

# INCENTIVES AND WORKERS' MOTIVATION IN THE PUBLIC SECTOR

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CESIFO WORKING PAPER NO. 1223  
CATEGORY 1: PUBLIC FINANCE  
JUNE 2004

PRESENTED AT CESIFO AREA CONFERENCE ON PUBLIC SECTOR ECONOMICS, MAY 2004

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# Incentives and Workers' Motivation in the Public Sector

## Abstract

Civil servants have a bad reputation of being lazy. However, citizens' personal experiences with civil servants appear to be significantly better. We develop a model of an economy in which workers differ in laziness and in public service motivation, and characterise optimal incentive contracts for public sector workers under different informational assumptions. When civil servants' effort is unverifiable, lazy workers find working in the public sector highly attractive and may crowd out workers with a public service motivation. When effort is verifiable, the government optimally attracts motivated workers as well as the economy's laziest workers by offering separating contracts, which are both distorted. Even though contract distortions reduce aggregate welfare, a majority of society may be better off as public goods come at a lower cost.

JEL Classification: H1, J3, J4, L3, M5.

Keywords: public sector labour markets, incentive contracts, work ethics, public service motivation.

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We thank Klaas Beniers, Laurent Franckx, Amihai Glazer, Pierre Koning, David Martimort, Efraim Sadka, Alois Stutzer, Otto Swank, and conference and seminar participants in Berlin (EPCS 2004), Munich (CESifo Area Conference on Public Sector Economics 2004), at the CPB Netherlands Bureau for Economic Policy Analysis, The Hague, at the University of California, Irvine, and at Erasmus University Rotterdam for useful comments. We also thank André Dickmann and Steven van der Walle for providing data. We gratefully acknowledge financial support from NWO, KNAW, and VSNU through a Vernieuwingsimpuls grant.

*"Citizens and taxpayers have their own global view of bureaucracy. To them, bureaucrats are lethargic, incompetent hacks who spend their days spinning out reels of red tape and reams of paperwork, all the while going to great lengths to avoid doing the job they were hired to do."* James Q. Wilson (1989), p. x.

## 1 Introduction

Bureaucrats have a bad reputation. Jokes about bureaucrats' laziness and stories on bureaucratic errors abound. The lack of monetary incentives at public organisations is supposed to attract workers who are most averse to exerting effort. This pessimistic view is also prominent in the economics literature. For several decades, the literature has identified bureaucrats as pursuing their narrow self-interest, usually being at odds with the interest of society (see Tullock, 1965, Downs, 1967, Niskanen, 1971, and Buchanan, 1978).

However, when citizens are asked for their personal experience with public agencies, many tend to be satisfied with the performance of the agency. Customers' evaluation of a specific agency or civil servant is significantly better than their evaluation of the government or bureaucrats in general (Katz et al., 1975, Goodsell, 1985). Hence, as Wilson (1989) phrases it: *"...those lazy, incompetent bureaucrats must work for some other agency..."* (p. x). This suggests that at least some civil servants do not fit the stereotype. It is also in line with a number of recent papers stressing the importance of 'public service motivation' for incentive schemes and workers' effort in the public sector (Francois, 2000, Dixit, 2002, Delfgaauw and Dur, 2002b, Besley and Ghatak, 2003, Prendergast, 2003, Glazer, 2004).

How to reconcile these seemingly opposing points of view? This paper develops a model with three types of workers: regular, motivated, and lazy workers. Compared to regular workers, lazy workers have higher cost of effort in both the private and the public sector. Motivated workers, to some extent, enjoy exerting effort in a public sector job, but are otherwise identical to regular workers. This public service motivation gives monopsony power to the government. We show that it is in the interest of a cost-minimising government to attract, besides motivated workers, lazy workers rather than regular workers.

Whereas we model the private sector as a competitive market in which workers are paid their full marginal product, the public sector is assumed to be a single organisation whose objective is to produce a certain amount of public goods at minimum cost. This organisation, which we refer to as the public firm, attracts workers by offering one or more contracts specifying the wage and, if verifiable, required effort. The public firm can not observe the workers' type and, hence, can not make the contracts contingent on worker

type. Workers choose the contract that yields them the highest utility, provided that the private sector is not a better option.

We consider two cases: verifiable and unverifiable effort. When effort is unverifiable, the public firm prefers to attract either motivated or lazy workers. We show that it may occur that the public firm prefers to attract only motivated workers, but that it can not avoid hiring lazy workers as well. However, if desired public production is sufficiently large, the public firm wants to attract both motivated and lazy workers, implying that the problem of nonexcludability of lazy workers is less severe.

When effort is verifiable and desired production in the public sector is sufficiently small, the public firm attracts only motivated workers, and extracts all motivational rents from these workers. This full rent extraction may not be possible if a second worker type is needed. Any rents motivated workers obtain when they would choose the other type's contract can not be extracted by the public firm. Since a contract satisfying a lazy worker's participation constraint has lower wage and lower required effort than a regular worker's contract, a lazy worker's contract is less appealing to the motivated workers. Therefore, the public firm can extract more motivational rents, and hence attracts motivated workers at lower cost, if it attracts lazy workers rather than regular workers.

The public firm distorts both contracts in order to extract even more motivational rents. It offers lower-powered incentives to lazy workers than do private firms. This way, the lazy worker's contract becomes even less appealing to the motivated workers. However, to keep production at the desired level, this implies that the public firm has to hire additional lazy workers, which is costly. These costs can be reduced by giving motivated workers higher-powered incentives, above the level private firms would offer.

These contract distortions are cost-efficient, but reduce social welfare. If we impose that the public firm maximises social welfare rather than minimises cost, it does not distort the contracts of the workers. Still, the public firm prefers to attract motivated workers, but if a second worker type is needed, it is indifferent between lazy and regular workers. Compared to a cost-minimising public firm, social welfare is higher. However, total cost of public goods production and, hence, taxes are also higher when the public firm maximises social welfare. Only motivated workers benefit, whereas the utility of lazy and regular workers decreases as a result of higher taxes. When motivated workers are a minority in society, politicians are likely to strive for cost-minimisation rather than for social welfare maximisation, so as to please the public at large.

