Make Economics Policy Relevant

Depose the Omniscient Benevolent Dictator

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Economic policy analysts typically specify a model that describes an optimal outcome—for example, an efficient allocation of resources, an optimal distribution of income, an optimal growth path, or an optimal macroeconomic outcome of stability with full employment and low inflation. Because economic models can become complex when they account for many things, all models employ simplifying assumptions to focus on one particular issue. Models that analyze policies to promote economic growth, for example, differ from models that describe the optimal distribution of income or the optimal policy for internalizing an externality (see Holcombe 1989). Nevertheless, the methodology is the same: develop a model that incorporates the particular issue, then show in the model the optimal result and identify what keeps the economy from producing the optimum. The recommended policy is one that should move the economy from a nonoptimal position to the optimal one by removing impediments to the attainment of an optimal outcome, by changing the incentive structure so that market participants trade to a Pareto optimum, or, where markets pose more difficult problems, by imposing regulations, government mandates, or government production to allocate resources optimally.

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When the invisible hand of the market fails, economic policy recommendations typically do not go beyond advising that the visible hand of government move the economy to the optimal outcome, without any detailed discussion of whether government action can achieve this outcome or whether public-sector actors have an incentive to implement the optimal outcome. Government is modeled as if it is an omniscient benevolent dictator. To make economics policy relevant, however, this omniscient benevolent dictator must be deposed. Government in contemporary Western countries is neither omniscient nor benevolent nor dictatorial.

The Planner's Problem

The omniscient benevolent dictator is often represented in economic analysis as the planner's problem. The analyst derives the conditions required for an optimal allocation of resources, and the planner's problem is to create those conditions. The policy problem is couched entirely in comparative-static terms, identifying the optimal outcome and the status quo, with policy recommendations intended to change the situation from the latter to the former. The comparative-statics methodology for evaluating economic policy measures goes back at least to A. C. Pigou (1920, chap. 1), who lays out a methodology for evaluating policy measures by comparing economic welfare with and without the implementation of the policy measure. Frank Ramsey (1928) explicitly lays out a planner's problem for finding the rate of saving that maximizes consumption over successive generations. In response to Ludwig von Mises's ([1922] 1951) claim that central planners cannot allocate resources rationally, Oskar Lange and Fred Taylor (1938) argue that central planners can allocate resources at least as efficiently as the market.[1] Abba Lerner (1944) delivers a policy analysis based on the planner's problem that identifies conditions for the optimal allocation of resources and then advises that the government implement these conditions.

We see, then, that the omniscient benevolent dictator who solves the planner's problem has been a part of economic analysis for at least three-quarters of a century, but it gained increased stature with the Arrow and Debreu (1954) proof of the uniqueness and stability of competitive equilibrium. Using competitive general equilibrium as a benchmark, one can develop a formal framework to depict cases in which the market fails to reach that optimum. In a frequently cited article, Takashi Negishi shows that the "existence of an equilibrium is equivalent to the existence of a maximum point of this special welfare function" (1960, 92). Francis Bator (1957) shows the conditions for welfare maximization and demonstrates (Bator 1958) conditions under which markets fail to reach this maximum. It is a short step indeed to show the conditions for an optimum and to demonstrate a reason why the market fails to get there.

1. Friedrich Hayek (1945) presents an insightful analysis that points out areas in which Lange and Taylor's analysis falls short. Pierre Desrochers (2001) builds on Hayek's insights in his discussion of the transmission of tacit knowledge.

The well-known public-goods articles by Paul Samuelson (1954, 1955) offer a good example. Samuelson titles his first article "The Pure Theory of Public Expenditure," indicating that his analysis of a possible market failure in the production of public goods is in fact not *a* theory, but *the* theory of public expenditure, even though the article contains no analysis of how government would succeed in producing public goods where the market would fail.[2] The only way Samuelson's public-good theory can be a theory of government expenditure is if the government is an omniscient benevolent dictator. This is the planner's problem: how to get from the imperfect allocation of resources in the real world, as depicted in a mathematical model, to the outcome that has been demonstrated mathematically to be optimal.

