Market Failure in Context: Introduction

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Market failure, conceived of as the failure of the market to bring about results that are in the best interests of society as a whole, has a long lineage in the history of writings on matters economic. As Steven G. Medema has shown in *The Hesitant Hand*, much of the history of economics can be read as a discussion of whether, and the extent to which, the self-interested actions of private agents, channeled through the market, will redound to the larger social interest. For much of this history, the answers given were negative, and it was assumed that the corrective hand of the state was needed as a constant and consistent regulating force. Thus we find Plato and Aristotle arguing for a wide range of legal restrictions to guard against macroeconomic (to use the modern term) instability; Aquinas making the case for rules that promote a measure of Christian justice in economic affairs; mercantilist writers lobbying for restrictions on various forms of trade (and support for others), as well as for regulations on

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consumption activity; and physiocratic thinkers pleading for restrictions on manufacturers and support for agricultural interests[1]—all based on the view that the pursuit of individual self-interest through a relatively unfettered marketplace does *not* promote the best interests of society as a whole. It is indeed fair to say that the first two thousand years of Western economic writings were, as much as anything, a study in the analysis of market failure and, indeed, that this analysis was developed as a *response to* real-world economic concerns.

It was the genius of Adam Smith ([1776] 1976) to make the case for how, under certain conditions, the pursuit of self-interest *can* promote the general welfare, or at least one particular conception of it—national wealth. Viewed from this angle, Smith's message stood on its head the long tradition of market failure analysis and offered in its place a theory of market success. Here, the state was in important respects the enemy of the good; it was required to establish a framework within which markets could function effectively and to undertake certain functions that the market itself could not perform adequately or at all. But beyond this, said Smith, the state should not interfere with the natural flows of resources. The pursuit of self-interest within such a framework would, via "the invisible hand," grow the wealth of the nation and distribute that wealth in adequate measure to even "the lowest ranks of the people" (Smith [1776] 1976, I.1.10, IV.2.9).

The enormous influence of Smith's message needs no rehearsing here. But though this message was at the heart of a goodly amount of nineteenth-century literature that built on his work and led some to offer even more vociferous defenses of individual liberty and the market, the passage of time brought with it increasing recognition of inadequacies in Smith's system—that we do not live in the best of all possible worlds. The population and insufficiency of demand concerns raised by T. R. Malthus (against the claims of Jean-Baptiste Say), the industrial slums described so vividly by Jane Marcet in a political economy context and (later) by Charles Dickens outside it, and the discovery of certain chinks in the theoretical armor by the likes of David Ricardo, Nassau Senior, and John Stuart Mill brought issues of market failure back into play. Karl Marx's theory of exploitation, the rise of robber barons, concerns for limiting concentrated economic power and offering workers a measure of protection against their employers, and the impact of industrial fluctuations on national economic condi-

1. The notion that the physiocrats were promoters of laissez-faire is misguided, their rhetoric notwithstanding. See, e.g., Samuels 1962 and Medema 2009, chap. 1.

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tions and individual livelihoods only added to the sense that political economy and its successor, economics, was incomplete in being sold as a theory of market success. But the operative word here is *incomplete*; Smith's vision of the market process as a foundation for economic growth remained central even as questions about the efficacy of a more or less unfettered system became more numerous and louder.

The modern analysis of market failure, then, has its roots in the inability of real-world market processes to measure up to the theory of those processes. Differently put, the origins of the theory lie in those contexts within which economic commentators lived and worked. The goal of the present volume, and of the conference that gave rise to it, is to explore the contexts within which "modern" (i.e., twentieth-century) notions of market failure were developed. The discussion here is by no means exhaustive, nor is it intended to be. Instead, our hope is that the case studies published here will serve as a stimulus to further analysis of how various notions and types of market failure made their way into economic analysis, the manner in which they have been treated, and the policy implications said to flow from them.

