Bounded Rationality

The Fallacy of Government as Deus Ex Machina

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With the rise of the technocratic welfare state in the late twentieth century, economists have now carved out a ubiquitous role in government, as technical experts, advisors, and even as government ministers. This is a somewhat natural result, owing, in part, to their hegemony over the social sciences, and in part, to the ceremonial value of high economic qualifications (Markoff and Montecinos 1993). Economists, more so than other government functionaries, are able to confer an aura of legitimacy on public policies, by putting forward recommendations for government action which has been filtered through the framework of economic rationality.

Notwithstanding this fact, the actual economic approach of economists working in the government is often highly flawed. There are many reasons for this, but part of the reason is that the economist is in the position of giving advice inside the organisation, such that the appropriate role is to provide advice on *a set of actions* that will alleviate some social problem, rather than giving an examination of institutional arrangements. In view of the fact that this is internal organisational advice (or

possibly advocacy of advice to government from outside), it is usually based on the presumption that the thing at issue is the optimality of a certain set of actions.

This presents a low standard for recommendations of government intervention in the economy. By providing internal advice, the government economist is able to ignore the institutional functioning and incentive mechanisms with the government apparatus and merely decide on a set of optimal actions. The standard for intervention then becomes one where intervention is recommended when the economist can identify a *set of actions* that would efficiently alleviate the social problem under consideration. Such a phenomenon plays out in many areas of public policy. In a discussion of anti-trust regulation Becker (1958) notes that:

> *"…the recommendation of government intervention does not follow from the demonstration that government intervention could improve matters. Demonstrating that a set of government decisions would improve matters is not the same as demonstrating that actual government decisions would do so. This kind of inference is logically equivalent to identifying the actual workings of the market sector with its ideal workings."*
> (p. 105, emphasis added)

Of course, it is well-known to government economists that their advice is not always taken, or that it may be taken, but bastardised into some unrecognisable form. This is an occupational hassle, as in any organisation, but it is not generally regarded as part of the economic problem under analysis. After all, if an economist proposes some set of actions, and the proposed actions are rejected, or altered beyond reasonable limits to some form which has some other effects, then any adverse consequence can hardly be laid at the feet of the initial advice!

In this advisory role, whether internal or external, economists are often unconcerned with the wider question of the institutional analysis of government, and unaware that they are implicitly treating the government as being outside of economics, insofar as it is treated as an entity *whose actions can be prescribed*. However, the real question to be dealt with in the analysis of government action is the economic problem of how this institution operates with its specific set of knowledge resources, incentives, and feedback mechanisms.

Incentives and feedback in firms

Economic theory analyses the behaviour of individuals and organisations whenever they act to achieve some desired goal using scarce resources. It seeks to understand how people will act in the face of a set of incentives, and what the social consequences of their actions will be. Analysing the actions of an organisation is especially challenging, because this entity is composed of multiple people who each have their own preferences and goals. The study of the behaviour of such collective entities has given rise to the 'theory of the firm', which seeks to describe why people come together into organisations to perform group tasks, rather than arranging individual transactions at arms-length using market prices.

The standard account of firm existence and behaviour is put forward in Coase (1937, 1988). Coase argued that firms exist to avoid the transaction costs involved in conducting market exchanges using the price mechanism. Exchanges on the market at prevailing market prices are substituted, within the firm, for inter-firm transactions made under the direction of a manager.[1] The fact that inter-firm transactions

1 The size and scope of firms depends on the rela-

are made under the direction of a manager, who represents the owner of the firm, does not necessarily imply that actions occurring in the firm will seamlessly reflect the goals and preferences of the owner. Indeed, it is often the case that the firm has several different part-owners, and their preferences and goals may also conflict.

Economists are well aware of these issues, and a substantial body of work within the theory of the firm is devoted to looking at the degree to which the goals of the firm's owners are perverted within the firm by the goals and preferences of the agents operating the firm (the principal-agent problem). The prevailing model of the firm that emerges in modern economics is one where the goals of the owners of the firm are mediated, and often perverted, through the influence of agents within the firm pursuing their own personal goals. Employees —including managers or subordinate employees— may wish to increase their own salary, perks, power and prestige, and might also want to minimise their labour, avoiding difficult or unpleasant work wherever possible.

Sowell (1980) has cogently analysed the knowledge problem in decision making by government and private parties, and stressed that the locus of a decision affects the incentives and feedback mechanisms of the decision maker, in ways that change the character of decision-making. In particular, he stresses that the important question of many resource decisions is not so much, *what* is to be done, but *who* is to make the decision, and subject to *what incentives and feedback*?

