

We investigate the terms of exchange between the legislative branch of the government and an administrative bureau with standard operating procedures (ABSOP). An administrative bureau is a not-for-profit public organisation responsible for the production of a non-marketable good. Such a bureau is tax-financed and the budget appropriations can be linked directly to a verifiable measure of the agency's performance. Also, the tax-financed transfer must not be less than the monetary cost of running the public agency. When standard operating procedures are central to the workings of the bureau, the agency is unencumbered by moral hazard. Yet, such agency is likely to have superior information over its production technology relative to the legislature. In such an information environment, we focus on how the legislature could minimise its welfare losses. Our results come in striking contrast to those in the literature on bureaucracies and to the received adverse selection findings. In a setting where the agency can be either of two cost-types, the principal finds it optimal in most cases to distort the production performance of the bureau *regardless* of its cost-type. Also the distortions are not of the same direction.

Effectively, the problem we investigate here is a principal-agent problem with hidden information, with the principal being identified with the legislature and the agent being identified with an ABSOP. Such a problem, in its standard form, has been used briefly in discussing the design of bureaucracies. This paradigm has also been used extensively in studies of procurement and regulation.

The main message of this paradigm is that the principal must leave rents with the agent who has an incentive to mis-report his type, in order to prevent him from doing so, and that these rents are decreasing with the production undertaken by the agent who has no incentive to mis-report his private information. Accordingly, the principal faces a trade-off between information rents and output distortion. This trade-off leads to underproduction on the part of the agent who has no incentive to deviate from truth-telling.

Nevertheless, in the standard version of this problem the principal is encumbered only by an information and a voluntary-participation constraint. In this paper, instead, we postulate, as we have already mentioned, that when an administrative bureau is designed its political principal(s) are also restricted by the constraint that the budget must be as low as the monetary production costs. This constraint, in conjunction with the fact that the bureau's manager may not aim at profit maximisation, implies that the legislature, when it contemplates what incentive-compatible contract to offer to the bureau, does not need to worry that the agency will reject its offer and hence that public output will not be produced. The reason is that the administrative constraint the enacting legislature faces is stricter than the agency's participation constraint.

The fact that, due to the agency's preferences, the administrative constraint makes redundant the voluntary-participation constraint implies that in analysing the optimal mechanism vis-a-vis a not-for-profit public agency which produces a non-marketable good we end up with a non-standard adverse selection problem. In more detail, the principal still faces a trade-off between information rents and output distortions, as it is the case in the standard paradigm. Yet, in our case, information rents can be reduced by distorting the

production undertaken by all types of the agent. The latter implies that, in a two-types setting, we can find instances where the low-cost agent undersupplies and the high-cost agent oversupplies its output under the optimal revelation mechanism, and cases where the reversed production scheme is implemented.