Milton Friedman, commenting on Lerner's book *The Economics of Control* (1944), observes: "Most of the book is devoted to the formal analysis of the conditions for an optimum. The institutional problems are largely neglected and, where introduced, treated by assertion rather than [by] analysis. . . . [N]ot only the title and the introduction but even a first reading somehow generate the expectation and the illusion that the book contains a concrete program for economic reform. . . . Much of what at first sounds like a concrete proposal, particularly about the general structure of society, turns out to be simply an admonition to the state that it behave correctly and intelligently" (1947, 405). Friedman's critique of Lerner holds more generally for the work that has followed, which tends to show the mathematical conditions required for an optimal allocation of resources but does not explain how a real-world government can make the economy satisfy these conditions. Because government is not an omniscient benevolent dictator, in many cases government failures will be at least as significant as market failures.

To make economic analysis policy relevant, the omniscient benevolent dictator must be deposed. Government is neither omniscient nor benevolent, and in contemporary Western countries it is not a dictator.

Not Omniscient

In many cases, the mathematical formulation of a market failure shows that the information required to correct that market failure is not available to policymakers. In a classic example from welfare economics, Pigou (1920) demonstrates that a corrective tax on an externality can bring about the internalization of external costs. As William Baumol (1972) shows, for the tax to be optimal, it must be precisely equal to the external cost and vary with it so that if the external cost rises, the tax must rise by an equal amount, and if the external cost falls, the tax must fall by an equal

2. Jora Minasian (1964) argues that the market is better suited than government to the production of public goods, but in a comment that directly follows Minasian's article, Samuelson (1964) shows that he does not agree. Samuelson (1955) does back away from his earlier claim (in Samuelson 1954) that his article is *the* theory of public expenditure, referring to it in the follow-up article as only *a* theory.

amount. However, the amount of the external cost cannot be observed, so unless government is omniscient, it cannot calculate the optimal tax, and therefore it cannot eliminate the market failure. It may be able to improve on the allocation of resources in cases where externalities exist by imposing corrective taxes or regulation, but even this improvement would be only conjectural because an essential piece of information—the amount of the external cost—is unobservable.

The same problem arises with government production of public goods. Even as Samuelson calls his public-goods theory a "public-expenditure theory," he states that "given sufficient knowledge the optimal decisions can always be found by scanning over all the attainable states of the world and selecting the one which according to the postulated ethical welfare function is the best. The solution 'exists' the problem is how to 'find' it" (1954, 389). This is the planner's problem, and although Samuelson offers no solution, he is nevertheless willing nevertheless to equate a theoretical inefficiency in the market with a theory of public expenditure. However, the optimal solution he proposes requires information that is not available, so a government that is not omniscient cannot correct this market failure. One can conjecture that government will get closer to an optimum than a market allocation, but no one can know, and others (Minasian 1964; Holcombe 2008) offer the opposite conjecture. Although one can debate the merits of government production of public goods, a point beyond debate is that to allocate resources optimally to correct this market failure requires that government have information that is unobservable and therefore unavailable to government decision makers. Because the government is not omniscient, it cannot solve this planner's problem.

As another example, consider the Ramsey (1927) rule for optimal commodity taxation, which states that to minimize the excess burden of commodity taxes, the taxes should be levied in inverse proportion to the elasticities of demand for the goods. Not only are the elasticities of demand unobservable, thus making the Ramsey rule impossible to implement by anything other than an omniscient government, but under reasonable assumptions about the political process that would be used to try to estimate those elasticities, any attempt to implement the Ramsey rule would result in an outcome more inefficient than if all commodities were taxed at an equal rate (Holcombe 2002).

Robert Lucas (1976) suggests the difficulty of collecting information on likely effects of government policies because any statistical data collected prior to a policy's implementation may not apply after the policy is implemented owing to people's adjustment of their behavior in response to the policy. Lucas's example is the use of a government macroeconomic policy to produce low inflation and full employment, but the argument applies more generally. Even though econometric results use actual data, they provide only information about the past, and relationships that held in the past may not persist into the future for many reasons, including the reason Lucas cites—that people will change their behavior in response to policy changes.

Practitioners of the new institutional economics have done a great deal of research on informational problems, as Oliver Williamson (1990) notes, but the bulk of this

analysis has been done on information problems in private markets, not on information problems that arise in government decision making. For economic analysis to be policy relevant, it must recognize the information that is available to policymakers; policy recommendations cannot be based on information that is beyond their reach.