While there has been quite some empirical research showing that a significant part of the civil work force has a public service motivation,<sup>1</sup> there

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<sup>1</sup>The literature is not fully conclusive (Wright, 2001), but the emerging picture is that civil servants are less motivated by high pay than their private sector counterparts,

**Table 1: Percentage of workers moving from the private sector to the public sector and vice versa who mention workload as one of the three most important reasons to leave their job (The Netherlands, 2002).**

Sector	Workload		Respondents	
	Inflow	Outflow	Inflow	Outflow
Central	16.3	1.7	307	171
Local	18.5	6.7	649	251
Police	9.4	2.3	483	104
Hospitals <sup>1</sup>	12.9	10.7	51	45
Research <sup>2</sup>	13.0	11.7	116	52
Defence	3.7	4.7	185	171
Education	15.3	27.0	429	146

<sup>1</sup> Only university hospitals are surveyed.

<sup>2</sup> Research consists of universities and research institutes.

Data source: BZK, Mobiliteitsonderzoek 2002.

exists little evidence confirming the stereotype view that civil servants are more averse to exerting effort than workers in the private sector. Our model implies that for lazy workers, the attractive feature of working in the public sector is that the workload is relatively low, either because effort is unverifiable, or because weak incentives are provided. In 2002, the Dutch Ministry of the Interior and Kingdom Relations undertook a survey of workers who had recently entered or left the public sector. In Table 1, we list the percentage of workers moving between the private and the public sector who mentioned workload as one of the three most important reasons to leave their job. Except for Defence and Education, workers who moved from the private sector to the public sector mention workload more often than workers who moved in the opposite direction. The difference is most pronounced for central government and local governments. Education is the main exception. This may be due to the shortage of teachers in The Netherlands, or it may indicate that our model does not apply to all jobs in the public sector. If we restrict our sample to people who worked full-time at both jobs, the results provide even stronger support for our predictions, at the expense of

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and have stronger intrinsic motivation (Houston, 2000, Jurkiewicz et al., 1998, Karl and Sutton, 1998). Heckman et al. (1996) also find evidence for intrinsic motivation of public sector workers. They study the introduction of a monetary incentive scheme for training centers under the Job Training Partnership Act. Rather than cream skimming, case workers accepted the least employable applicants into the program. The authors argue that case workers' "social service mentality..." gives them "...a strong desire to aid the least well off." (p. 2).

a smaller number of observations.

The paper is organised as follows. The next section discusses how the paper relates to the literature. Section 3 describes the model. In Section 4, we analyse a benchmark case where worker type is observable. Section 5 deals with the case where worker type is unobservable. Section 6 compares our results with the case where the public firm maximises social welfare rather than minimise costs. Section 7 concludes.

## 2 Related Literature

Our model is related to the literature on screening of workers' ability following the seminal papers by Spence (1973) and Rothschild and Stiglitz (1976) (for an overview, see Riley, 2001). In a standard adverse selection model (see e.g. Laffont and Martimort, 2002), a firm induces the 'low' type to exert a suboptimally low level of effort, so as to extract more of the rents from the 'high' type. The contract of the 'high' type is efficient. In contrast, in our model the contracts of both types are distorted. Whereas in the standard model a firm designs contracts for a fixed number of workers, our model describes the behaviour of a firm which has to meet a production requirement.<sup>2</sup>

Heterogeneity in laziness may stem from differences in people's physical fitness or ability, as in the standard adverse selection model, but may also stem from heterogeneity in general work ethic or morale. Differences in work ethic have been associated with, for instance, personality traits (Furnham, 1992) and cultural factors (Hofstede, 1991). Companies deem these differences important, as can be seen from the widespread use of personality tests to select from the pool of job applicants (see Jenkins (2001) for the UK and Ryan et al. (1999) for an international comparison of selection methods). Theoretical work by Stowe (2002) shows that higher morale leads to higher effort of the worker, but does not necessarily translate into a higher wage.

A new strand in the economics literature emphasises that workers in public organisations (or, more generally, in non-profit organisations) may be intrinsically motivated to work. For instance, Dixit (2002) argues that organisations that have an idealistic or ethical purpose may be attractive to workers who share these goals. Besley and Ghatak (2003) show that a good match between an organisation's and a worker's mission may reduce the need for monetary incentives. Francois (2000) and Glazer (2004) develop models where workers intrinsically value the output of the public organisation, see also Preston (1989). In Benabou and Tirole (2003) and Delfgaauw and Dur (2002b), as in this paper, workers may enjoy exerting effort at work or intrinsically value their contribution to output ('warm-glow'). The main

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<sup>2</sup>It is easy to extend our model to allow for price-elastic demand for the public good. Then, as in the case of a production requirement, both contracts are distorted.

difference between our paper and earlier work is that we relax the assumption that types of agents are fully observed by the principal.<sup>3</sup>

Most related to our work is a recent paper by Prendergast (2003). He assumes that workers differ in altruism for clients. The government prefers to attract different worker types for different agencies. For agencies where the preferences of the government and clients are aligned, as in health care, the government prefers the most altruistic bureaucrats. However, when the preferences of the government and clients are not aligned, as with (suspected) criminals, bureaucrats should be biased against their clients. Prendergast shows that, when agents' types are unobservable, agencies are likely to attract both the most preferred and the least preferred workers. The latter enter the agency because they benefit most from diverting from the government's most preferred policy.

Our work also relates to Lazear (1986). He argues that firms can use their wage policy so as to attract certain types of workers, just like the public firm in our model does. Strong monetary incentives induce highly productive workers to apply at a firm, whereas less productive workers prefer a high base salary and weak incentives (see also Lazear, 1995, and Prendergast, 1999, for surveys). Moen and Rosen (2001) have recently built on this and argue that, when there is a multi-tasking problem, competition between firms for highly productive workers may result in too high-powered incentives from a social welfare perspective. Burgess and Metcalfe (1999) show empirically that private companies make far more use of incentive wages than public organisations. Moreover, they argue that there are insufficient grounds to justify the low incentivisation of the public sector. Our model implies that lazy workers get indeed weaker monetary incentives at the public firm compared to the private sector, and suggests that this may be cost-efficient. On the other hand, motivated workers get stronger incentives.

