Dispelling the Myth of the Invisible Hand

An Argument for Democratically Legitimate Interorganizational Governance Networks

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The legitimacy of democratic governments hinges on the capacity of public institutions and their elected and appointed leaders to successfully fulfill their sovereign obligations. Efforts to privatize (Savas, 1987) and contract out (Cooper, 2003) government functions and deregulate industries (Peltzman, 1976) have all been recognized as contributing to the "hollowing out" of governmental institutions (Milward, Provan, & Else, 1993). Some have suggested that this hollowing out has contributed to the delegitimization of governments, undermining their roles as effective agents of public policy and positive social change (Frederickson, 1999). We argue that these trends have served to simultaneously atrophy governments' capacities to regulate and stimulate the economy, while also laying the foundation for the rise of solutions found within the range of governance networks that have arisen in the wake of these trends.

Dating back to Alexander Hamilton's insistence on creating the Treasury Department, these sovereign obligations have presumably been extended into matters pertaining to the health of the national economy. Since the Great Depression, national economic policies have been designed and implemented with regularity. These policies have ranged from large-scale public works projects of the New Deal, to the creation of economic regulation subsystems during the post–World War II era, to the deregulation and privatization movements of the reinventing government era. Economic policies have often been framed in terms of certain philosophies, political ideologies, and governance theories that run the gamut from Keynesian, neoclassical, and the Real Business Cycle to New Public Management (NPM) conceptions of government and market relationships.

In the public administration field, "market-driven solutions" to policy and governmental failures became the hallmark of the NPM framework. The notion that markets are systems capable of self-regulating behavior has

Administrative Theory & Praxis / September 2009, Vol. 31, No. 3, pp. 417–423.

1084-1806 / 2009 $9.50 + 0.00.
DOI 10.2753/ATP1084-1806310311

been used to legitimize the move toward market-driven solutions to public problems. In essence, NPM was founded on the notion that governments were broken and incapable of delivering effective public policy. During the Reagan administration and the two decades that followed, the scope and functions of governments experienced a significant period of retraction. This era was described by Kettl (2002) as one of "indirect" government and deregulation. Perhaps the crescendo of the era of indirect government hit in the winter of 2007, when the number of contractors funded through the U.S. federal budget exceeded the number of career civil servants (Shane & Nixon, 2007).

The current economic and financial crisis follows on the heels of a significant period of adherence to laissez-faire free market, neoliberal approaches to markets and market regulation. It has been assumed since the time of Adam Smith that the "invisible hand" of markets imbued them with the capacity to self-regulate, engender greater efficiencies, and lead to positive outcomes for society at large. This ideologically driven view fueled the U.S. federal government's lack of regulatory oversight over significant portions of the mortgage and risk insurance industries.

The current financial and economic downturn is widely acknowledged as resulting from underregulated mortgage markets; widespread speculation in the buying and trading of what had been at the time marketed as "innovative" mortgage products; and the failure in forward thinking and planning of certain industries (particularly auto and insurance). The resulting credit crunch and slowing of the economy has led to high levels of unemployment and an extensive contraction of the economy. Increasing globalization has created stronger interdependencies among different specialized markets, so the failure of one market has stronger ripple effects that reverberate throughout the economic system with positive feedback loops occurring between increasingly interdependent markets. In the current economic crisis, overvalued "innovative" mortgage products were traded as securities by investment firms at the global scale, which led to a cascading crisis in other markets, initiating a vicious spiral toward recession, which some fear could lead to a global depression without massive government intervention.

Alan Greenspan recently confessed to the ideological inadequacy of this free marketeering model (i.e., the failure of capitalist institutions to hedge themselves against the risk of massive losses). The crisis rekindled interest in Keynesian economics and renewed considerations regarding the role of government. An analysis of the current economic and financial crisis suggests that markets do not operate under many of the major assumptions guiding neoclassical economic theory. Information is not perfect. Access to information is never completely open. Consumer and producer behaviors are guided by irrational factors that defy logical rationalizations often ascribed to enlightened self-interest. We may conclude from the current economic crisis that markets are, in the end, socially constructed systems that are subject to human error and unregulated manipulation of either intentional or unintentional design.

Behavioral and experimental economists have started to argue that predictably irrational behaviors are undertaken within and on behalf of market forces (Ariely, 2008; Parisi & Smith, 2005). Market behaviors are often predicated on consumer and investor confidence—perceptions that get shaped by a number of irrational factors that lie far beyond the reach of perfect/ideal markets, into the realms of social psychology, judgment and decision-making, policy framing, and the mass media. Major organizations and institutions operating at regional, national, and international scales play a significant role in determining market behavior.

Markets are not closed networks structured around the simple exchanges taking place between utility-maximizing buyers and sellers. As open systems, they may be influenced by external factors, including those *observing* the exchanges between buyers and sellers and those *regulating* the exchanges between buyers and sellers. The recent economic and financial meltdown is a clear indication of the failure of Adam Smith's fundamental principle that exchanges between self-interested firms and consumers lead to the protection of collective interests through the emergence of some kind of invisible hand.