1. The Many Faces of "Market Failure"

The term *market failure* is of relatively recent lineage, even if the more general economic phenomena that it intends to capture are as old as economic thinking itself. The term owes itself to the MIT economist Francis Bator, who, in "The Anatomy of Market Failure" (1958), defined it as follows:

> What is it we mean by "market failure"? Typically, at least in allocation theory, we mean the failure of a more or less idealized system of price-market institutions to sustain "desirable" activities or to estop "undesirable" activities [among which he included both production and consumption activities]. The desirability of an activity, in turn, is evaluated relative to the solution values of some explicit or implied maximum-welfare problem. (351)[2]

In Bator's hands, the issue was the ability of the market to generate a Pareto-efficient outcome (352), and his analysis was derivative of a preoccupation among economists, particularly in the post–World War II period,

2. There were very few occurrences of the expression before Bator (King 1913; Wolf 1955), and the plural *market failures* was no more popular than the singular (Wolf and Mintz 1957). However, none of these uses of the term was within the economics literature.

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with delineating the conditions under which a decentralized pricing system would do so. Market failure, so conceived, was at its heart an internalist theoretical construct, one that went to the definition of the properties of idealized systems. A market failure was a condition, rather than an economic phenomenon.

Even those things said to give rise to these so-called market failures were neatly tied to the theoretical properties of the activities and interactions taking place within the competitive model.[3] "The relevant literature," said Bator (1958, 356), "is rich but confusing. It abounds in mutually reinforcing and overlapping descriptions and explanations of market failure: external economies, indivisibility, nonappropriability, direct interaction, public goods, atmosphere, etc." His goal in "The Anatomy of Market Failure" was, as much as anything, "simply to sort out the relations among these"—to bring order to what was becoming a theoretical mess. This sorting, however, gave rise to a set of three classifications of market failure that revolved around the idea of externalities, a term also coined by Bator (1957). Thus Bator presents us with a typology of market failures including (1) "ownership externalities," where nonappropriability of resources gives rise to unpaid factors and attendant inefficient use; (2) "technical externalities," where increasing returns result in inefficiencies, including monopoly; and (3) "public good externalities," à la Paul Samuelson (1954, 1955), with their inefficiency-inducing nonrivalry and nonexcludability in consumption. Though Bator made occasional mention of real-world phenomena that reflect the theoretical properties with which he was concerned, the exercise was almost wholly along the lines of probing the world in the model. And if one looks to the literature with which Bator was dealing in this synthetic discussion, one finds that the illustrations, when they are given, are of the potted variety and not motive forces for the analysis.

So defined, the "context" in which the analysis of market failure developed was an insular theoretical one. There was no larger context that, for example, stimulated Samuelson to pursue his analysis of public goods. But if we adopt a less strict conception of market failure than did Bator—say, of the market's failure to generate outcomes that promote the best interests of society, however defined—a very different picture emerges. Consider, for example, the modern tripartition of the concept, which breaks down market failure into stability, distribution, and allocation variants.[4] The first

3. For an excellent recent analysis of the role of the modeling process in the history of economics, see Morgan 2012.

4. This conception of market failure has its roots in Richard Musgrave's (1959, chap. 1) demarcation of the essential roles of the state.

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of these is concerned with macroeconomic stability and the potential inability of the market system to generate appropriate levels of aggregate prices, unemployment, and GDP. Distribution failure, meanwhile, goes to the question of whether the market system, left to its own devices, generates distributional outcomes that maximize social welfare (variously defined) or comport with society's vision of an appropriate distribution of income and/or wealth. Allocation failure goes to the efficiency concerns that occupied Bator and includes phenomena such as monopoly, externalities, and public goods. So conceived, market success and failure issues have been at the heart of economic thinking for two millennia.

But even this broad-based conception of our subject is not definitive, for the notion of "failure" is itself subjective. What is considered acceptable market performance on the price level or unemployment front, to say nothing of the distributional front, varies (and, over time, has varied) widely across economists, and the controversies that preoccupied welfare economics throughout much of the twentieth century point to the difficulties with hard-and-fast definitions. This matters theoretically, but also for policy, given that the perception of market failure is, for many, a siren song for state corrective action, while, for others, the perceived success of the market is a signal that such action is unwarranted at best and harmful at worst.

