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The problem of market bias in modern capitalist economies

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Modern societies are presently facing a number of challenging and often contentious issues regarding how to organize and govern a variety of activities that employ a substantial and growing fraction of their resources. In certain cases, to make market organization work satisfactorily will require strong and fine-grained regulation, and perhaps a number of other supplementary non-market elements. For other activities, it would be best to rely centrally on other basic organizational modes, with markets in an ancillary role. In these latter cases, too strong an adherence to a belief in the general efficacy of simple market organization can hinder the achievement of a satisfactory solution. The central purpose of this essay is to call attention to the complexity and variegation of the sectoral or activity-specific governing structures employed by modern capitalist economies, and to argue that such structures need to be tailored to the details of the activities involved.

1. Introduction

The title of this essay seems like an oxymoron. Hasn't the market proved a general purpose solution to the economic organization problem? And, in any case, doesn't the characterization of an economy as 'capitalist' imply that the market is the standard mode used there to organize and govern economic activity?

This point of view is exactly the problem I want to flag here. Of course sophisticated empirical analysts of modern economies that are called 'capitalist' recognize that, in fact, they are complex and variegated. While these economies make extensive use of market organization, in many sectors and activities where markets play a central role, one also sees specialized regulatory structures, and often a variety of non-market elements. And for many important activities, market organization plays a relatively limited role, and in some cases is fenced out.

However, in recent years a much simpler view of what modern capitalism is, and should be all about, has been widely articulated, indeed canonized.[1] As a result, particularly in the United States, contemporary political discussion about the appropriate

[1]For statement in this spirit see Fukuyama (1992) and Yergen and Stanislaw (1998). I will discuss this point of view further in Section 2 of this essay.

organization of a sector or an activity almost always starts with the presumption that market organization, of a relatively simple kind, is the right governance structure. This is the 'default' solution. Consideration of whether some kind of regulation, or other ancillary structures, are needed as well, or whether perhaps market organization is not appropriate for the activity in question, come in only later, and there is an apparent strong preference to use the market as much as possible.

The notion of market organization, with which the discussion usually starts, is lean and pure, along the lines of the standard textbook model in economics. For-profit firms are the vehicles of production. They decide what to produce and how on the basis of their assessments about what is most profitable. Given what suppliers offer, free choice by customers, deciding on the basis of their own knowledge and preferences where to spend their own money, determines how much of what is bought by whom. Competition among firms assures that production is efficient and tailored to what users want, and that prices are kept in line with costs. The role of government is limited to establishing and maintaining a body of law to set the rules for the market game, and assuring the availability of basic infrastructure needed for the economy to operate.

A case can be made that this bias in favor of market organization almost surely is, on net, a plus. It points policy right from the start towards market organization that, in fact, has served effectively as a central part of the governing structure over a wide range of sectors and activities. It is associated with bias against governing structures that rely heavily on central planning and top-down command and control, which often have proved problematic or worse in contexts where they have been employed. However, if the presumption in favor of market organization is accompanied by a blindness to the complexity and variegation of modern economies, and an ideological resistance to mixed forms of organization and governance, especially to structures that make little use of the market, this can be a real problem. And this is the 'problem' of market bias I am flagging in this essay.

The basic theme of this essay is as follows. At the present time, modern societies are facing a number of challenging and often contentious issues regarding how to organize and govern a variety of activities that employ a substantial and growing fraction of their resources. For some of these, a satisfactory solution likely can be found through market organization that is not too far away from the economic textbook model. However, in other cases, to make market organization work satisfactorily will require strong and fine-grained regulation, and perhaps a number of other supplementary non-market elements. And for other activities, it likely would be best to rely centrally on other basic organizational modes, with markets in an ancillary role. In these latter cases, too strong an adherence to a belief in the general efficacy of simple market organization can hinder the achievement of a satisfactory solution.

Yet a strong ideological commitment to simple market organization as a general purpose governing structure clearly exists, particularly in the United States. This has happened despite a resurgence of interests among scholars in several social sciences in the actual complexity of the institutions of modern capitalism, and the diversity of the economies that are called capitalist.[2] And even these more sophisticated understandings of the institutional structures involved in governing economic activity tend to be posed at a high level of abstraction: the economy 'as a whole'. Hence they do not call attention to the diversity of activities that need to be governed.

