can directly observe the impact of their contribution—and withdraw it without collective action. When charities are large and management is left to the organization's agents, this connection is less apparent. Even here, however, the donors' ability to move from one charity to another provides an incentive to contribute their money wise-

ly. Because donors are spending their own money rather than that of taxpayers, they have much stronger personal incentives to withdraw support from failing programs.

Mutual-aid and charitable organizations may also provide better incentives to discourage shirking and opportunism. In the case of mutual aid, for example, the decision of an individual to join and contribute to an association determines whether or not he will be eligible for subsequent benefits. The supply of funds from a mutual-aid association are conditional: they depend on the individual having made a financial contribution to the association rather than reflecting a state-guaranteed "right" to support. Because mutual-aid associations rely on a pool of economically active members, members have stronger incentives to ensure that successful measures are put in place to limit dependency and fraud. By contrast, Cato scholar Michael Cannon has reported a level of fraud in Medicare and Medicaid payments in excess of 10 percent, a level which would not be sufficiently reduced "with any plan that retains a role for government."

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If there is a case for moving toward greater reliance on voluntary welfare for the poor, there is an even stronger argument for replacing more generalized government benefits such as Social Security. If individual retirement benefits become more directly related to personal saving decisions, then not only will there be more private saving but there will also be stronger lines of accountability between those investing money and those charged with managing it. This need not imply preference for a regime where people hand over their savings to corporate fund managers. Rather, it is to favor a regime in which people choose whether to entrust their savings to managed funds or to alternatives such as personal investment or private savings clubs and cooperatives.

If we are serious about addressing the core of the fiscal crisis, we must do two things. First, we must abandon a system in which those who claim future benefits have the ability to dismiss those who finance them. And second, we must address the fact that those who manage taxpayer dollars have every incentive to favor short-term political gain over long-term sustainability. ■

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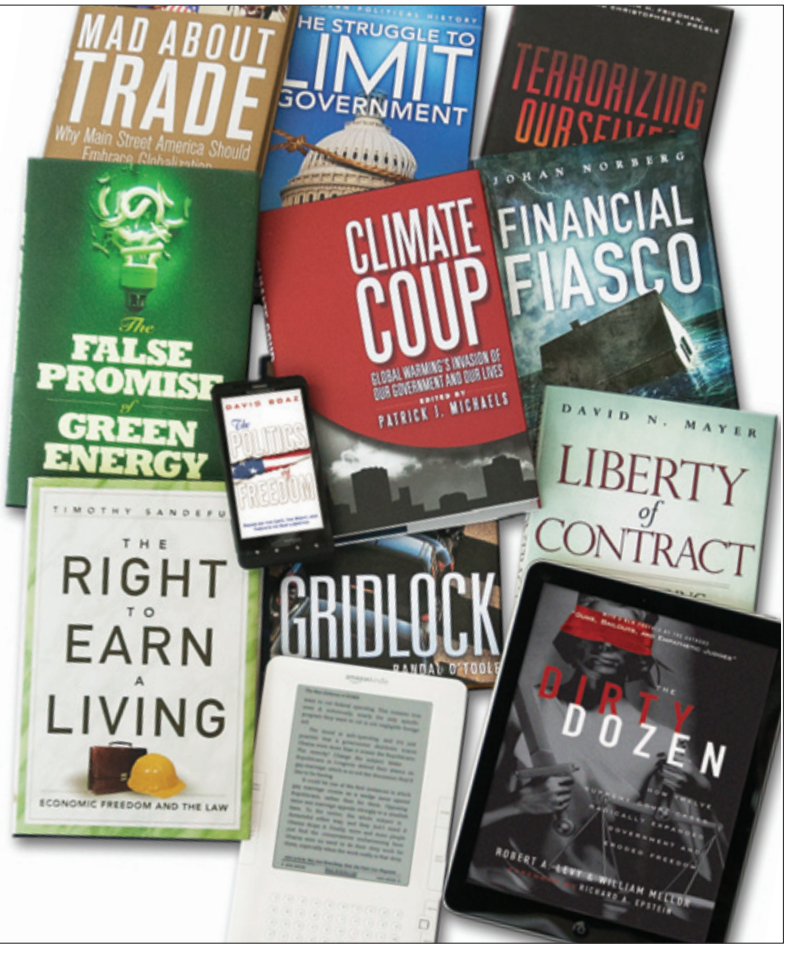
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