All of this makes just that much more interesting the history of economists' identifications of market failures, their attempts to bring the insights of economics to bear on those failures and, perhaps, develop new tools or modeling strategies to deal with them, and the development of policy prescriptions to remedy the failures. This volume, and the conference from which it emanated, presents case studies that contextualize the processes through which market failure analysis emerged in economics during the twentieth century. It does not pretend to be comprehensive, but exploratory—to present a set of snapshots with the goal of promoting additional work along these lines by historians of economics and others concerned with the development of economic ideas and understandings.

2. Contextualizing Market Failure in the Twentieth Century

Our decision to focus on the history of "market failure(s)" in the twentieth century was grounded in factors both practical and conceptual. On the practical front, we needed an organizing principle for a conference and associated volume that would include, at most, a dozen papers that had a reasonable level of scholarly cohesion. But equally important, the twentieth

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century is the historical moment when the concept of market failure crystallized and thus where we have a particularly rich set of case studies to be probed. It also reveals a crucial distinction between the failure of *markets* as a system of economic and social organization, and the failure of a single market to perform according to the dictates of some objective function. This distinction is important, as it reveals a transformation in how economists view themselves and their discipline that was also operative during this century. Though making strict chronological demarcations is often dangerous, this transformation maps reasonably well around World War II (Morgan and Rutherford 1998) and so accounts for the chronological organization of the volume. This is a rough periodization, but it captures quite well the different approaches to the issues under consideration here.

2.1. Before "Market Failure(s)": The Failure of the Market System

The absence of any precise definition of market failure in the pre–World War II period is, at least in part, an artifact of the lens through which economists viewed the problems of the market. With a handful of prominent exceptions—largely derivative of the writings of A. C. Pigou (Aslanbeigui and Oakes, this volume) and those who built on aspects of his analysis[5]—the dominant conception of market failure was a general one, relating to the functioning of the entire economic system. Thus, as Roger E. Backhouse (this volume) illustrates, we find references to "general market failure" and even the "failure of capitalism." The view was shared by opponents or critics of capitalism and the competitive market system—including the progressive reformers (Leonard, this volume) and the institutionalists (Rutherford, this volume)—and certain defenders of the system such as the University of Chicago economists Henry Simons (the author of the "failure of capitalism" reference) and Frank Knight, both of whom saw serious obstacles to the proper functioning of competitive markets (Backhouse, this volume). Despite the significant ideological gulf that existed between the progressives and the institutionalists, on the one hand, and Simons and Knight, on the other, there was a felt need in both camps to reform capitalism because of its perceived weaknesses and flaws.

5. Even here, however, we must be careful, for much of Pigou's concern was of this more general nature, despite the modern tendency to identify him with the problem of externalities—the analysis of which occupied only a small amount of his attention in *Wealth and Welfare* (1912) and *The Economics of Welfare* (1932).

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There can be no doubt that the larger economic and social contexts played a nonnegligible role in shaping economists' attitudes toward capitalism and the market system at the time of the Great Depression. Economists were facing one of the major economic crises of all times, an event that could have shaken the confidence of the most convinced defenders of capitalism (Backhouse, this volume; Bateman, this volume), just as the 2007 crisis shook the confidence in capitalism of someone like Richard Posner (Bateman, this volume).[6] This is not to say that economists came to these positions solely because of the crisis, but it played a triggering role. The economic context for the work of the progressive reformers and of the institutionalists who wrote prior to the 1929 crisis played a different but no less important role. The institutionalist economists and the progressive reformers were interested in, and concerned with, the failure of a market-based free-enterprise system to spread the benefits appropriately—to effectively promote the general welfare of society—even in the best of times. Some of these concerns were a reflection of the mapping of economic outcomes onto particular ideologies and an attendant concern that the mechanics of the market system needed to be reformed to achieve a more acceptable level of well-being for groups, such as labor, not felt to be properly served by the existing system. Others, though, were derived from concerns that classical economics and the economics associated with the recent marginalist turn abstracted from important features of economic reality—features that were felt to be necessary for a proper understanding of the workings of a market system and for passing judgments on the outcomes to which it gave rise.