The assumptions driving the NPM framework, which arose in response to the cold war myth of invincible governments at home (Great Society Program) and abroad, appear to hold onto the myth of the invisible hand (i.e., let markets rule and government observe). As a counter to NPM, we believe that the public administration field is set to be fully influenced by some combination of neo-Keynesian, game, and network theories to advance a balanced and more symbiotic view of the relationship between government and market actors.

Karl Marx first questioned the myth of the invisible hand, but Keynes (2007/1936) dispelled the logic of the invisible hand and argued that governmental intervention is that "visible hand" that is needed during recessionary times. Schumpeter (1962) buried the myth of the invisible hand with his clarion call for the inevitable creative destruction wrought by the globalization of capitalist structures. Neo-Keynesians vouched for stronger fiscal and monetary policies to regulate market transactions and advocate for the infusion of public expenditures, even through deficit financing in recessionary times, to stimulate jobs creation (Chiarella & Flaschel, 2000). Game and institutional theorists argue for government's visible hand to set up the "rules of the game," which in turn allow market actors to play the game of buying and selling (see Koppenjan & Klijn, 2004, for a discussion of game theory in the context of public administration). Network theorists view governments as network actors that are tied to nongovernmental actors through the use of grants and contracts, regulatory arrangements, or public–private partnerships through which administrative arrangements are developed through extensive negotiation and bargaining (Kickert et al., 1997; Rhodes, 1997; Salamon, 2002).

Although the current economic crisis is leading to the repudiation of certain assumptions concerning markets, democracies, and the role of government, we assert that any critique of neoclassical economic and market theory needs to be grounded in certain assumptions regarding governance and the "polycentric" governance networks that have emerged over the course of the past 40 years. We suggest that as a result of an increasing reliance on indirect and third-party governance structures (Salamon, 2002), the roles and responsibilities of democratic governments in addressing pressing public problems have been drastically altered. We argue that the question of democratic legitimacy has shifted focus from being a matter solely relevant to governments to being an attribute of governance *processes* (Cleveland, 1972; Frederickson, 1999). Grounded in a now three-decade-old body of literature that views governance processes as unfolding in interorganizational policy or governance networks (Agranoff & McGuire, 2003; Baumgartner & Jones, 1993; Goldsmith & Eggers, 2004; Heclo, 1978; Kickert et al., 1997; Milward & Provan, 2006; Rhodes, 1997), we suggest that the question of how and to what extent the legitimacy of the public sector thrives or suffers depends on the capabilities of government actors to reassert their capacity to regulate regulatory subsystems, to effectively manage contracts, to enter into equitable public–private partnerships, and to infuse governance processes with sufficient "democratic anchorage" across all of these areas (Sørensen & Torfing, 2005).

The development of new regulatory subsystems will likely need to be constructed through the intentional development of interorganizational governance networks. Network administrative structures (NAO) (Provan & Kenis, 2008) may be devised whose governance structures can include governmental actors, citizens, industry representation, and other interest groups. The rules of the game guiding these NAOs should be transparent, abiding by the democratic norms that have been a central mainstay of democratic theory (March & Olsen, 1995) and appearing in the literatures concerning deliberative democracy (Innes & Booher, 1999), collaborative governance (Fung, 2006), and the democratic anchorage of governance networks (Sørensen and Torfing, 2005). Democratically anchored network administrative structures should replace outdated commission structures, like the Securities and Exchange Commission, that rely on political appointees to set and implement their agendas.

Second, the role of governments as actors within extensive governance networks designed to deliver public goods and services needs to be better articulated and executed. The Works Progress Administration (WPA) of the New Deal was essentially carried out as a direct provision of services undertaken by government. The current networked landscape of extensive grant and contract agreements and public–private partnerships must be viewed as vehicles for jobs creation and service delivery, essentially building on the networked infrastructure that has emerged over the course of the last few decades. This will require extensive leveraging of public, private, and philanthropic funds, combined with the intentional development of quasi-public–private institutions and network arrangements through which collective action may be carried out with the public interest in mind.

What must not be lost amid all this is the assertion that the legitimacy of government hinges on the extent to which its sovereign obligations are being honored. Democratically sanctioned governmental institutions at the international, national, state, regional, and local levels are accountable to their citizenry. The range of regulatory subsystems, grant and contract agreements, and public–private partnerships needed to effectively manage our way out of the current economic crisis and beyond requires proactive government roles. Governments bring a measure of democratic anchorage to these networks (Sørensen & Torfing, 2005). Market ideologues have long painted a picture of modern democracies as being dependent on the existence of open, free, and essentially unregulated markets. The current economic crisis suggests to us, at least, that the only means by which markets can survive is through the infusion of democratic accountability into regulatory frameworks and the wide array of third-party, indirect governance service delivery mechanisms. The "network turn" in public administration can contribute to the development of effective governance structures that may, in the end, stave off future incarnations of self-regulated markets gone amok.

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