The central purpose of this essay is to call attention to the complexity and variegation of the sectoral or activity-specific governing structures employed by modern capitalist economies, and to argue that such structures need to be tailored to the details of the activities involved. By a governing structure I mean a set of institutions that do two roughly separable kinds of things. First, they determine the values and interests that are to count in determining how much of what is to be provided and distributed. Second, they assign responsibility for provision, and provide a system of incentives and controls for enforcing accountability. This divide, of course, corresponds to the distinction in political science between policy making and administration. While political scientists have concentrated on activities and sectors where the government plays a central role, the conceptual distinction is useful as well in analyzing activities and sectors where the market is central. For economists, the divide here can be seen as roughly between how demand is organized, and how supply is organized. While much of economics is oriented towards activities and sectors where demand is largely generated by private parties making decisions about how to spend their own money, and supply organized through for-profit firms, economists also recognize a variety of other means through which demand and supply can be structured.[3]

I use the term 'governing structure' to keep open the particular ways in which demand and supply are organized, and also to draw attention to the fact that society can, and does, have a choice about the matter—a choice that is ultimately political. Market organization clearly is a form of governing structure, in the above sense. However, just as one size of shoe does not fit all feet, a single mode of sectoral governance can not cope with the great variety of human activity.

Societies recognize this, sometimes explicitly and sometimes implicitly. Despite the strength of the belief in the ubiquity and desirability of simple market organization, modern societies in many cases draw back from or supplement this model and devise activity or sectoral governance structures that are at least roughly tuned to the important peculiarities of an activity or sector. This leads to a much more complex and variegated economy than that generally pictured. In what follows, the particulars of the examples I use generally will relate to the United States. But while there are important cross-country differences, in other countries the situations often are similar.

Thus consider pharmaceuticals, or airline services. Both sectors make extensive use of the canonical elements of market organization: for-profit firms, customer choice, competition. However, there is much more to the governance structures of both of

[2] This is very much the emphasis of the new writings on institutions. See e.g. North (1990) and Hodgson (2000).

[3] For a good discussion, see Lipsey *et al.* (1998: ch. 3).

these than included in the simple folk formulation. In both cases the products or services being delivered can pose a major safety risk to customers, which has led to the regulation of their products, and also of some of the details of operation of the firms in the industries. Modern societies clearly feel a moral commitment to ensure that all who need medical treatment can receive it, regardless of their income, and thus a significant portion of the sales of pharmaceuticals is funded or subsidized by various government programs that support the provision of medical care for certain groups. Members of Congress also take an active interest in the flights available to cities they represent, and do not leave it simply to the airlines and airports to decide, based on their assessment of market demand. The R&D of pharmaceutical companies draws heavily on publicly supported biomedical research. The airlines depend on investment in airports, which in almost all cases is publicly funded or subsidized, and on a government funded and operated air traffic control system. To continue in this vein, think of automobiles that run on public roads, under a specialized system of traffic law. Or agriculture.[4]

As one reflects on these sectors, it becomes evident that the provision of supportive and regulatory bodies of law, and necessary infrastructure, which are widely regarded as necessary tasks of government, are to a considerable extent sector specific. Regulation of pharmaceuticals is very different than regulation of airline services. The publicly funded programs that support the two industries are very different. More generally, when looked at closely these two sectors—and I would propose most sectors generally thought of as market governed—do not quite match the simple model that most people have in mind. They are more complex than the simple model because basic market organization, in itself, does not provide a governance structure that society can live with, but rather needs to be supplemented and complemented in ways that fit the particular circumstances of the sector in question.

The fact that its core elements can be supplemented and complemented in a variety of different ways is, I would argue, a central reason why market organization can be a useful component of the governing structures over a wide range of human activities and economic sectors. However, devising the supplementary machinery to make sectors that rely heavily on the core elements of market organization work satisfactorily often isn't easy, and in many sectors there tends to be continuing controversy about that supplementary machinery.

To return to our first example, presently there are some important debates about what evidence is required for a new drug to be admitted for use by the regulatory authority, or covered by an insurance plan. There are serious controversies about drug pricing, and about whether some kind of price controls, or government subsidy of drugs for certain classes of users, are needed. All of these issues are compounded by the

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[4]The tailoring of government policies regarding 'market organized' industries recently has become the subject of considerable scholarly attention. The recent book edited by Mowery and Nelson (1999) discusses in detail the differences in government policies across seven 'high-tech' industries. Tucker's thesis (1998) deals with similar issues. For a congruent point of view expressed by sociologists, see Hollingsworth *et al.* (1997).

recent policies of pharmaceutical companies to advertise their products directly to potential users, rather than limiting their advertising, as earlier, to physicians. On the other hand, spokespersons for pharmaceutical companies are not alone in arguing that price controls would kill the goose that lays the golden egg. And getting more information directly to customers has been touted as a necessary counter to physician autocracy, and it has been argued that more, not less, patient information and decision-making power are needed.