This larger frame of reference led the institutionalists to train a good deal of their attention beyond (or beneath) the market system proper, on the *legal-political institutions of capitalism*, to paraphrase John R. Commons. The institutionalists' approach was derivative of their perception that the focus of the analysis of a capitalist or any other economic system should be on the form of economic organization and the set of institutions that undergird it, as well as the implications of this for economic structure and performance. The legal and other institutions on which the economy was built could play a positive role and support its functioning, but they could also be the source of its failure. For example, Walton Hamilton considered the patent system flawed because firms used it to protect themselves and their

6. Of course, it is not simply a matter of "context." Knight, to name but one economist analyzed by Backhouse, and Keynes, of course, were genuinely political economists for whom economics was aimed at discussing the foundations and functioning of societies.

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inventions rather than to promote invention. As a consequence, the prevailing market was guilty of underproviding what he termed "social goods" (Rutherford, this volume). Among those not identified with the institutional tradition, one could cite Henry Simons, for whom "the so-called failure of capitalism" was ascribed "primarily [to] a failure of the political state in the discharge of its minimum responsibilities under capitalism"—in particular, as respects ensuring the continued existence of highly competitive market environments (quoted in Backhouse, this volume). But Simons was an exception. As Backhouse's essay illustrates, economists tended to look inward, linking the failure of the economy to *economic* factors, blaming factors such as monopolies (e.g., Adolf Berle and Gardiner Means, Arthur E. Burns, Edward Chamberlain, J. M. Clark) or "the financial machine" (John Maynard Keynes). In other words, the failure of capitalism was seen, above all and fundamentally, as an economic failure, driven at least in part by the unrestrained actions of self-interest-seeking individuals and the inability of unfettered markets to successfully coordinate them in a wide range of circumstances.

These economic failures, however, were seen as genuinely problematic because their consequences went far beyond the boundaries of the economy. As Malcolm Rutherford writes in his contribution on the institutionalists—though it applies to all the economists dealt with in the first part of this volume—the failure of markets lay in their inability, in certain contexts at least, to guide "business activity in *socially* desirable directions" (emphasis added). Not surprisingly, a similar frame of reference pervaded economists' responses to the Great Depression. Unemployment was so massive that it was difficult to see it as simply a problem with the functioning of the labor market. Whether we look to the institutionalists, the progressive reformers, or even Pigou, the focus of discussion was not singular, specific issues but connections with other spheres or realms of social action. The concern, in short, was with the general social consequences of economic issues.

As a result, the institutionalists and reformers put the economic issues they discussed in a broad perspective. Thus, as shown by Nahid Aslanbeigui and Guy Oakes (this volume), the tariff reform controversy that took place at the beginning of the twentieth century was envisaged by the opponents of free trade—Joseph Chamberlain and William Hewins—as an "existential choice." Great Britain was, they claimed, at a historic crossroads. Pigou participated in this controversy—first as a defender and subsequently as an opponent of free trade—and what he wrote formed the basis for the later and much more general analysis found in *Wealth and*

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Welfare (1912), the book from which evolved the very idea of "social cost" that informs significant elements of the modern approach to market failures. Though his analysis in *Wealth and Welfare* was grounded in the value of output produced in a society—the national dividend—it bears emphasizing that Pigou was not interested solely in prosperity, welfare, or in "economic" welfare somehow defined. The dividend was, in essence a theoretical convenience imposed by the Marshallian framework on which Pigou was building, a necessary compromise for erecting the scaffolding of economic science, as he conceived it, around important social issues. As Aslanbeigui and Oakes (this volume) point out, Pigou "saw no value in the study of the economy for its own sake," and his welfare analysis was thus at once an attempt to balance and integrate a response to pressing social problems, an extra-economic set of ethical norms, and the dictates of sound economic theorizing.