The double-standard — government as *deus ex machina*

In view of this complexity of incentives, economists are generally well aware that it is not legitimate to recommend socially desirable actions to a firm, and simply assume that the firm will take the suggested actions. No economist with any understanding of the theory of the firm would propose that a firm act according to some set of actions, and then blithely assume that the advice will be carried into effect, irrespective of the goals and incentives of the owners and employees. An economist who, for example, entreats a firm to avoid profit maximisation in order to pay above-market wages to its workers, would understand that this proposal might not be in accordance with the goals of the owner, and the resultant incentives of the management. To expect such a proposal to be carried into effect merely because it has been articulated as alleviating some social problem, and despite its mismatch with incentives, would be to abandon economic analysis, and treat the action as a *deus ex machina*.

In cases where the firm is connected to other firms, in the sense that other firms may influence its internal behaviour, it is also understood that this must be taken into account. The sensible economist, who gives advice to firms as to how they should operate, understands that the advice will be mediated through the goals and incentives of the principals and agents of the firm, and it may emerge in an altered form as a result of this. A recommended set of actions might be adjusted according to the goals and incentives of the principals and agents of the firm, as well as other influential outside parties.

This is all well-understood and well-appreciated except when it comes to government action. Economists who would laugh riotously at the prospect of advising private firms to sacrifice profits for some alternative social goal nonetheless earnestly advise government on actions without any regard to how that advice will be filtered through the incentives of the

tive costs of managing inter-firm transactions (including any lost efficiency compared to the use of market prices) versus the costs of conducting exchanges on the market using the price mechanism.

agents within the government apparatus, and associated lobby groups which can influence government action. In some cases they are entirely unaware of this institutional problem.

When economists undertake analysis of social problems it is frequently the case that they identify some alleged deficiency in the functioning of the free market (often relative to an idealised model of perfect competition among price-taking firms) and then prescribe a set of actions for government to intervene to correct the alleged deficiency. There is usually no analysis of whether the government can actually be expected to take the chosen actions as a result of the incentives operating on it, and how the prescribed action is likely to be altered by agents within the government, or within other firms that influence the operation of government.[2] In most cases it is regarded as sufficient to assume that, so long as the proposed set of actions yields an improvement in the social problem under consideration, then it is appropriate to advocate government intervention in the market.

This gives rise to a destructive double-standard in the way firms are analysed by many economists. For private firms there is usually appropriate scepticism of any proposals for action to alleviate social problems, since it is understood that such action may not be consistent with the incentives operating within the firm, and may be perverted by owners, managers, or subordinate employees. However, for the firm which calls itself the government, such scepticism is absent. Government is treated as an entity outside of economic analysis, giving rise to the "fallacy of government as *deus ex machina*". Such an approach is a repudiation of the very essence of economic thinking.

It is important to note how this fallacy plays itself out in destructive ways in public policy matters. When economists recommend government intervention in a market to perform some specific set of actions, designed to alleviate some social problem, the proposal has two elements. The first, and most important element, is the suggestion for intervention —i.e., the idea that it is proper for government to intervene in the market.[3] The second, and less important element, is the specific recommendation of the set of actions that the economist wishes the government to perform. When such a proposal is put forward it is common to see the recommendations of economists used publicly as support for government action, but the details of the specific actions or methods recommended are often too complex for public consideration. Once the need for government action is established, and made politically palatable to the electorate, the actions actually taken by the government are determined not by the economist, but by the process of decision-making occurring within the government, subject to all the incentives and interests of its internal agents, and any external interest groups that are able to mount pressure on these agents. In other words, the recommendation from the economist for a *specific set of actions* has the effect of helping to legitimise a certain set of *powers* of government, meaning that the government is then empowered to take a wider class of actions than those proposed. Once the proposal for government intervention in the market is made, the specific set of actions that were proposed will be mediated through the incentive operating on agents within the government. This is an unavoidable aspect of the fact that the government is itself an

2 Often it is also the case that the social problem is created or exacerbated by another set of government actions, but that is another matter.

3 Of course, in many cases, the government may already be intervening heavily in the relevant market. In such cases it is necessary to consider whether or not the suggestion for a specific kind of action by government implies endorsement of the intervention. In many (but not all) cases endorsement of government intervention in the market will be implicit in the proposal for specific actions.

economic entity which is subject to economic law.

A proper analysis of public policy issues, seeking solutions to social problems, must confront the fundamental institutional problem of how knowledge is transmitted in different kinds of firms and social institutions, and how decisions are made in those institutions. In dealing with such questions, it is crucial to consider the incentives and feedback mechanisms operating on decision-makers. When government is treated outside of this framework, as an entity *whose actions can be prescribed*, this is a recipe for intervention in the market on even the flimsiest pretexts.

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