

Revisiting Okun's Concept of the "Leaky Bucket"

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Introduction

This paper will explore the notion of contracting, and will consider whether the government, in collaboration with the non-profit and for-profit sectors, can potentially produce a more cost-effective delivery of public services. In doing so, the paper will consider Arthur Okun’s concept of the “leaky bucket”, and will in essence explore whether the government can utilize contracting as a means of limiting spillage from the leaky bucket. In doing so, the paper will initially describe theories of market and government failure and will critically examine the role of the non-profit sector in addressing these failures. The paper will then draw on the work of Ferris (1993) to assess whether the government can utilize contracting as a means to reduce one element of leakage from the “leaky bucket”, namely, administrative costs.

Market failure

The *raison d’être* for the existence of both the government and non-profit sectors rests essentially on the notion of market failure. It is therefore relevant to define concept of market efficiency and then to outline the conditions under which the market fails or is unable to deliver an efficient solution. According to Brodtkin and Young (1989: 125) a state of Pareto efficiency or economic efficiency is achieved in the marketplace when, “all firms seek to maximize profits and are small relative to their industries; there are no restrictions on firms wishing to enter an industry; consumers are well informed and have well-defined preferences about alternate products and prices; all goods and services are private in nature; production technologies are well-known; and both consumer preferences and production characteristics are of a certain “well-behaved” (convex) mathematical form”.

According to Wolf (1979), it is the externalities and public goods aspects of market failure that provide a theoretical justification for the government provision of certain goods and services. Wolf (1979: 116) defines externalities as, “benefits or costs that are not, respectively, appropriable by, or collectible from, the producer.” Externalities may be negative (e.g., environmental costs not collectible from the producer), or positive (e.g., public goods are a form of positive externalities). In the presence of externalities, an inefficient allocation of

resources can emerge if nothing is done about it. There are two ways in which the private sector can address externalities. In the case of mergers, an externality is internalized by combining the involved parties. However, unlike firms, individuals cannot merge to internalize externalities. Rather individuals can rely on social conventions to address the externalities they generate. In cases where individuals acting alone cannot attain an efficient solution, the government can intervene in several ways, for example, by levying taxes, subsidies, creating markets or property rights or through regulation (Rosen, 1999).

Pure public goods are said to have an important characteristic i.e. they are non-rival. This is in contrast with private sector goods, which are typically rival in nature. Non-rivalness refers to a certain situation in which one individual's consumption of a particular service is not diminished by another's ability to consume the same service. Another characteristic which is often linked to public goods is the notion of "excludability". The consumption of a good is said to be non-excludable, "when it is either very expensive or impossible to prevent anyone from consuming the good who is not willing to pay for it." (Rosen, 1999). It is important to note, however, that the notions of "non-rivalness" and "excludability" are not absolutes. They depend on market conditions and state of technology. Therefore, classification as a "public good" is also not an absolute. There are very few "pure" public goods. Rather, most public goods are "mixed" in the sense that they exhibit characteristics of both the public and private sectors. "Mixed" public goods are at the heart of the government contracting debate i.e. should the government contract with the for-profit or non-profit sectors in order to deliver certain "mixed" public goods. This question will be addressed later in the paper.

To understand the conditions underlying the efficient provision of a public good, it is useful to initially consider the efficient provision of a private good. According to Rosen (1999), in order to establish the market demand of a private good at any given price, one is required to sum the horizontal distance between each of the private demand curves and the vertical axis at a given price. Equilibrium in the market is found where supply and demand are equal. In contrast, "the efficient provision of a public good requires that the sum of each person's marginal valuation on the last unit just equal the marginal cost." This is based on the fact that public goods must be consumed in equal amounts.

It is theoretically possible for private markets to efficiently provide non-excludable public goods. This depends on the extent to which individuals reveal their true preferences for the particular good. When a private good is exchanged in a competitive market, an individual has no incentive to lie about how much he/she values it. In the case of a non-excludable public good, however, this may not necessarily be so. Rather, the free rider effect is apparent. This refers to the tendency of people to let other people pay while they enjoy the benefits. As a result, people have no incentive to reveal their true preferences and the market would most probably fall short of providing the efficient amount of a public good.

Therefore, efficiency requires government provision of such goods. In terms of this argument, the government can somehow obtain everyone's true preferences, and then by using its coercive power, force everybody to pay for public goods. While the free rider concept is an important one, it is important to note that it is not a fact. One can find examples in which individuals can and do act collectively without government coercion. The area of philanthropy illustrates this point (Rosen, 1999).