Though his technical economics was very different from that of the US progressives and institutionalists, Pigou was in important ways of like mind with both groups. For each of them, efficiency concerns were almost secondary; the failure(s) of the market system had social and ethical dimensions that, for them, were at the heart of how economic performance should be evaluated and how the analysis of the system should be conceptualized. The systemic social conflicts and the unjust distribution of resources that attended industrial capitalism were matters of grave concern (Rutherford, this volume; Leonard, this volume), and ethics constituted an important dimension of the reforms that they proposed. No wonder, then, that, as Thomas C. Leonard (this volume) tells us, the reformers were, tellingly, characterized as "the real philosopher[s] of social life" by Edwin Seligman. And what emerged from their analysis because of this were arguments for the introduction of new methods of *social*—and not simply economic—control. These controls were to be based on the recommendations of economic *experts*—"engineers" able to understand how to improve the economy and the society—and put into practice through the aegis of the state. The (ostensibly) competitive *system* was not able to channel forces of self-interest in directions that served the larger interests of society. More regulation was viewed as the answer—indeed, as the only answer.

2.2. Market Failures: The Post–World War II Narrowing

After World War II, the social and economic contexts changed radically, and economic analysis changed with them. It was no longer the economic

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crisis of the 1930s that provided the background that legitimized and oriented economic analysis but rather postwar reconstruction and planning, and the tensions of the new—and cold—war that divided the world into two main blocks of nations. Predicting how the individuals of the other block would behave now seemed particularly vital, and this prediction was felt to require formal, axiomatized, mathematical models. The heyday of institutionalism was now past, its approach being criticized as too descriptive and unable to provide scientific guidance for understanding individual behavior and for making properly grounded public policy recommendations (Morgan and Rutherford 1998). Institutionalists largely disappeared from the intellectual landscape of economics, at least in terms of influence on the direction of research, and the dominant neoclassical economics that emerged during this period was typified by Samuelson's *Foundations of Economic Analysis* (1947) and by his undergraduate textbook, *Economics*, first published in 1948.[7] To see the influence of this turn on market failure analysis, one need look no farther than Samuelson's work in the area of public economics, which very much epitomized this transformation. As described by J. Daniel Hammond (this volume), Samuelson was convinced that mathematics was a valuable language for economic science, and one of the domains to which Samuelson applied his method was public goods–related market failures. The context here, though, was not the question of how best to provide certain types of goods demanded by society—goods that, as Adam Smith ([1776] 1976, IV.ix.51, V.i) had pointed out nearly two centuries earlier, the market could not provide in satisfactory amounts. Instead, "The Pure Theory of Public Expenditures" (Samuelson 1954) "was conceived as a demonstration of the usefulness of mathematics in economics" (Hammond, this volume).

Samuelson's article was by no means the first to formalize the analysis of a situation of market failure (Medema 2014), though its influence on the literature was far more extensive than that of previous efforts—see, for example, Meade 1952. But its importance was not limited to the *analysis* of market failures per se. It also captured and reinforced how economists increasingly envisaged market failure(s). At issue was the question of whether a particular market could achieve a Pareto-efficient allocation of resources in the presence of interdependencies of the type that we now

7. On the development and impact of Samuelson's *Foundations*, see Samuelson 1998 and Backhouse 2015. On *Economics*, see Giraud 2014.

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label externalities or public goods.[8] This is exactly what Bator (1958, 351), Samuelson's MIT colleague, carefully stressed in the definition of market failure that he provided a few years after the publication of Samuelson's article: "Typically, *at least in allocation theory*, we mean the failure of a more or less idealized system of price-market institutions to sustain 'desirable' activities or to estop 'undesirable' activities" (emphasis added). Here, the distributional, ethical, and larger institutional dimensions of the problem posed by the failure of the market were set aside as the focus narrowed to the price mechanism, the allocation of resources, and the norm of efficiency. Samuelson's approach was emblematic of this transition. As Hammond writes, for Samuelson, "ethics trumps efficiency; yet ethics is not scientific, so a modern social scientist has little to say about its substance." We have moved from a discussion of the failures of competition or of capitalism, moral and otherwise, to a discussion of the impossibility for an "individual market [to reach] an efficient equilibrium," as Bateman (this volume) puts it. The perspective was obviously narrower, even as (and in part because) the tool kit was expanding.