Not Benevolent

Even with sufficient information, public policy might not be made in the public interest because the people who are making the policy may not have an incentive to act in the public interest. Thus, policy analysis must take account of the incentives of those who make the policies. The "market failures" that public policy tries to correct are often attributable to the incentives to which people in the private sector respond, as their self-interest leads them to make decisions that are not in the public interest. People generate externalities, free ride on public goods, and monopolize markets because they make decisions to further their private interests, not the public interest. James Buchanan (1975) argues that public-sector behavior should be evaluated by using the same types of models and by assuming the same type of behavior for those in the public sector that economic analysts assume for private actors.

One commonly recognized example is elected officials' reelection motive. They have an incentive to implement policies that will generate support for them in the next election even though these policies may conflict with the public interest. One manifestation of the reelection motive is the political business cycle described by William Nordhaus (1975). Reelection probabilities are higher when the economy is growing and unemployment is low, giving politicians an incentive to use macroeconomic policy to stimulate the economy prior to elections. Another manifestation is the provision of special-interest benefits at public expense to constituencies that can thus be encouraged to cast their votes for the incumbents, as described by Bruce Bueno de Mesquita and his colleagues (2003) and William Niskanen (2003). Because elected officials must be reelected to remain in power, this incentive pushes them toward short-sighted policies that produce immediate benefits but also perhaps long-term costs. Thus, they tend to put much more weight on effects that occur before the next election than on effects that may occur afterward.

Incentive problems are not limited to elected officials. Niskanen's (1971) bureaucracy model deals with government bureaucrats' incentives and shows that in the same way that profit maximization is a useful simplification of the incentives facing those who run private firms, budget maximization describes the incentives facing government bureaucrats. Niskanen develops a model of how bureaucratic incentives, coupled with the institutional framework in which government's budgetary decisions are made, lead government bureaucracies to produce a larger-than-optimal output with a larger-than-optimal budget.

Governments have the same type of agency problems that Michael Jensen and William Meckling (1976) describe for private actors, and we have no reason to think

that government agents are any less responsive to the incentives they face than are private-sector agents. For economic analysis to be policy relevant, it must take into account the incentives of those who are designing public policies. Governments are not benevolent. Their actions are determined by individuals who often have incentives to work against the public interest.

Not Dictatorial

In contemporary Western countries, most government decisions are not made by a dictator—indeed, the same is true even in dictatorships! Rather, a collective decision-making process determines what action a government will take. This process has been analyzed most extensively with regard to democratic government, where analysts in the subdiscipline of public choice have shown that many factors prevent collective decisions from generating an optimal result. The median-voter model, explained well by Anthony Downs (1957), is a standard description of the outcome produced by representative democracy. Democratic decision making, even at its best, cannot identify and select the optimal allocation of resources (Holcombe 1985). Democracy, however, is not always at its best. Mancur Olson (1965) notes the influence of interest-group politics, showing that intense minorities can organize to steer public policy to further their interests at the expense of the general public. The interaction of voters, interest groups, legislators, and bureaucrats, all with their own personal interests, means that democratic decisions are not made by a dictator, but through a collective decision-making process with institutions that give weight to private interests in ways that do not necessarily produce an outcome that furthers the public interest. As Buchanan argues, "Economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made" (1987, 243).

Democratic decision making also has aggregation problems, as Kenneth Arrow (1951) has shown. The Arrow problem indicates that democratic decision making cannot be used to aggregate preferences in a way that produces a consistent ordering of social preferences. There is no unique stable outcome under majority-rule decision making, and R. D. McKelvey (1976) demonstrates that majority-rule decision making is inherently unstable. Gordon Tullock (1982) argues that democratic outcomes are more a function of political institutions than of citizens' underlying preferences and that this situation creates a stable outcome but tends to work against efficiency. Barry Weingast, Kenneth Shepsle, and Christopher Johnsen (1981) show why political institutions in democracy give rise to inefficient outcomes.