In any case, despite the disputes about matters such as regulation and government support, in these two industries at least no one now is arguing that market mechanisms should not play a central role in governance. Within these sectors there is broad faith that for-profit firms, competition, and customer choice can provide the core of a satisfactory governing structure, if suitably augmented and constrained.

However, even given the broad adaptability and flexibility of market mechanisms, for many important human activities the governance structures that modern societies have chosen to employ make little use of markets, or even fence them out. Thus consider crime prevention and criminal justice, and the care of young children, to identify two areas where modern societies presently are facing some difficult problems of organization and governance. Neither of these activities is governed largely through the market, at least as market organization is generally conceived. While these cases are not what most people have in mind when they think of 'economic' activities, they certainly do employ considerable resources that could be used productively in other activities. Expenditures on police and the courts get counted in the GNP statistics. So does much of extra family child care, and the purchased inputs used in family child care, and feminists have not been alone in arguing that such services of housewives, or househusbands, should be counted in GNP. And it surely is important that the quantity and quality of resources dedicated to these activities be appropriate to the task, and that these resources be effectively employed to serve the primary values at stake.

These examples are important in their own right, because they surely do present major problems of governance of activities employing substantial resources. But they also are important because they highlight the often neglected fact that the lines between 'economic' activities, and activities that generally might be thought of as political or governmental, or social or cultural, are blurry not sharp. An economy is not a sphere of activity that is separate from dealing with crime, or making and conducting foreign policy, or running a political campaign, or caring for children, or running a girl scout troop, or supporting art or religion. Rather, economics should be viewed as an aspect of any activity. From that point of view, it should be clear that the problem of economic organization and governance is not simply about the production and distribution of commodities such as peanut butter.

In any case, preventing crime, and operating the criminal justice system more generally, traditionally are viewed as basic activities of government. In general it is expected that individuals are to be treated as equals by the system, and that justice is 'not for sale'. Under standard circumstances, child care is presumed to be the province of the child's parents or extended family. At the same time, parents, or those in a parental role, are presumed to have an obligation to care adequately for their children; they are not seen as having a right to choose whether or not to provide that care, as they have the right to buy whatever kind of car they like or none at all. In both of these areas there is considerable resistance to the idea of letting market values and mechanisms play a central role in governance.

These examples bring into clear view the wide use of non-market mechanisms to govern important and extensive areas of human activity, economic activity in the sense that significant resources are involved. Government itself, of course, is a governing structure, or rather a complex of them. Government machinery provides a way to represent group or collective interests on the demand side, through provision of public moneys, or through regulation. As we have seen, both of these mechanisms play important roles in the overall governance structures of pharmaceuticals and airline services, and there are many other sectors where governmental demand-side machinery augments or replaces individual consumer sovereignty.

The case of police, and the courts, shows government machinery employed on the supply side as well as the demand side. Perhaps because much of the recent writings about the advantages of broad capitalist economic organization have as their contrasting background the old communist economies, which made little use of markets and extensive use of government organization, the conception of economic organization under capitalism has tended to ignore, or play down, the wide range of activities that not only are funded by but operated through government. Another reason, of course, is the belief of many of these writers that a good fraction of the sectors where government is the central actor would work better if there were more market and less government in the governance system. In many cases this may be true. But the examples of police and criminal justice suggest that in some areas where we use government centrally, there may be good reasons for doing so.

Rather than formal government, or markets, the various structures of civil society—families, clans, friendship groups, neighborhoods, voluntary associations of a variety of shapes and forms, formal not-for-profit organizations—provide the core governing structures over a host of human activities, from child care, to organized neighborhood vacant lot clean up, to the little league, to organized religion. It is interesting that this form of economic governance tends to be repressed in much of the current discussion of economic organization. Yet, many difficult and controversial issues relate to the encroachment of markets into areas that traditionally had been the domain of these non-governmental, non-market structures.

It is apparent that these other basic governing structures, like market organization, are highly variegated, and almost always operate in conjunction with other elements. The police can not protect a neighborhood from crime without the assistance of the neighborhood itself. Families are structured partly by a body of law. And both the criminal justice system and child care, of course, draw extensively on market mechanisms. Lawyers are an important part of the former, and for the most part lawyers sell their services on markets. There recently has been considerable use of for-profit contractors to run prisons. Baby sitters and nannies serve for pay. The demand for extra family child care is large and growing and there are many for-profit providers.