If the nature of the problems being considered and the framework within which market analysis was undertaken were in many instances very different in the post–World War II period, the same cannot be said for the solutions envisaged to remove or otherwise deal with these issues. When markets were perceived to fail, even on a smaller scale, most economists seemed to contemplate no alternative other than an intervention of the state, whose coercive force would be guided by economic experts and expertise. This is the conclusion reached by Samuelson, even if, as Marianne Johnson notes, coercion was not really Samuelson's concern. His worry, rather, was the prospect that economic decisions could be "made by nonexperts" (Johnson, this volume). But coercion remains unavoidable: if individuals do not spontaneously and voluntarily internalize the external effects that their actions produce or if they do not pay for the public goods they consume, they have to be forced into "cooperation." This was a position that Richard Musgrave (1939) had defended some two decades prior to Samuelson's discussion.

While some strands of the early post–World War II literature were content to point to the prospects for market failure under certain assumed

8. Samuelson did not distinguish between public goods and externalities. He analyzed a situation in which there are (pure) public goods and these goods give birth to external effects or externalities because of the interdependence between consumers.

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conditions and offered little or nothing in the way of policy remedy discussion (Medema 2014), Samuelson and Musgrave believed that government intervention was necessary to "solve" market failures because there is no other alternative. This theme was soon picked up more widely in the literature, slightly lagging but more or less along with the tide of Keynesian-informed stabilization policy prescriptions. The market process had done its work and had been found wanting, and there was no sense that the market itself or other private mechanisms could themselves be used to deal with these failings. In particular, no private arrangements based on direct bargaining between agents, that is, based on *voluntary exchange*, could reasonably and realistically be envisaged. Musgrave was clear about this in one of the first articles on voluntary exchange theories of the state in 1939, as shown by Johnson in her discussion of the initial Anglo-American forays into exchange-based approaches to public finance.[9] One reason for Musgrave's pessimism—a reason identical to that later put forward by Samuelson—was that individuals are too self-interested to engage in voluntary transactions that would facilitate collective action through the state. Because of this tendency to favor their own interests, individuals free ride. At the same time that Samuelson was formalizing the problematics of such arrangements, however, James Buchanan was taking issue with the pessimistic view. Though Buchanan admitted that individuals are self-interested and attempt to free ride,[10] and that markets may fail to allocate resources efficiently because of this, he rejected the claim that this implied the need for the intervention of the state. Drawing on work by Knut Wicksell (1896, [1896] 1958) a half-century earlier, Buchanan argued the case, both formally and informally, that private arrangements are, under certain conditions, both possible and desirable mechanisms for resolving the shortfalls of the market (Johnson, this volume).[11]

Between Samuelson and Musgrave, on the one hand, and Buchanan, on the other, we find Charles M. Tiebout, the subject of the essay by

9. Of course, the voluntary exchange approach to public finance has its roots in the work of Knut Wicksell (1896, [1896] 1958) and others writing in Continental Europe in the late nineteenth and early twentieth centuries. See, e.g., the discussions in Buchanan 1960, Wagner 1997, Medema 2005, Backhaus and Wagner 2005, and Eusepi and Wagner 2012, as well as the excerpts from Continental writings translated in Musgrave and Peacock 1958.

10. Buchanan came only reluctantly to the idea that individuals could free ride. His first real mention of such behaviors was in "What Should Economists Do?" (1964), and he treated this topic more explicitly, and more clearly, in "Ethical Rules, Expected Values, and Large Numbers" (1965). On free riding, see Fontaine 2014.

11. See also Marciano 2013 and forthcoming, as well as the brief discussion of Coase 1959 and 1960, below.

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John D. Singleton. A student of Musgrave, Tiebout was interested in attempting to solve the problem that self-interest could represent for an optimal allocation of resources in the context of collective consumption. He demonstrated, in "A Pure Theory of Local Expenditures" (1956), that free riding is context-specific and that there are conditions under which coercion is not necessary to alleviate potential market failures induced by free riding. Individuals, he said, will reveal their demands accurately if they are able to select among communities that offer competing packages of goods and services and are free to move to the one that produces the bundle that satisfies their utility.[12] Though Tiebout's result did not have the immediate impact of Samuelson's, it gained increased traction with the development of a literature in state and local public finance over the next two decades (receiving a particular boost from the publication of Wallace Oates's 1969 article on the "Tiebout hypothesis") and is now one of the more well-known—both famous and infamous—results in economics.[13]

As Singleton shows, Tiebout's career is emblematic of the transition in economic analysis taking place during the Cold War period. Though he is identified exclusively in the professional mind with the Tiebout sorting of his 1956 article, an exercise in pure theory, Tiebout wrote much more extensively on "applied" problems of public finance, as exemplified by his work with Robert Warren and Vincent Ostrom on municipal governments. The quasi-institutional character of these writings likely played no small role in the lack of attention paid to Tiebout's work until comparatively recently, for his approach was going against the tide of an increasingly technical profession.