As already noted, it is the externalities and public goods aspects of market failure that provide a theoretical justification for the government provision of certain goods and services. Another type of market failure, termed "information asymmetry or contract failure", is often cited to justify the non-profit provision of certain goods and services. One of the conditions of Pareto efficiency, as mentioned above, is that consumers are well informed about the product or service they are purchasing – i.e. information symmetry exists between the consumer and the firm providing the product or service. According to Hansmann (1986: 59), non-profits can be differentiated from for-profit organizations primarily by the "absence of stock or other indicia of ownership that give their owners a simultaneous share in both profits and control. In other words, non-profits are unable to distribute net earnings, if any, to individuals who exercise control over them, such as officers, directors or trustees. Rather, net earnings must be applied towards the maintenance and enhancement of the services that the organization was established to provide. Hansmann described this condition as the "non-distribution constraint". Since non-profits cannot distribute profits, the owners have no incentive to exploit any superior information they may have (e.g. on product quality) in order to maximize profit i.e. consumers are protected to some extent against contract failure, where information asymmetry is present.

While Hansmann's theory of the non-distribution constraint is probably the most cited in the literature on non-profits, a number of criticisms have been levelled against it. Ortmann (1996) notes that the validity of the theory rests on two fundamental assumptions. Firstly, that the non-distribution constraint precludes opportunistic on behalf of the owners of non-profit organizations. Ortmann cites a number of sources which highlight several instances of opportunistic Behavior on behalf of several non-profit organizations. Indeed he argues that based on a voluminous literature, "it seems generally accepted that they (net profits) can be, and are routinely spent on everything from power, prestige and other perks, to cross-subsidization, influence costs, advocacy expenditures, and organizational slack" (Ortmann, 1996: 472). Secondly, for-profit firms entering the marketplace in order to compete with non-profits have neither the ability nor interest to establish a positive reputation in the eyes of consumers. Ortmann points out that for-profits have learned over the years that a solid reputation is a key to success.

Weisbrod (1998) emphasizes the fact that unless the non-distribution constraint is enforced (i.e. legally), it may have little effect on behaviour.

Moreover, he points out that enforcement is costly and that the laws governing the non-distribution constraint are generally complicated. Hansmann himself recognizes that the theory itself largely applies to the case of third party non-profit purchases (donative non-profits) whereby the customer purchases services to be delivered to third parties with whom the customers have little or no contact. Here, the problem of information asymmetry is obvious. However, Hansmann notes that in other types of non-profit organizations where the customer directly receives the purchased services (commercial non-profits), the costs resulting from asymmetric information are less serious. “As evidence of this, commercial non-profits, in contrast to donative non-profits, nearly always share the market with for-profit firms providing similar services.

Lastly, according to Ben-Ner (2001), technological advancement is reducing informational failures in many sectors and is thereby enhancing the symmetry of information. He asserts that when faced with the possibility of information asymmetry, a consumer has one of three choices. Firstly, “they can just go to established organizations and hope that their sustained existence is proof of their reliability” (Ben-Ner: 24). The second option involves relying on word of mouth or social networks as well as making use of consumer-oriented publications and professional organizations. Thirdly, they can rely on information resources on the Internet. He notes that the Internet is an extensive growing resource that can be utilized by consumers to investigate the reputation and quality of numerous product and service providers. In sum, Ben-Ner predicts that the traditional advantage that non-profits have enjoyed with regards to information asymmetry in the past, will likely be eroded in the future due to advances in information technology. For-profit organizations that are able to establish a solid online reputation will capture a will growing advantage in the marketplace.

Government failure

Weisbrod (1977) advanced a theory of government failure in which he compared the nature of individual/citizen preferences with the nature or level of government services provision. According to Weisbrod, different citizens want public goods to varying degrees i.e. they have different demand functions for public goods. However, governments produce public goods to the level determined by the mean voter’s demand schedule. As a result, there will always be citizens who are unsatisfied with the level of production of a particular public good (either receiving more of a public good than they want, or receiving less). Those that fall into the latter group “are presumed to be willing to provide additional (supplementary) levels of a public good by mobilizing resources on a voluntary collective basis through the non-profit sector” (Young, 2000: 152). It is relevant to note that Weisbrod emphasizes the fact that an unsatisfied citizen may alternatively choose to purchase a private-market substitute (e.g. private security

guards to supplement public policing). Another option involves moving to another political jurisdiction where tax rates and public goods levels better match their individual preferences (described as “voting with your feet” by Public Choice Theorists). However, as Young (2000) notes, it can be costly to move from one jurisdiction to another. He states further that private goods are not necessarily ideal substitutes for public goods. All things considered, he concludes that the non-profit sector deserves careful consideration in its role of a supplementer of government services.