Not everyone argues that democratic decision making leads to inefficient outcomes. Gary Becker (1983) depicts the legislature as a political marketplace that weighs the interests of both supporters and opponents of legislation, and Donald Wittman (1989, 1995) makes persuasive arguments about the efficiency of political decision making. Even these arguments, however, do not represent government as a dictator

but rather treat public policy as the outcome of a collective decision-making process that involves legislators, voters, interest groups, and government bureaucrats.

Even in dictatorships, few government decisions are made by one individual. As Niskanen (2003) and Bueno de Mesquita and his colleagues (2003) argue, dictators can remain in power only as long as they have a supporting group with enough power to keep them from being overthrown. Therefore, policy decisions must supply sufficient payoffs to the dictator's supporters for the dictator to retain that support base, in much the same way that democratic leaders must maintain the support of their supporting coalitions to remain in power. Dictatorships have a narrower support base, including the military and law enforcement institutions to stifle any challengers, but even dictators must adopt particular public policies to retain support. They cannot simply make any decisions they choose, much less make decisions that further the general welfare without considering the provision of benefits to those who keep them in power.

To understand why particular tax policies are put into place, one should consider the beneficiaries of those policies and how much political power they have (see Holcombe 1998). Tax policies are created through the political process and therefore result from the efforts of various interests working through political institutions to implement policies they favor. This same idea applies to all public policy. To understand why specific policies are enacted, rather than asking why they might be in the public interest, we need to ask who benefits and how they use their political influence to get those policies put in place.

Welfare Maximization in the Real World

Welfare maximization means arriving at a Pareto optimal allocation of resources (Bator 1957; Graaf 1957). The unique stable Pareto optimum provides the benchmark, and welfare maximization means identifying any conditions that stand in the way of an economy's arriving at that optimum. Francis Bator (1958) follows up by discussing factors that can keep an economy from reaching that welfare maximum. As neoclassical welfare economics is laid out, the implementation of policies that can facilitate attainment of an optimal allocation of resources is the omniscient benevolent dictator's role. The methodology of welfare economics is to show the conditions that prevent the economy from arriving at a global optimum in a mathematical framework and then to demonstrate the mathematical conditions for a Pareto optimum. An economy not at an optimum suffers from market failure, and the implication is that a set of policies is available to make possible the attainment of the optimum. Neoclassical welfare economics implies that government policy will eliminate the market failure, but this success can occur in the general case only if the government is an omniscient benevolent dictator.

As Buchanan (1975) notes, the conclusion that a market failure exists compares the market's real-world conditions with an ideal optimum that may not be attainable

in practice. To make a policy-relevant assessment, one must compare the market's performance with the real-world government's performance, incorporating the same types of information and incentive problems in the assessments of both market performance and government performance. Government interventions are unlikely to lead to the theoretical optimum for the same reasons that welfare economics claims that markets fail: information problems and incentives for less-than-optimal outcomes. The literature has noted this conclusion to a degree—for example, with Nordhaus's (1975) political business cycle and Niskanen's (1971) bureaucracy model. The problem from the standpoint of policy-relevant economic analysis is that these models stand as isolated examples, and realistic modeling of government decision making has for the most part not found its way into the bulk of the economics literature.

Welfare economics also falls short in another area: it rests on an unrealistic model of welfare maximization. Welfare economics works within the comparative-statics, general-equilibrium framework and concludes that welfare is maximized when resources are allocated Pareto optimally. This static depiction of welfare maximization is not closely related to the factors that actually produce economic welfare. If one considers how well off people are today relative to their condition twenty, fifty, or a hundred years ago, most of the improvement in welfare has been the result of economic progress that allows people to cross oceans in jet aircraft rather than steamships, that allows people to send messages to each other by email rather than by mailing messages written on paper, that allows people to cook with microwave ovens, and that allows them to watch television on giant flat screens in addition to listening to the radio. Improvements in welfare come from economic progress and only trivially, if at all, from movements toward Pareto optimality (see Holcombe 2009). Indeed, despite the huge increases in economic welfare over the decades and centuries, the aggregate economy is probably farther from Pareto optimality than it was a century ago because technological advances have created more ways in which people's behavior can generate externalities.