But Tiebout is far from being the only economist whose message or larger body of work was minimized or obscured by this technical turn. The same can be said for K. William Kapp, an economist often linked to the post–World War II institutionalist remnant (Rutherford, this volume; Berger, this volume) and who contributed both a particularly pointed critique of theory of the neoclassical theory social costs and an alternative approach to this arena of market failure during the 1950s. Influenced by both the socialist calculation debate and problems such as large-scale industrial pollution, Kapp attempted to move the debate over market

12. Tiebout's argument is frequently viewed as anticipating Buchanan's (1965) theory of clubs. This is not the case, at least, in the sense that Buchanan disagreed with Tiebout. See Boettke and Marciano 2014.

13. This result is usually viewed as a defense of "institutional" competition or pure federalism and a criticism of the intervention of the state.

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failure away from the Pigovian-driven neoclassical framework and into the more broad-based frame of reference often associated with institutionalism. But, as Sebastian Berger shows, Kapp's impact was minimal at best, though the importance of his work was acknowledged by other important scholars such as Buchanan and Guido Calabresi.

A similar story could be told about Ronald Coase, who, though not treated to any great extent in the present volume (but see Colander, this volume), has been the subject of no small amount of discussion in the literature over the last two decades.[14] Coase's analysis of social costs—externality-related market failures—was not of the a-institutional variety that dominated the post–World War II market failure literature; instead, it was derived from the concrete context of how the US Federal Communications Commission should allocate broadcast frequencies, and, like Kapp's, it was written as a challenge to that literature's approach and conclusions. Coase was of the mind that the market deserved more consideration as a mechanism for frequency allocation than it had been given by economists, policymakers, and bureaucrats. The FCC paper (Coase 1959), and the more famous "The Problem of Social Cost" (1960) that emerged from it, argued that, in theory, market/exchange-based processes could efficiently resolve market failure problems—an insight that, in the hands of George Stigler (1966, 113), soon became known as the "Coase theorem." As Coase himself emphasized, however, the reality of the costs—often significant—associated with each of the various possible institutions that could be used to coordinate resource allocation necessitated a comparative institutional approach, including consideration of doing nothing at all about the ostensible market failures. Coase's overtly institutional-related message was largely lost on his audience, which was much more concerned—both positively and negatively—with the fictional world of the Coase theorem, an idea that lent itself to formalized modeling strategies in ways that comparative institutional analysis did not.

The evolution of environmental economics provides a further interesting illustration of the intersection of larger contextual concerns with the formalized post–World War II approach to market failures, but one that ran in a somewhat different direction in an episode that has yet to be extensively probed by historians of economics (including in the present volume). At issue was the question of whether economics had anything to add to the discussion of how to deal with the increasingly pressing prob-

14. See, e.g., Medema 1994, 2009; Campbell and Klaes 2005; and Bertrand 2010.

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lems of air and water pollution, the social conversation over which became increasingly loud during the 1950s and 1960s. The economists provided an affirmative answer, albeit one that was rather slow in developing, and the path chosen was the grafting of the Pigovian-neoclassical theory of externalities onto environmental problems. In retrospect, this seems almost obvious; pollution is now a textbook case of an externality. But this decision to analyze environmental problems with Marshallian partial-equilibrium externality models set the course of environmental research and framed the way that economists came to view environmental problems and the policy prescriptions derived. By the late 1960s and early 1970s, however, leading scholars in the field were of the mind that this decision was an unfortunate one, in that it did not allow economists to capture within their models the broad-based effects of large-scale environmental pollution, something for which general equilibrium models—or, one could argue, some other alternative modeling strategy developed specifically to deal with environmental issues—might have been better suited (Kneese 1971).