However, in both of these areas there is considerable controversy about how large a role markets should play in the overall system, and where market elements should be regulated, and where they should be fenced out. The ability of persons of wealth and status to get a better break from the criminal justice system than those towards the bottom of the social order, in good part because they can use their money effectively, strikes many people as contrary to the goal of equal justice. Whether governments should be allowed to contract for prison services is a contentious issue. The question of the appropriate regulatory regime over extra family child care is a matter of considerable dispute, and it is clear that many people would prefer a system of public or not-for-profit provision to for-profit provision.

The governance of basic scientific research is another important area where one sees a complex, mixed governing structure. Presently, the market plays a relatively modest role in that structure, but there is considerable debate about just what that role should be. The scientific community has long argued that it is a mistake to have conjectures regarding short-run practical application play a central role in governing the allocation of resources to basic research. Rather, the dominant criterion ought to be promise of advancing fundamental understanding, which the scientists themselves are in the best position to judge. Further, research findings ought to be published and open to anyone to test and use. For-profit companies are not prone to support much research, under these terms and ground rules. It long has been broadly accepted that funding basic research is an appropriate mission of government. By and large, governments have provided funding for basic research under a regime of self-governance by scientists, with universities the principal loci of the activity.

However, while open publication and open access traditionally have been the norm in basic science, in recent years universities, as well as business firms, have begun to patent the results where they can, and to require that users take out licenses and pay fees. And corporations now are important sources of support for basic research in certain fields, with their profiting from this activity tied to their ability to restrict access to results. There is a growing debate about whether or not public funds should go into fields of research that companies seem willing to support out of their own money, and regarding whether it is a plus or a minus that university research results increasingly are being patented. The debate can well be regarded as about the scope and nature of the role markets ought to play in governing the basic science enterprise.

I propose that virtually all activities in modern economies are governed through a mix of market and non-market mechanisms, with the relative importance of markets, the constraints put on their workings, and the strength and nature of non-market mechanisms, varying from activity to activity, and from sector to sector. My focus in this essay is on the debates about the mix.

As another example, consider hospital services, an arena where the debate is intense.

The hospital sector contains numbers of both public and non-profit units, as well as for-profit hospitals. Part of hospital revenues come from private patients and private insurance. Part comes from public programs that support the care of persons in certain categories. Hospitals are subject to a number of different forms of regulation. Physicians, as a profession, play a major role in determining what is done. In recent years, managed care organizations and insurance companies also have played major roles in the hospital governance structure. There is often bitter debate about the relative power that these different parties and interests should play in the governing structure, as well as about the role that public finance should play in supporting the system.

Or, consider some of the issues surrounding the governance of the Internet. Should the content of the Internet be regulated, and if so in what ways and by whom? Should the government require that the Internet be made available on favorable terms to schools, and if so who should pay for it?

Other areas of dispute involve markets for things some people believe should not be bought and sold, or, in some cases, be available at all. It is generally accepted that human beings should not be able to sell themselves into slavery, or be sold by others. Much of the argument about political-campaign finance reform is a debate about whether willingness and ability to spend money to achieve a political end is, or is not, antithetical to democracy. Or reflect on the controversy about the emerging market for kidneys and ova, or about the decriminalization of prostitution and drugs.

This already is a lengthy and diverse list of areas where the appropriate role of markets and non-market modes of governance is under dispute. But let me stress their common properties. First, they all involve a particular class of goods or services that do, or arguably should, show up in the GNP accounts, because they employ scarce resources to meet particular kinds of human needs. Second, they all involve disputes about the appropriate structure of governance: that is about the values and interests that are to count in the determination of what and how much should be provided and distributed, and about who is to do the work under what regime of incentives and controls.

In almost all of the examples I have given above, something has happened, or changed, that has raised questions about appropriate organization and governance. In the case of electric-power systems (and the telephone system) there were technological advances that weakened the argument that these systems were natural monopolies, and which tempted policy makers to make more use of market governance. The rise in the demand for extra family child care is largely the result of large increases in the labor force participation rates of women with young children that has occurred over the last forty years, and raises questions about how a society should care for its children in an era where an at-home parent is not the norm, much less the rule. The new discussion about subsidizing drug purchases or putting price controls on them is the result of the development in recent years of a number of effective but expensive new drugs, which put strong pressure on the individuals and organizations paying for medical care. The Internet is a whole new ball game.