A few papers consider heterogeneity in ability among government workers in the context of downsizing the government (Jeon and Laffont, 1999, and Rama, 1999). Jeon and Laffont (1999) show that the optimal voluntary downsizing mechanism consists of a menu of public wages, severance pay, and probabilities of dismissal. The government's choice which workers to retain closely resembles our results in Section 6, where we impose that the government maximises social welfare. When workers differ in a sector-specific trait, the government prefers the workers that have a comparative advantage in the public sector, whereas when workers differ in a general trait, the government is indifferent. Our paper differs in three important

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<sup>3</sup>This paper builds on previous work. In Delfgaauw and Dur (2002a), we examine the implications of workers' intrinsic motivation for optimal monetary incentive schemes and show that by offering a higher wage, a firm may attract less motivated workers. In Delfgaauw and Dur (2002b), we analyse the consequences of deregulation of a sector previously dominated by a public firm, assuming that workers differ in their intrinsic motivation to work in the sector.

aspects. First, we consider a model in which workers are heterogeneous both in general and in sector-specific productivity, whereas Jeon and Laffont study heterogeneity in general and in sector-specific productivity separately. We show that heterogeneity in sector-specific motivation implies that a cost-minimising government is not indifferent between workers who differ in general work ethic. Second, in their model, effort is fixed, implying that they do not consider optimal incentive schemes. Third, most of our analysis focuses on a cost-minimising government rather than a social welfare maximising government.

### 3 The Model

There are two sectors in the economy, a private and a public sector. The private sector is a fully competitive market where workers receive their full marginal product. The public sector is run by a single entity, which can be thought of as the government. This single organisation will be referred to as the public firm. Both sectors have the same linear production function:

$$q(e) = e \tag{1}$$

where  $q$  is production and  $e$  is effort. Each unit of production of the private sector can be sold on the world market for the exogenous price  $p$ . The public firm produces public goods, which are therefore not priced. The desired amount of public production is given by  $Q$ .<sup>4</sup> First, we assume that the public firm minimises cost of production. Next, we compare the results with a social welfare-maximising public firm. We abstract from principal-agent problems between voters, politicians, and managers of the public firm, which implies that the objective of the public firm is in line with the interest of (a majority of) the voters.

Three types of workers exist in the economy: regular workers  $r$ , motivated workers  $m$ , and lazy workers  $l$ . The number of workers of each type in the economy is given by  $N_i$ ,  $i \in \{r, m, l\}$ . Lazy workers incur a greater disutility from working than the other worker types. Motivated workers derive intrinsic utility from exerting effort in the public sector, but are otherwise identical to regular workers.<sup>5</sup>

The utility of a worker of type  $i$  from working in the private sector is given by:

$$U_i = w - \theta_i C(e) \tag{2}$$

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<sup>4</sup>Price-elastic demand for public goods would not alter any of the results qualitatively. By varying the level of  $Q$ , our analysis yields the supply function for public goods. Together, demand and supply then determine the optimal level of  $Q$ .

<sup>5</sup>Allowing for worker types with private sector motivation does not change the results, as these workers would seek employment in the public sector only when wages in the public sector are very high.



where  $w$  is the wage,  $C(e)$  describes the cost of effort, with properties  $C(0) = 0$ ,  $C'(\cdot) > 0$ , and  $C''(\cdot) > 0$ , and  $\theta_i$  measures the degree of laziness. We assume that  $0 < \theta_r = \theta_m < \theta_l$ .

The utility of a worker of type  $i$  from working in the public sector is given by:<sup>6</sup>

$$U_i = w + \gamma_i V(e) - \theta_i C(e) \quad (3)$$

where  $V(e)$  is a concave function with properties  $V(0) = 0$ ,  $V'(\cdot) > 0$  and  $V''(\cdot) < 0$ , and  $\gamma_i$  measures the public service motivation of a worker. We assume that  $\gamma_m > \gamma_r = \gamma_l = 0$ . Hence, only motivated workers derive utility from exerting effort in the public sector. Motivated workers have an action-oriented motivation, as in Benabou and Tirole (2003) and Delfgaauw and Dur (2002a, 2002b). Since  $q = e$ , results are the same if we assume that motivated workers intrinsically value their contribution to output ('warm-glow'). As motivated workers derive motivational utility only at the public firm, the firm has monopsony power over these workers.<sup>7</sup>

Competition in the private sector ensures that workers in the private sector receive their full marginal product. Hence, total wage of a worker of type  $i$  is given by  $pe_i$ . It follows from (1) and (2) that the optimal level of effort  $e_i^*$  of a worker of type  $i$  in the private sector is implicitly given by:

$$C'(e_i^*) = \frac{p}{\theta_i} \quad (4)$$

The resulting level of utility is:

$$U_i^* = pe_i^* - \theta_i C(e_i^*) \quad (5)$$

Note that  $U_i^*$  is decreasing in  $\theta_i$ .

For future reference, we derive the level of effort motivated workers would exert in the private sector *if* they would have intrinsic motivation to work in the private sector. This level of effort, denoted by  $e_m^x$ , is implicitly given by:

$$C'(e_m^x) = \frac{p + \gamma_m V'(e_m^x)}{\theta_m} \quad (6)$$

In the public sector, we distinguish two cases, verifiable effort and unverifiable effort. If effort is verifiable, the public firm offers one or more contracts in which both the level of effort and the wage are specified. In the

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<sup>6</sup>We assume that workers are employed either in the private or in the public sector. Allowing for part-time jobs in the private sector increases the distortions in the optimal contracts when worker types are unobservable. We also abstract from subcontracting, thereby ruling out that a motivated worker takes over the contracts of two or more lazy workers at the public firm.

<sup>7</sup>Allowing for a fourth type of worker, who derives motivational utility from working in the public sector, but is lazy as well ( $\gamma = \gamma_m$ ,  $\theta = \theta_l$ ) does not affect the results, unless there are much more lazy motivated workers than regular motivated workers and  $\gamma_m$  is very low compared to  $\theta_l - \theta_r$ .

second case, effort (and output) is unverifiable above a certain level of  $e$ ,  $\bar{e}$ .<sup>8</sup> We assume that  $\bar{e}$  is sufficiently small such that it is a binding restriction for lazy and regular workers. This requires that  $\bar{e} < e_i^*$ . Then, the public firm can only offer a contract in which a wage level is specified, along with the threat not to pay the wage if effort is below  $\bar{e}$ .