While the analysis of externalities was perhaps *the* growth industry in market failure analysis in the last third of the twentieth century—the economic analysis of law and, in particular, property and contracts being another important illustration[15]—new avenues of analysis continued to emerge, or reemerge. Prominent among these was the analysis of information-related market failures (an issue that goes back at least to John Stuart Mill [1848]), perhaps most famously in George Akerlof's (1970) analysis of the market for lemons, but much more generally in environments within which strategic behavior (itself an artifact of incomplete information) was said to manifest itself and where the application of game theory revealed the plethora of suboptimal outcomes that can emerge in wide varieties of economic settings.[16] The range of inefficiencies suggested by the emerging work in behavioral economics has only compounded the sense that market failures are widespread and systemic, and, for those seeking empirical validation for their suspicions about the market, the economic crisis of the early twenty-first century provided ample ammunition for the argument that Smith's invisible hand was faltering at best.

15. See, e.g., the discussions in Marciano and Romaniuc 2014 and Marciano 2013.

16. In a 1998 survey, Stiglitz wrote, "In the last two decades, we have explored much more seriously the consequences of the informational assumptions implicit in the belief that markets are efficient" (3). J. O. Ledyard (2008) makes explicit the connection between asymmetric information and externalities/public goods as sources of market failure.

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2.3. Public Policy and Market Failures/Failures of Markets

Though there have been moments in the history of economics when discussions of market failure were not accompanied by additional commentary on what might or should be done about it, the largest share of this literature has a significant policy-oriented component, whether that be ethically grounded arguments for or against laissez-faire, the derivation of optimal Pigovian taxes to correct situations of externality, or claims about the efficacy of fiscal/monetary stimulus. Throughout the twentieth century, the dominant view—what David Colander (this volume) calls the "market failure policy frame"—was, and continues to be, that market failures require correction via the intervention of the state. The revolution against this line of thinking, led by economists at Chicago and Virginia, took an opposing stance, asserting both that the extent of market failure was overstated in the literature[17] and that the view that the state could accomplish efficiency-enhancing corrections was misguided—the latter claims being grounded in emerging rational choice models of political/governmental decision-making processes.[18] On both market and macroeconomic levels, the great battle within economics during the last quarter of the twentieth century was over these contrasting gospels and whether the road to the heaven of efficiency ran directly through a relatively unfettered market system or required the mediation of the state.

As Colander points out, the contrast with the more broad-based and nuanced approach found in the "classical policy frame," as he labels it, of the late eighteenth and nineteenth centuries is stark. The concept of efficiency had not yet been invented, though issues of economic growth and development weighed heavily on the minds of economic thinkers. But the approach to policy here was broad-based and practical, not narrow and technical. The insights of economic theorizing were not sufficient for policy conclusions; ethics, too, featured prominently in the picture, as did the practical ability of the state to carry out meaningful reforms. Nirvana was largely absent from the discussion, either as a theoretical possibility or as a goal to strive for. The question, instead, was how to improve economic and social life for the citizenry, the answer to which lay in no singular institutional form or, for that matter, in the theory of the workings of the economic system.

17. See, e.g., Buchanan and Stubblebine 1962; Demsetz 1964, 1966; and Coase 1960.

18. The work of Buchanan and Gordon Tullock, together and separately, was instrumental here. See, e.g., Mitchell 1988 and Medema 2000.

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3. Conclusion

The idea that markets could fail to perform in ways that best promoted the larger interests of society is as old as economics itself, and the question of the appropriate scope to be given to private action and to its collective alternative is one of the most crucial issues with which economic thinkers have had to grapple. It bears on the organization of the economy and brings into play the most fundamental, essential values undergirding the organization of our societies. Through two-plus millennia of economic commentary on failures of the market, the contexts—social, political, and intellectual—in which these discussions and debates have played out have loomed large, though our understanding of their roles remains limited and imperfect. It is our hope that the present volume goes some way toward addressing this lacuna, both directly and by stimulating additional scholarship exploring this important facet of the history of economics.

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Part 1
Before “Market Failure(s)”: The Failure of the Market System

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