Douglas (1983) considers the constraints that inhibit the government from fulfilling public demands for service. He identifies several sources of restraint that suggest a role for private non-profit organizations in the provision of public services. For example, the “categorical” constraint reflects the requirement that government provide services in a uniform and universal way. This leaves unsatisfied those individuals that exhibit preferences that differ from the norm (the “categorical” constraint is consistent with the theory of Weisbrod as outlined above). The “time” constraint is concerned with the short tenures of politicians and thus the possibility that they will therefore neglect long-term consequences of public policies. The size constraint is based on the observation that government organizations are commonly large, impersonal and difficult to approach, thus necessitating the presence of “mediating structures” as liaison between government and the people. Each of the so-called “constraints” thereby serves as a source of unsatisfied demand for public goods that can be satisfied by voluntary organizations that mobilize subgroups of the citizenry (Brodkin and Young, 1989).

Niskanen (1996) attempts to characterize and describe the relationship between a bureau (such as a government bureau) and its sponsor (the government). In doing so, he makes certain assumptions regarding the nature of this relationship and its participants. Firstly, in addressing the factors that motivate individual and therefore bureaucratic behaviour, Niskanen, while expressing some reservations, generally assumes that individuals are motivated by the maximization of their personal utility. Within the context of the government bureau, these motives are said to translate into variables such as power, salary and output of the bureau. Such variables are generally associated with larger budgets and Niskanen therefore assumes that bureaucrats tend to maximize their budgets. He does note, however, that a bureaucrat who may not be personally motivated to maximize the budget of the bureau is driven by internal and external conditions of the bureau to do just that.

Furthermore, Niskanen assumes that the relationship between a bureau and its sponsor is one of a “bilateral monopoly”. On the one hand the bureau provides the sponsor with an all-or-nothing choice (in the form of a budget). On the other hand, the sponsor stands as a sole purchaser of services. There are, however, two major advantages that a bureau has in this model. Firstly, it is assumed that the agency has a good knowledge about the sponsors demand and

budget ceiling (through things like past budgets). Secondly, the agency is not required to itemize and cost individual outputs; it supplies levels of output as opposed to units of output (characteristic of the free market). It is the bureau's control over information (information asymmetry) that gives rise to monitoring problems in the relationship which is intensified by the bilateral monopoly nature of the relationship.

According to Mueller (1989), a major difference between a for-profit corporation and a public bureau is that the power motives of corporate managers can be monetized. Therefore, while "bureaucratic" man pursues power in the form of budget maximization, "economic" man pursues profit in the modern corporation. Farsi and Filippini (2004) point out that due to the non-distribution constraint, non-profit organizations are unable to monetize the power motives of non-profit managers. As a result, these individuals may also be likely to engage in budget maximization. However, they also note that the incentive for non-profit managers to be honest may stem from their personal satisfaction in providing a particular social service, which is likely to be stronger than that of their counterparts in the public sector.

Niskanen proposes several suggestions in order to deal with some of the above-mentioned problems. For example he suggests that the introduction of competition in the form of several bureaus would provide the sponsor with a better base for identifying an inefficient budget proposal from a single bureau. In addition he proposes that a change in the incentives of bureaucrats should be considered. This involves designing a reward system that induces bureaucrats to maximize, not the total budget, but the difference between the obtainable budget and the minimum total costs of the service. Lastly, he proposes that a partial use of private sources in the supply of public services from either for-profit seeking or non-profit organizations.

Lastly, Salamon (1995) considers why the pure voluntary provision of public goods may be inefficient. Salamon identifies four voluntary sector failures. Firstly, Philanthropic Insufficiency refers to the fact that non-profits are unable to generate resources on a scale that is both adequate enough and reliable enough to cope with the human service problems of an advanced industrialized nation. This thereby leads to inefficiencies in the system. Secondly, Philanthropic Particularism refers to the tendency of non-profits and their benefactors to focus on particular subgroups in the provision of services. Thirdly, Philanthropic Paternalism refers to the fact that those with the greatest resources can ultimately influence the definition of community needs. Lastly, Philanthropic Amateurism refers to the tendency of non-profits to adopt amateur approaches to dealing with human problems.