Wages in the public sector are financed through a lump-sum (non-distortionary) tax, uniformly levied on all workers in the economy. This implies that we can ignore taxation when deriving the optimal occupational and effort choice of the workers.

## 4 Benchmark: Observable Types

Suppose that the public firm can distinguish between the different types. Then workers are unable to opt for a contract designed for another type, and the public firm can tailor the contract to each worker type.

### 4.1 Unverifiable Effort

When effort levels above  $\bar{e}$  are unverifiable, lazy and regular workers optimally choose to exert exactly effort level  $\bar{e}$ . Motivated workers may decide to exert more effort than  $\bar{e}$ , which occurs when the level of effort  $e_m$  implicitly defined by first-order condition

$$C'(e_m) = \frac{\gamma_m V'(e_m)}{\theta_m}$$

is greater than  $\bar{e}$ .

Total cost of the public firm  $Z$  when hiring  $n_i \leq N_i$  workers of type  $i$  is given by:

$$Z = \sum_i w_i n_i \quad (7)$$

The minimum wage  $w_i$  at which the public firm can attract a worker of type  $i$  is given by the participation constraint:

$$w_i = U_i^* + \theta_i C(e_i) - \gamma_i V(e_i) \quad (8)$$

where  $e_i = \bar{e}$  for lazy and regular workers. Using (5), we find that for non-motivated workers:

$$\frac{\partial w_i}{\partial \theta_i} = [p - \theta_i C'(e_i^*)] \frac{\partial e_i^*}{\partial \theta_i} - C(e_i^*) + C(\bar{e}) = -C(e_i^*) + C(\bar{e}) < 0$$

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<sup>8</sup> $\bar{e}$  reflects that workers who do not show up at work or remain idle behind their desk all day can be detected and are fired. When  $\bar{e} = 0$ , no extrinsic incentives can be provided, implying that public goods production has to rely completely on intrinsic motivation.

where the first term drops out using first-order condition (4). The inequality follows from the restriction  $\bar{e} < e_i^*$ . Hence, the public firm prefers lazy workers to regular workers. Lazy workers value the relatively low level of effort in the public sector more than regular workers and, hence, demand a lower wage. The same holds for motivated workers, but for a different reason: They require a lower wage than regular workers, as they derive motivational utility from working in the public sector. Moreover, motivated workers may exert more effort than regular workers,  $e_m \geq \bar{e}$ . Note that when the optimal level of effort of motivated workers  $e_m$  is greater than  $\bar{e}$ , it holds that  $\theta_m C(e_m) - \gamma_m V(e_m) < \theta_m C(\bar{e}) - \gamma_m V(\bar{e})$ . Hence, the higher the optimal level of effort of motivated workers, the lower the wage needs to be to attract them. Whether the public firm prefers motivated workers to lazy workers is ambiguous. Motivated workers may exert more effort and need less monetary compensation for their effort, but have higher opportunity cost of working in the public sector than lazy workers. If  $Q$  is sufficiently large such that the public firm needs to hire two worker types, it hires both lazy and motivated workers.<sup>9</sup>

## 4.2 Verifiable Effort

When effort is verifiable, the public firm can induce the workers to exert a certain level of effort, and compensate them such that their participation constraint (8) is just met. Consider first the case where  $Q$  is sufficiently small, such that the firm needs only one worker type. Given the type of worker, the optimal contract then minimises (7) with respect to  $e_i$ , subject to the participation constraint (8) and the production constraint  $Q = e_i n_i$ . This gives first-order condition:

$$[\theta_i C'(e_i) - \gamma_i V'(e_i)] - \left[ \frac{U_i^* + \theta_i C(e_i) - \gamma_i V(e_i)}{e_i} \right] = 0 \quad (9)$$

In the optimum, the marginal cost of effort by the employed workers (the first term) is equal to the marginal cost of effort by hiring an additional worker (the second term). Using (4) and (5), it is easy to verify that condition (9) is satisfied for lazy workers and for regular workers if  $e_i = e_i^*$ . Hence, if the public firm chooses to hire lazy or regular workers, it induces them to exert as much effort as they do in the private sector. By (8), this implies that the public firm has to pay them the same wage as they earn in the private sector,  $pe_i^*$ . When we substitute  $e_m = e_m^*$  into equation (9) for  $i = m$ , we

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<sup>9</sup>In Appendix A1 we prove that for each case considered in the main text, there exists a level of  $Q$  for which it is optimal for the public firm to attract two worker types instead of one. For each case considered, the supply function of public goods is continuous but displays a kink at this level of  $Q$ , except when worker types are not observable and effort is unverifiable. Then, the supply function for public goods displays a discontinuous jump at this level of  $Q$ .

find, by using (4) and (5), that condition (9) is not satisfied, since:

$$-e_m^* \gamma_m V'(e_m^*) + \gamma_m V(e_m^*) > 0$$

where the inequality follows from the concavity of  $V(e)$ . Hence, motivated workers are induced to exert *less* effort than in the private sector, even though their intrinsic motivation makes them willing to exert more effort at the same wage than in the private sector. The intuition is straightforward. As the marginal rents from motivation of a single worker decrease in  $e_m$ , it is optimal for the public firm to set  $e_m$  relatively low and attract additional motivated workers. Thereby, the public firm increases the total rents from motivation generated in the public sector, resulting in lower costs of public goods production.<sup>10</sup>

Comparing the cost per unit of effort for each worker type, it follows that the public firm prefers to hire motivated workers. It has to pay lazy and regular workers as much for their effort as the private sector does, which implies that total cost would be  $pQ$ . Even if the public firm would let motivated workers work as hard as they do in the private sector, total cost would be lower than  $pQ$ , namely  $pQ - n_m \gamma_m V(e_m^*)$ , as the firm can fully extract the rents from motivation. Since the firm optimally sets  $e_m < e_m^*$ , it follows that total cost are even lower.

