4 New Institutional Economics, New Public Management and Government Failure

4.1 INTRODUCTION

Although the growing literature on government failure has undermined the authority of the once dominant market failure paradigm from its throne in policy analysis, and obliged both theorists and practitioners alike to rethink the appropriate role of government in advanced market economics, uncertainty still surrounds the implications of this literature for public sector reform. After all, as we saw in Chapter 3, an emerging consensus is developing around the concept of the 'enabling state' as a means of describing socially desirable forms of government intervention. Moreover, this consensus represents something of a compromise between the interventionist bias of the market failure paradigm and the radical proposals for limited government offered by the public choice variant of the government failure literature. But both the theory of market failure and its government failure counterpart focused heavily on the desirability or otherwise of government intervention in market or exchange processes rather than on the public sector per se. With relatively few exceptions, like the economic theory of bureaucracy (Niskanen, 1972) and its derivative notion of bureaucratic failure, until very recently economists have ignored public sector organizations. If the core assumptions of economic analysis consist of rational maximizing behaviour, stable preferences and comparable equilibria, and if neoclassical economics adds peripheral concepts like perfect information and costless market exchange (Eggertsson, 1990), then this reticence about examining hierarchical relationships characteristic of public bureaux would appear warranted. However, with the development of New Institutional Economics (NIE) and its emphasis on introducing institutional realism into economic analysis, especially agency theory and transaction costs economics, economists now possess powerful tools for the analysis of organizational behaviour and design. In this chapter we take up the question of NIE and its explanatory abilities in a public sector context.
A second consequence of the debate over the appropriate role of government has been an emphasis on reducing the extent and magnitude of government failure. To a significant degree this question has revolved around decreasing the size of the public sector through privatization and other means: that is, 'matching the role of the state to its capacity' in the language of the 1997 World Bank Development Report. But core functions which must remain within the public sector call for different solutions to the problem of government failure. The predominant response to this need to 'enhance the capacity of the state' has been managerial. Indeed, a new public administration management philosophy known as 'New Public Management' (NPM) has been developed as a means of reducing government failure. In this chapter we will use the term 'generic managerialism' (GM) to refer to the particular stream of management theory that has been applied to public sector organizations. We use the term NPM to refer to the amalgam of NIE and GM from which a policy paradigm has been constructed that provides the principles or 'broadly similar set of administrative doctrines' (Hood, 1991, p.1) that have been employed to reform the structure of the public sector in many countries since the early 1980s.

The chapter itself is divided into five main sections. In section 2 we outline the essence of NIE and focus on its two chief strands, agency theory and transaction costs economics. In section 3 we examine the applicability of NIE to the analysis of problems in a public sector context. The nature of GM is investigated in section 4, and especially the compatibility of its NIE and managerialist elements. Section 5 considers the extent to which the public sector reforms associated with NPM can be seen as solutions to the problems of government failure. The chapter ends with a brief discussion of the policy implications of the foregoing discussion.

4.2 NEW INSTITUTIONAL ECONOMICS

In common with the major earlier institutionalist tradition associated with Thorstein Veblen, Wesley Mitchell, John R. Commons and Clarence Ayres, New Institutional Economics (NIE) represents a loose collection of ideas aimed at bringing institutional characteristics back to the core of economic analysis (Rutherford, 1996). However, unlike the older tradition, NIE scholars have few problems with \textit{a priori} deductive theorizing. For example, Furubotn and Richter (1992, p.1) have observed that:

The change in analytic approach adopted by the new institutionalists has not resulted from any deliberate attempt to set up a new and distinct