This situation means that not only the methodology underlying policy analysis but also the goals of economic policy should be reevaluated. Economic policy should focus more on the development of policies to generate economic progress rather than on policies to eliminate market failures. Surely both are worth examining, but if policies to eliminate market failures also diminish entrepreneurial incentives, the policies might well reduce welfare even if they succeed in eliminating what economists call "market failures." Improvements in economic welfare come from economic development, as Joseph Schumpeter (1934) describes it. This approach to economic welfare envisions an economy as a group of individuals who are engaged in an ongoing process of exchange rather than as an equilibrium outcome that occurs when no further mutually beneficial exchanges can take place. This process-based depiction of economic activity has a solid standing in economics, as described by Oliver Williamson (1990) and Meir Kohn (2004), but when analyzing economic welfare

and developing public-policy recommendations, academic economists still work mainly within the framework that depicts welfare maximization as an outcome rather than as an ongoing process and that depicts government policies that can maximize welfare as if an omniscient benevolent dictator can implement them.

Conclusion

The component parts of the argument given here are well known in the mainstream literature. I support all my arguments on why government is not omniscient, not benevolent, and not dictatorial by references to well-known sources that go back decades, so I have to wonder how the omniscient benevolent dictator has been able to remain at the center of economic policy analysis despite so many well-known arguments against him. All dictators have their critics, and they remain in power only as long as their supporters have sufficient power to keep the dictator from being deposed.

The omniscient benevolent dictator gains support from several sources. One is the mathematical elegance of the general-equilibrium framework. Economists, like artists, are often in love with their models.[3] There is something aesthetically pleasing about demonstrating an optimal policy with mathematical precision regardless of how loosely the math is connected to reality. A second source of support, which goes back for centuries, is the push to make economics more "scientific," which often means more mathematically rigorous, like physics. Donald McCloskey (1983) has argued that mathematics and econometrics are often used in economic analysis for persuasive purposes. If one can prove an optimal outcome with mathematical precision, the outcome is difficult to argue against because it has been logically proven. The technical rigor of such demonstrations often does in fact persuade editors and referees, as McCloskey argues. That positive reinforcement encourages further "research" using those methods, and the people who publish such work become the profession's experts—the editors and referees who determine what will be published as the discipline progresses. As Leland Yeager (1997) notes, success in academic research is measured by peer approval rather than by whether the ideas actually work in the real world, and in this way the marketplace for ideas differs from a real marketplace.

Yet another source of support for the omniscient benevolent dictator comes from economists who aspire to be a part of the policymaking process. Armed with their models, they are often willing to claim that if they were in a position to make policy, they would do it as the omniscient benevolent dictator does in their models. A look at actual political incentives shows that the political process is regrettably biased in their favor. Who is more likely to be chosen for a policymaking position in government—the economist who says, "I have analyzed this issue, and here is the

3. I cannot take credit for this observation, but I do not recall where I first heard it.

optimal solution I would impose if I had the power," or the economist who says, "Because of information and incentive problems, any policy to deal with this issue is likely to make the situation worse rather than better"?

For a number of reasons, the omniscient benevolent dictator has substantial support in economic analysis, even though a large body of economic analysis demonstrates that this figure is a fiction. This situation is problematic for economic policy analysis, but it points to a more serious shortcoming in economic analysis. When analyzing markets, economic analysts draw conclusions based on models of individual behavior that are then aggregated to draw conclusions about the implications of that behavior in particular markets and in the economy as a whole. A complete economic analysis demands that the public sector be depicted in the same way—as individual decision makers whose decisions are aggregated to produce policy outcomes that affect particular markets and the entire economy. The omniscient benevolent dictator points to a serious and fundamental flaw in how economic analysis is generally undertaken. To make economic analysis policy relevant and to make it logically consistent, the omniscient benevolent dictator must be deposed.

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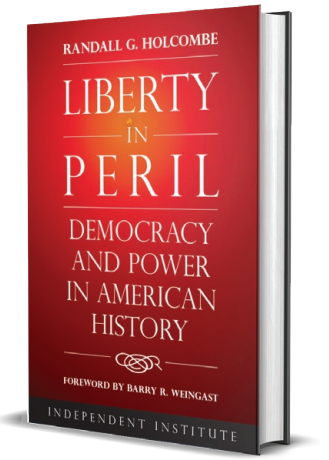
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