If  $Q$  is sufficiently large, such that the public firm needs workers of a second type, it is indifferent between lazy and regular workers, as it has to pay  $p$  for each unit of effort of both types. In Appendix A1, we derive that, in this case, motivated workers are induced to exert *more* effort than if they would be employed in the private sector. The public firm sets  $e_m = e_m^x$ , where  $e_m^x$  is the level of effort motivated workers would exert in the private sector *if* they would have intrinsic motivation to work in the private sector, as defined by (6). This level of effort maximises the joint surplus of the public firm and the motivated workers. Total cost of public goods production are:

$$Z = pQ - N_m \gamma_m V(e_m^x) \tag{10}$$

The public firm optimally designs the contracts such that it pays  $p$  per unit of effort and extracts all of the rents from motivation from the motivated workers.

## 5 Unobservable Types

Next consider the case where the public firm can not distinguish between worker types. When effort is verifiable, the public firm can separate the types by clever design of contracts. When effort is not verifiable, separating contracts are not feasible, and crowding out of the desired type may occur.

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<sup>10</sup>It is easy to verify that if  $V(e)$  would be a linear function, the public firm optimally sets  $e_m = e_m^*$ .

## 5.1 Unverifiable Effort

The effort choice of the workers, the wage needed to attract workers of a particular type, and the public firm's preference ordering over worker types are the same as in Section 4.1. Hence, regular workers are least attractive, and lazy and motivated workers may both be the best option. However, as the firm can not distinguish between types, it is possible that the firm prefers to attract only motivated workers, but that at the wage it has to offer to attract them, lazy workers apply as well. This occurs when  $w_l/\bar{e} > w_m/e_m$  and  $w_l < w_m$ , where  $w_i$  is defined by (8).<sup>11</sup> Then, setting  $w_m$  rather than  $w_l$  is optimal if:

$$w_l/\bar{e} > w_m \frac{N_l + N_m}{N_l\bar{e} + N_me_m}$$

where we assume that, when setting  $w_m$ , the public firm randomly attracts workers from the groups of motivated and lazy workers, and that utility from public goods is linear. Hence, for a larger range of parameter values, it is optimal to attract lazy workers only. With concave utility from public goods, the condition becomes even more stringent as total public output becomes uncertain when the firm sets  $w_m$ .

Crowding out of motivated workers may also happen when  $Q$  is sufficiently large, such that the public firm would like to attract all of the motivated workers in the economy and a limited number of lazy workers. Then, as the public firm can not distinguish between lazy and motivated workers, some of the motivated workers may not obtain a public sector job. Compared to the case where worker type is observable, costs of production are always higher, as the firm can no longer offer different wages to lazy and motivated workers.

## 5.2 Verifiable Effort

When effort is verifiable, the public firm offers several contracts, so as to separate worker types. Consider first the case where  $Q$  is sufficiently small, such that the public firm needs only one worker type. It is easy to verify that the results are identical to those of Section 4.2. The public firm thus attracts only the motivated workers, induces them to exert less effort than in the private sector, and extracts all of their motivational rents.

Next, consider the case where  $Q$  is sufficiently large, such that two worker types are needed. As in the case of observable worker types, the firm prefers to hire all of the motivated workers as they are the only workers who are willing to work for less than  $p$  per unit of effort. The interesting question is which worker type the public firm prefers to hire in addition to the motivated

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<sup>11</sup>Note that motivated workers have no incentive to underbid: their participation constraint is just met, whereas lazy workers earn a rent in a public sector job when  $w_l < w_m$ .

workers. Total cost  $Z$  is given by:

$$Z = w_m N_m + w_k n_k \quad (11)$$

and the production constraint is given by:

$$e_m N_m + e_k n_k = Q \quad (12)$$

where  $k \in \{r, l\}$ . To attract and separate the two types, the firm creates two contracts that meet the following conditions. First, the contracts must meet the participation constraint of both types:

$$\begin{aligned} IR_k & \quad w_k - \theta_k C(e_k) \geq U_k^* \\ IR_m & \quad w_m + \gamma_m V(e_m) - \theta_m C(e_m) \geq U_m^* \end{aligned}$$

Second, the contracts must meet the revelation constraints, that is, each worker must prefer the contract designed for his type to the other contract:<sup>12</sup>

$$\begin{aligned} IC_k & \quad w_k - \theta_k C(e_k) \geq w_m - \theta_k C(e_m) \\ IC_m & \quad w_m + \gamma_m V(e_m) - \theta_m C(e_m) \geq w_k + \gamma_m V(e_k) - \theta_m C(e_k) \end{aligned}$$

Consider first the case where the public firm decides to attract motivated and regular workers,  $k = r$ . This resembles a standard adverse selection problem, where workers differ in their productivity inside the firm, but have the same outside option (since  $\theta_r = \theta_m$ ). As in the standard model, the participation (or Individual Rationality) constraint of the ‘low’ type and the revelation (or Incentive Compatibility) constraint of the ‘high’ type are binding, while the other two constraints are non-binding (see e.g. Laffont and Martimort, 2002, chapter 2). The optimisation problem of the public firm is to minimise cost (11) with respect to  $e_m$  and  $e_r$ , subject to  $IR_r$ ,  $IC_m$ , and the production constraint (12). This gives the following two first-order conditions for  $e_m$  and  $e_r$ , respectively:

$$-\frac{N_m}{e_r} [U_r + \theta_r C(e_r)] + N_m [\theta_m C'(e_m) - \gamma_m V'(e_m)] = 0 \quad (13)$$

$$[e_r \theta_r C'(e_r) - U_r^* - \theta_r C(e_r)] \left[ \frac{Q - e_m N_m}{e_r^2} \right] + N_m [\gamma_m V'(e_r) + C'(e_r)(\theta_r - \theta_m)] = 0 \quad (14)$$

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<sup>12</sup>We assume that workers choose which contract to sign after applying. If a worker had to choose for which contract to apply, motivated workers would have to take into account that not all workers applying for the contract designed for the other type may get a job, as the number of applications may exceed the number of jobs. This would weaken  $IC_m$ , and hence further reduce the rents that motivated workers obtain. Further, we also assume that the public firm can commit not to renegotiate the contracts after the types have been revealed, such that the ratchet effect has no bite.