According to Salamon (1995), none of these theories takes account of the possibility of a flourishing government-non-profit partnership, which would truly explain why it is critical to have a non-profit sector in the first place. Salamon states that government and voluntary sector failures are complimentary and that if

the two sectors collaborate, they can compensate for each others failures and achieve optimum service delivery. In other words, the voluntary sector's weaknesses correspond with the government's strengths, and vice versa.

The assumptions of the "Partnership Model" come mainly out of welfare economics, which is rooted in turn in assumptions of neoclassical economics. The two-sector model of welfare economics, which explains public policies as a response to market failures, is extended to three sectors to accommodate the non-profit sector. According to Salamon, early theories of the non-profit sector focused on government and market failure. Salamon argues that by focusing specifically on government and market failures, past theories of the non-profit sector have been limited by their conceptual point of reference. Salamon's Partnership Model inverts this logic by proposing that non-profits have pioneered in the production of certain public goods, such as social services, and that the government essentially "stepped in" with welfare state policies because of "voluntary sector failure". Salamon argues that with regards to Philanthropic Insufficiency, the government can provide non-profits with a more reliable stream of resources. Furthermore the government can address the failures of Philanthropic Particularism and Philanthropic Paternalism by setting priorities on the basis of a democratic political process instead of the wishes of the wealthy, and thereby ensuring that access to care is a right instead of a privilege. Lastly, regarding Philanthropic Amateurism governments can institute quality control standards and thereby improving the quality of service delivery (Salamon, 1995).

On the other hand, Salamon argues that non-profits are better positioned to provide more personalized services than governments, operate on a smaller scale, adjust to the needs of clients rather than the structure of government agencies and introduce some degree of competition among service providers. Therefore, in sum, the Partnership Model proposes that government and voluntary sector failures are complimentary in the sense that if government and non-profit sectors collaborate with one another, they can compensate for each others weaknesses.

The leaky bucket

In his discussion of American society, Okun (1975) points out that capitalism and democracy, "are really an improbable mixture". This is due to what he describes as the double standard inherent in a capitalist democracy i.e., on the one hand the system professes and pursues an egalitarian political and social system, while on the other hand, it simultaneously generates gaping disparities in economic well being. Therefore, according to Okun, while our political system, in theory, gives preference to equality, our economic system is ravaged by gross inequalities. Nonetheless, Okun argues that despite its inherent inequalities, the capitalistic system has the important virtue of efficiency.

Okun goes to great lengths to differentiate between economic rights and political rights. In doing so, he highlights a fundamental principle concerning

political rights i.e., they cannot be bought. While Okun recognizes the significance and value of a free market economy, he nevertheless holds political rights to be sacrosanct stating, “the market needs to be kept in its place”.

Okun felt that the government had an obligation to intervene in the economic sphere in order to address some of the inequalities inherent in a capitalistic system. In his discussion of political rights, Okun points out that those rights, which are prohibitively expensive to enforce, are intentionally left out of the statute books. Nevertheless he argues that the “fuzzy” right to survival (which includes some minimum standard of nutrition, healthcare and other essentials of life), while costly, should be available to all individuals. This, he argues, is in keeping with the assurance of dignity for every member of society (a political right). While Okun does recognize the right to survival, he states, “I am not persuaded by the arguments for many proposed new rights”. Therefore, he clearly places a limit on the extent of government intervention.

Okun, who was close to an egalitarian position, saw that government policies that reduced income inequality could reduce total production. Hence, trying to divide the pie more equally could shrink the size of the pie. Okun described this phenomenon metaphorically as a “leaky bucket” and identified four reasons for leakage i.e., administrative costs of redistribution, changes in work effort, changes in savings and investment behaviour and changes in attitudes – all induced by redistribution. Okun argued that the leak represents an inefficiency and that the fundamental question that arises in each case is what degree of efficiency is one willing to forgo in order to achieve some degree of equality. Okun characterized this difficult question as a trade-off between equality and efficiency and stated that he was willing to accept a leakage of up to 60%.

This section of the paper will address one of the above identified reasons for leakage i.e., administrative costs. In particular, this paper will consider whether the government can utilize contracting as a means of limiting these costs. This could include, for example, contracting with non-profit organizations to conduct job training programs for the poor or contracting with for profit organizations to carry out all administrative activities associated with the processing and distribution of payments for redistribution purposes.