By substituting  $e_r = e_r^*$  into first-order condition (14) and using (4) and (5), the first term drops out. Since the second term is positive, it follows that the public firm induces the regular workers to exert less effort than they do in the private sector,  $e_r < e_r^*$ . Substituting this result into equation (13), we find that the contract for the motivated workers is also distorted. The public firm induces the motivated workers to exert more effort than they would do in the private sector *if* they would be motivated to work in the private sector,  $e_m > e_m^x$ .

Intuitively, as in the standard adverse selection model, the public firm makes the contract of the regular workers less attractive to motivated workers by decreasing the level of effort in that contract. Thereby, it can extract a greater part of the rents from motivation from the motivated workers. However, this decrease in effort implies that the public firm needs to hire more regular workers to meet the production constraint, which is costly. It can decrease these costs by increasing the effort of motivated workers. In the optimum, the cost of an additional unit of effort by giving stronger incentives to the motivated workers is equal to the cost of an additional unit of effort by hiring an additional regular worker.<sup>13</sup>

Next, consider the case where the public firm decides to attract motivated and lazy workers,  $k = l$ . If the revelation constraint of motivated workers  $IC_m$  is binding, the optimisation problem of the public firm is similar to that above, leading to first-order conditions (13) and (14) with  $r = l$ . Hence, the public firm distorts both contracts by giving lazy workers weaker incentives than private firms do, and motivated workers stronger incentives than private firms would.

Interestingly, however, when the public firm attracts lazy workers, it is also possible that the revelation constraint does not bind, i.e. that the contract for lazy workers is less appealing to motivated workers than working in the private sector.<sup>14</sup> In this case,  $IR_m$  and  $IR_l$  are binding, while  $IC_m$  and  $IC_l$  are non-binding. Then, the optimisation problem of the public firm is to minimise cost (11) with respect to  $e_m$  and  $e_l$ , subject to  $IR_l$ ,  $IR_m$ , and the production constraint (12). This gives the following two first-order conditions for  $e_m$  and  $e_l$ , respectively:

$$-\frac{N_m}{e_l} [U_l^* + \theta_l C(e_l)] + N_m [\theta_m C'(e_m) - \gamma_m V'(e_m)] = 0 \quad (15)$$

$$[e_l \theta_l C'(e_l) - U_l^* - \theta_l C(e_l)] \left[ \frac{Q - e_m N_m}{e_l^2} \right] = 0 \quad (16)$$

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<sup>13</sup>Allowing for part-time jobs in the private sector makes contract distortions less costly. Regular workers would take a part-time job in the private sector alongside their public sector job, thereby increasing their utility. Hence, the cost of the downward distortion for the public firm is lower, implying that the firm can extract more rents from the motivated workers.

<sup>14</sup>Note that this can never happen when the public firm hires regular workers rather than lazy workers, since regular and motivated workers have the same outside option.

By substituting  $e_l = e_l^*$  and using (4) and (5), we find that the first term between brackets of first-order condition (16) is zero. Hence, the public firm sets the level of effort for the lazy workers equal to their optimal level of effort in the private sector. Obviously, their wage must also be at the same level as in the private sector. Substituting this result into first-order condition (15) gives  $e_m = e_m^x$ . Hence, neither contract is distorted and the contract offered to motivated workers extracts all of their rents (as  $IR_m$  is binding). Note that these contracts are identical to those in Section 4.2, where we assumed that worker types are observable.

The final step is to show which type of workers the public firm optimally attracts in addition to the motivated workers. Let us start with the case we just discussed, where the participation constraint of motivated workers  $IR_m$  is binding if the firm attracts lazy workers. Since the public firm offers the same contracts as in the case of observable types, total costs are as low as in the case of observable types, as described by (10). Hence, the public firm pays  $p$  per unit of effort to lazy workers and extracts all of the motivational rents from motivated workers. When, instead, the public firm attracts regular workers, the revelation constraint of the motivated workers is always binding. Therefore, the public firm can not extract all of the rents from motivation. Moreover, it distorts the contract of the regular workers, implying that the cost per unit of effort of regular workers is greater than  $p$ . Hence, total cost are lower if the public firm attracts lazy rather than regular workers.

Next, consider the case where the revelation constraint of motivated workers  $IC_m$  is binding if the public firm attracts lazy workers. In Appendix A2, we prove that total cost  $Z$  decrease in the general work ethic of the non-motivated worker type  $\theta_k$ ,  $\partial Z/\partial \theta_k < 0$ . Hence, besides motivated workers, the public firm prefers to attract the economy's laziest workers. The intuition is straightforward. The extraction of motivational rents from motivated workers by the public firm is hampered by the revelation constraint for motivated workers  $IC_m$ . To induce motivated workers to choose the proper contract, they must receive all rents they would obtain by choosing the other type's contract. A contract satisfying a lazy worker's participation constraint has lower wage and lower required effort than a contract satisfying a regular worker's participation constraint. Therefore, a lazy worker's contract is less appealing to a motivated worker than a regular worker's contract, implying that the public firm can extract more rents, and hence attracts motivated workers at lower cost, if it attracts lazy workers rather than regular workers.<sup>15</sup>

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<sup>15</sup>Without motivated workers,  $N_m = 0$ , it follows from first-order condition (14) that the government does not distort the contract of regular or lazy workers. Then, the government is indifferent between lazy and regular workers, as both are willing to work in the public sector for  $p$  per unit of effort. Hence, the contract distortions and the preference for lazy workers stem from the presence of motivated workers.



It follows that the public firm can produce the same output at lower cost by attracting lazy rather than regular workers. Moreover, the public firm may deliberately provide weak incentives to lazy workers, implying that lazy workers in the public sector exert less effort than lazy workers who are employed in the private sector. Hence, the laziness of civil servants may be a sign of cost-efficient government!

## 6 Social Welfare

In this section, we impose that the public firm maximises social welfare, which we define as the sum of utilities of all workers in the economy.<sup>16</sup> Recall that, so far, we ignored taxation as our assumption of lump-sum taxes implies that none of the decisions by the workers or the cost-minimising public firm are affected by taxation. However, taxes do affect workers' utility and, hence, social welfare. The total amount of taxes is simply the sum of the wages of the public sector workers ( $Z$ ). Since utility is linear in income, social welfare can be written as:<sup>17</sup>

$$\Psi = \sum_i [(N_i - n_i)U_i^* + n_i U_i] - Z \quad (17)$$

Recall that  $n_i$  denotes the number of workers of type  $i \in \{r, m, l\}$  hired by the public firm. By using (3), the above expression can be rewritten to:

$$\Psi = \sum_i \{(N_i - n_i)U_i^* + n_i [-\theta_i C(e_i) + \gamma_i V(e_i)]\} \quad (18)$$

Hence, the public firm maximises total utility in the private sector minus the net cost of effort in the public sector.

In Appendices A3 and A4, we prove that the optimal choice of the social planner is identical to that of a cost-minimising public firm when effort is unverifiable, and when effort is verifiable and  $Q$  is sufficiently small, respectively. Thus, when effort is unverifiable, regular workers are least attractive to the public firm, and lazy and motivated workers may both be the best choice. When effort is verifiable and  $Q$  is sufficiently small, the public firm attracts motivated workers, and induces them to exert a level of effort smaller than private firms do,  $e_m < e_m^*$ .

### 6.1 Verifiable Effort, Large $Q$

Suppose that  $Q$  is sufficiently large, such that it is optimal for the public firm to hire two types of workers. Again, the public firm prefers motivated

<sup>16</sup>We maintain the assumption that the public firm can not observe worker type. Observability does not affect the results in this section, except for the minimum compensation which is given by (8) when worker type is observable.

<sup>17</sup>Since the public firm's output  $Q$  is fixed, we can safely ignore the utility from public goods in the optimisation problem.

workers to regular and to lazy workers, as motivated workers derive utility from working at the public firm. Social welfare (18) can be rewritten as:

$$\Psi = \sum_i (N_i U_i^*) - n_k [U_k^* + \theta_k C(e_k)] - N_m [U_m^* + \theta_m C(e_m) - \gamma_m V(e_m)] \quad (19)$$

where subscript  $k \in \{r, l\}$  denotes the non-motivated worker type the firm hires. Maximising (19) with respect to  $e_m$  and  $e_k$ , subject to production constraint (12), yields the following first-order conditions:

$$\frac{N_m}{e_k} [U_k^* + \theta_k C(e_k)] - N_m [\theta_m C'(e_m) - \gamma_m V'(e_m)] = 0 \quad (20)$$

$$\frac{Q - N_m e_m}{e_k^2} [U_k^* + \theta_k C(e_k) - e_k \theta_k C'(e_k)] = 0 \quad (21)$$

Using (4) and (5), it follows that first-order condition (21) is zero for  $e_k = e_k^*$ . Hence, the non-motivated worker type is induced to exert the same level of effort as in the private sector. This implies that the public firm is indifferent between hiring lazy and regular workers, as both types derive the same utility in the private and the public sector. Substituting this result into first-order condition (20), it follows that the effort of motivated workers is (implicitly) given by (6), the level of effort motivated workers would exert in the private sector *if* they would derive utility from working there,  $e_m = e_m^x$ . Hence, a social planner does not distort the contracts of its employees. Wages are set such that the participation constraints  $IR_k$  and  $IR_m$  and the revelation constraints  $IC_k$  and  $IC_m$  are all satisfied.<sup>18</sup>

The social welfare maximising contracts differ from those offered by the cost-minimising public firm. This implies that, when the public firm maximises social welfare, social welfare is higher, but also that total cost and, hence, taxes are higher. Apart from the difference in taxes, lazy and regular workers attain the same level of utility,  $U_i^*$ , in both cases. Hence, as taxes are higher, social welfare maximisation makes lazy and regular workers worse off. It follows that only motivated workers benefit from having a social welfare maximising government. When motivated workers constitute a minority in society, politicians are likely to act in the interest of lazy and regular workers and strive for minimum cost of public goods production.

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<sup>18</sup>Because utility is linear in income, the distribution of income does not affect social welfare. When the social welfare function is extended to allow for distributional concerns, as in e.g. Boyer and Laffont (2003, Section 6), the public firm may distort contracts. Then, rent extraction from motivated workers may be considered optimal for distributive reasons. Rent extraction may also be optimal when taxes are distortionary, as in e.g. Laffont and Tirole (1993). Then, the social planner trades off the inefficiencies arising from taxation against the inefficiency of distorting the contracts of the workers in the public sector.

## 7 Concluding Remarks

In this paper we have shown that, in addition to workers with a public service motivation, the public sector may prefer to hire the economy's laziest workers and provide them with weaker incentives than the market sector does. Even though this reduces aggregate welfare, a majority of society may be better off, as motivated workers can be hired at lower wage, and hence public goods are produced at lower cost. When effort is to a large extent unverifiable in the public sector, the public sector may hire too many lazy workers as they crowd out motivated workers.

We have restricted  $Q$  such that two worker types are sufficient. It is a straightforward repetition of the analyses to allow for values of  $Q$  such that the public firm needs all three worker types. When the difference in general work ethic  $\theta$  between lazy and regular workers is sufficiently large, the contract for lazy workers is not distorted, whereas the public firm distorts the contracts for motivated and regular workers. Otherwise, the contract for lazy workers will be distorted as well. In the limit, when  $Q \rightarrow \infty$ , the public firm does not distort any contract, as can be seen from first-order condition (14). When the firm needs a great number of non-motivated workers, the costs of distorting the contract for non-motivated workers are large compared to the benefits of rent extraction from the motivated workers.

We have abstracted from interactions between the workers. Work morale, however, may be affected by the behaviour of one's colleagues. The enthusiasm of coworkers may be stimulating, whereas shirking colleagues may reduce the incentive to work (Stowe, 2002). Likewise, motivated workers may consider the wage paid to lazy workers to be unfair given the difference in effort. Then, attracting lazy workers may be detrimental to the effort of motivated workers. Further, if the pace of production depends on the 'weakest link', it may not be optimal to hire lazy workers.

An interesting extension of our analysis would be to introduce careers within the public sector. In many public agencies, job descriptions change radically when one is moving up in the hierarchy. When, for instance, policemen, firemen, nurses, teachers, researchers, and so on, are motivated by the work that they do, they may be reluctant to accept a management position. How this affects the incentivisation and selection of workers for both field and management positions is an interesting topic left for future research.