According to Ferris (1993: 364), “once a government chooses to finance a social service, it must decide how to produce it. It has an array of institutional arrangements from which it may choose – internal production as well as contracts with other governments, for-profit firms, or non-profit organizations”. In deciding which option provides the most cost effective delivery, it is important to consider two variables, namely, production costs and transaction costs. Production costs refer to inputs such as labour and capital. The various institutional arrangements have differing implications for each of these two types of costs. In assessing production costs, governments must consider the costs associated with the efficiency incentives of managers. Ferris points out that managers in public organizations have little incentive to minimize costs. This is due to the fact that

public sector performance is not easily measured in terms of explicit costs and outputs. Conversely, in for-profit organizations the manager can be given a share of the profits. “The calculation of profits (revenues minus costs) and their distribution to managers enables owners to reward management for performing in accordance with the owners desire to maximize profits (Ferris, 1993: 365). In a similar vein, non-profit organizations can make profits but they are not allowed to distribute them (non-distribution constraint). These excess revenues can be used, for example, to expand services or enhance quality. Consequently, while non-profits lack the primary objective of profit maximization, which is apparent in for-profit firms, they are nevertheless able to devise better incentive schemes than public sector organizations.

Ferris (1993: 366) states further that the ability to deliver cost efficient solutions depends on “managerial discretion in selecting inputs and production technologies”. For example, public personnel policies limit the ability of public sector managers to rearrange their staffs to deliver services at minimum costs. Furthermore, within the public sector there are separate budgetary processes for capital financing and operations. Consequently, public sector managers are not able to obtain the level of financing they require. These problems are not apparent in for-profit and non-profit organizations. However, for-profit firms have easier access to financing than non-profit organizations as they have the ability to sell shares to finance capital acquisition. Furthermore, non-profit organizations are generally seen as more risky than their for-profit counterparts, and this can impact negatively on their ability to obtain financing. In sum, based on the above information it seems that for-profit firms offer the greatest production cost savings, followed by non-profit organizations and lastly by the public sector.

The contracting government incurs transacting costs to ensure that the contractor will behave so as to meet the government’s objectives. Of particular relevance here is the principle-agent problem, which implies that the agent or contractor always possesses more information pertaining to a given service than the principal (information asymmetry) and that the principal cannot thereby ensure that the agent is acting in its best interests. This requires that the principal employ a variety of monitoring mechanisms which can be very costly and demand excessive administrative responsibilities.

While there are transaction costs associated with internal production, the transaction costs associated with external production are probably greater. Furthermore, the transaction costs will vary depending on the type of institutional arrangement. For example, non-profits are generally seen as being trust worthier than non-profit firms. This is due to a number of reasons. Firstly, non-profit organizations are unable to distribute profits. Secondly, non-profit organizations in contrast to for-profit firms receive considerable donations and this creates the possibility that donors will monitor the performance of these organizations, particularly when they are in a position to volunteer. As a result, non-profit organizations can reduce transaction costs at both the contract writing and

monitoring stages. Therefore, non-profit organizations may be preferred to for-profit firms as a contracting arrangement. Ferris (1993) points out that similar reasoning suggests external public organizations may also be a preferred contracting arrangement to for-profit organizations. In sum, internal production is likely to produce the least transaction costs. With regards to external production, non-profit and public sector organizations are more likely to produce more transaction cost savings than for-profit firms.

Starr (1987) argues that the lower costs sometimes associated with private firms (for-profit and non-profit) can stem from a variety of “inefficient means”. Firstly, he states that in some instances, private firms engage in “creaming” which involves the provision of services specifically to the higher end of the client base. Secondly, some private firms lower costs by using part-time workers with fewer fringe benefits. Thirdly, the available evidence usually lacks any information about the quality of services, making it difficult to determine whether lower costs stem from greater efficiency or deteriorating quality. Starr argues that if contracting enables providers to skim off the best clients, it is a means of imposing losses on beneficiaries. Furthermore, he states that if it allows governments to cut wages and break unions, it is a means of imposing losses on public employees. Implicit in Starr’s argument here is the proposition that contracting can undermine important values, such as equality.

Conclusion

Based on the above information it is evident that contracting is indeed a complex and multifaceted phenomenon. It seems that under certain circumstances contracting the government can utilize contracting as a means of limiting spillage from the leaky bucket. It is widely believed that contracting allows for a more efficient and streamlined delivery of public services in all cases. However, in considering the public-private balance we need to be attentive, on a case-by-case basis, to all the considerations (both practical and values oriented) that arise in each case. Only then can we hope to make an informed decision about the potential benefits of contracting.

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