## A Appendices

### A.1 Conditions under which hiring two types of workers is optimal

#### All cases, unverifiable effort

Because the public firm can not induce workers to exert a certain level of

effort, it is necessary to attract a second worker type as soon as  $Q > N_i e_i$ , where  $i$  is the worker type the firm prefers to employ when  $Q$  is sufficiently low. Recall that if worker type is not observable, it might happen that the public firm can not single out its most preferred type. Then, the public firm always employs two worker types.

**Observable types, verifiable effort**

As the marginal cost of a unit of effort provided by a lazy or regular worker is  $p$ , the firm attracts lazy or regular workers when the marginal cost of effort by the motivated workers exceeds  $p$ . Differentiating the participation constraint (8) of motivated workers with respect to  $e_m$  gives:

$$\frac{\partial w_m}{\partial e_m} = \theta_m C'(e_m) - \gamma_m V'(e_m) \quad (\text{A1})$$

Hence, the public firm attracts a second worker type when  $Q > N_m e_m^\xi$ , where  $e_m^\xi$  is defined by:

$$\theta_m C'(e_m^\xi) - \gamma_m V'(e_m^\xi) = p \quad (\text{A2})$$

Note that (A2) is identical to (6). Hence,  $e_m^\xi = e_m^x$ , which is the optimal level of effort motivated workers would exert in the private sector *if* they would derive utility from working in the private sector.

**Unobservable types, verifiable effort**

First, consider the case where the participation constraint of motivated workers  $IR_m$  binds when the public firm attracts lazy workers, while the revelation constraint  $IC_m$  is non-binding. Marginal cost of effort when hiring a lazy worker is  $p$ . This implies that the public firm hires lazy workers as soon as the marginal cost of effort of motivated workers exceeds  $p$ . As this is identical to the benchmark case, the public firm attracts lazy workers when  $Q > N_m e_m^\xi$ , where  $e_m^\xi$  is defined by (A2) (and (6)).

Next, consider the case where the revelation constraint of motivated workers  $IC_m$  binds when the public firm attracts lazy workers, while the participation constraint  $IR_m$  is non-binding. It is obvious that the public firm attracts only motivated workers when  $Q \leq N_m e_m^\xi$ . Now consider higher levels of  $Q$ . When the firm does not attract lazy workers, total cost can be found by substituting the production constraint  $Q = N_m e_m$  and the participation constraint (8) of motivated workers into total cost  $Z_1 = N_m w_m$ :

$$Z_1 = N_m \left[ U_m^* + \theta_m C\left(\frac{Q}{N_m}\right) - \gamma_m V\left(\frac{Q}{N_m}\right) \right] \quad (\text{A3})$$

It is easy to verify that  $Z_1$  is a continuous and convex function of  $Q$ . When, instead, the public firm attracts both motivated and lazy workers, total cost discontinuously increase, as the public firm can no longer extract all motivational rents from the motivated workers. Suppose the public firm

would not distort the contracts of its workers,  $e_l = e_l^*$  and  $e_m = e_m^\xi (= e_m^x)$ . Then, total cost when the public firm attracts both lazy and motivated workers,  $Z_2$ , is a linear function of  $Q$ , as the marginal cost of effort equals  $p$ . Hence,  $Z_1$  and  $Z_2$  intersect at some level of  $Q > N_m e_m^\xi$ . Since the public firm optimally distorts the contracts of its workers when it attracts both lazy and motivated workers so as to decrease cost, the minimum level of  $Q$  at which it is optimal to attract lazy workers is smaller than the level at which  $Z_1$  and  $Z_2$  intersect.

### **Social planner, verifiable effort**

As the public firm induces lazy and regular workers to exert the same level of effort as in the private sector, this case is similar to the benchmark case.

### **A.2 Proof that $\frac{\partial Z}{\partial \theta_k} < 0$**

By substituting the production constraint (12),  $IR_k$ ,  $IC_m$ , and (5) into total cost (11), we find:

$$Z = \{pe_k^* - \theta_k[C(e_k^*) - C(e_k)]\} \left( \frac{Q - e_m N_m}{e_k} + N_m \right) + N_m \{ \theta_m [C(e_m) - C(e_k)] - \gamma_m [V(e_m) - V(e_k)] \}$$

A marginal increase in  $\theta_k$  leads to a decrease in  $Z$ :

$$\frac{\partial Z}{\partial \theta_k} = -[C(e_k^*) - C(e_k)] \left( \frac{Q - e_m N_m}{e_k} + N_m \right) < 0$$

where, by the envelop theorem, all effects through  $e_k^*$ ,  $e_k$ , and  $e_m$  are zero, and the sign follows from  $e_k < e_k^*$  (see first-order condition (14)).

### **A.3 Proof that cost-minimisation and welfare-maximisation yield identical results when effort is unverifiable**

A cost-minimising public firm attracts the worker type that minimises  $Z = n_i w_i$ . After substituting the production constraint  $n_i = Q/e_i$  and (8), we find that:

$$Z = \frac{Q}{e_i} [U_i^* + \theta_i C(e_i) - \gamma_i V(e_i)]$$

A welfare-maximising public firm attracts the worker type that maximises (18). After substituting the production constraint  $n_i = Q/e_i$ , we find that:

$$\Psi = \frac{Q}{e_i} [-U_i^* - \theta_i C(e_i) + \gamma_i V(e_i)]$$

Obviously, these two optimisation problems yield the same results.

#### A.4 Proof that cost-minimisation and welfare-maximisation yield identical results when effort is verifiable and $Q$ is sufficiently small

A welfare-maximising public firm maximises (18) with respect to  $e_i$ , subject to the production constraint  $n_i = Q/e_i$ . This gives first-order condition:

$$- [\theta_i C'(e_i) - \gamma_i V'(e_i)] + \left[ \frac{U_i^* + \theta_i C(e_i) - \gamma_i V(e_i)}{e_i} \right] = 0$$

which is, except for opposite signs, identical to first-order condition (9) derived in Section 4.2. Hence, the optimal contract of a welfare-maximising public firm is identical to that of a cost-minimising public firm.

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