Social and political decision making regarding how to organize and govern economic activity is not done all at once, but rather is a continuing process, a vital part of the more general processes of economic change. In many instances these decisions are of extreme importance. The stakes, clearly, are very high in several of the areas discussed above. It is important to get the nature of these debates, and the issues at their core, into clear view. This is especially important today, given the strong faith in the almost universal efficacy of simple market solutions. In some of the cases above, this faith may hasten decision making towards a satisfactory solution. But, in a number of these cases, a strong initial bias towards a market solution may hinder actually getting to a governance solution that works, given the particularities of the case.

For reasons that should be clear now, and which I hope to make clearer in the analysis that follows, these kinds of governance issues are not easy to resolve. The contribution I aim for here is simply to get some of the important ones on the table, and to shed some light on what the argument is all about.

I begin by trying to place the current broad debate, which starts from almost historically unprecedented faith in the efficacy of markets, into some historical perspective. Then, in Section 3, I consider the various virtues that market organization has been proposed to have over other kinds of governance structures, and raise some questions about those arguments. One important limitation of the theories about the virtues of market organization is that they fail to recognize that what we call 'market' economies in fact are very mixed in structure. In Section 4 I discuss market failure theory and certain other bodies of theory that provide arguments for a mixed economy, and try to draw from these a synthetic view that illuminates the nature of the current debates.

In the concluding section I will elaborate why finding appropriate ways of governing economic activity often is a very difficult problem.

2. The past as prologue

The presumption and fact that markets play a pervasive role in the governance and organization of economic activity are relatively recent phenomena. A significant expansion in the role of markets occurred first in Great Britain around the beginning of the 18th century, and later spread to continental Europe, and the United States, still later to Japan, and recently, of course, to large portions of the world. Certain kinds of markets have existed from virtually the dawn of history, but until recently were central in only a small portion of human activity. It is the pervasiveness of markets, and the system that came to be called capitalism, that is relatively new on the historical time scale.

With the spread of markets, of production that was largely for sale on markets, and of a context where either net receipts from sales or wages garnered on labor markets largely determined the access of an individual or family to goods and services, a sphere of economic activity began to emerge in its own right, as a system that was distinct from the broader society and polity. Thus Adam Smith's *The Wealth of Nations* (1776) is about a market economy, influenced profoundly, to be sure, by the culture and government of the nation containing it, but as an object in its own right, and with its own basic rules of operation. That book could not have been written a century earlier. And today, of course, the standard economics textbooks draw a picture of an economy that is quite separate from the rest of human activity.

From the time capitalism began to take on recognizable form, and students of its operation began to write about it (with time these analysts came to be called economists), the system has had its proponents and its opponents. The balance of opinion about capitalism has swung back and forth over the years, and at any time has varied from country to country.

While the British 'classical school' often is thought of as a strong proponent of markets, as unencumbered as possible, and extended to as wide a range of human activity as possible, in fact that is not quite accurate. Adam Smith's enthusiasm for markets was nuanced, and he clearly saw a downside. John Stuart Mill did not like certain aspects he saw of the rising capitalism of mid-19th-century England. The United States today is regarded as the locus of almost unwashed enthusiasm for unfettered markets. However, Alexander Hamilton, in his famous *Report on Manufactures*, argued that protection and subsidy were needed if American industry were to survive and prosper. Many of the founders of the American Economic Association (towards the end of the 19th century) were much concerned about what they saw as the excesses of market capitalism, and with devising policies to tame it.

Outside of the UK and the US, and the cultures they strongly have influenced, the enthusiasm traditionally has been even more muted, and the climate of opinion sometimes downright hostile. Indeed the socialist economic tradition was, to a considerable extent, basically a negative reaction to market capitalism. That tradition defines a very roomy tent. On the one side one can find the British Fabians who did not want to abolish markets (at least not in the short run), but rather to regulate them in the public interest, and to supplement markets with a variety of other institutions to deal with the inequities they saw as inevitable in raw capitalism. On the other side stand a variety of scholars strongly hostile to the market system and proposing to completely replace it with something else; here one finds socialists as diverse as Robert Owen and Karl Marx.

Marx, of course, saw capitalism as a system of power. For him, political and economic power were intertwined. It is no coincidence that, until recently, nationalization of heavy industry and, more generally, the organizations that provided the basic infrastructure for economic life, was at the top of the agenda for socialist parties after they were able to attain and hold political power.

With all the enthusiasm today for market capitalism of a relatively extensive and unrestricted sort, it is easy to forget that half-a-century ago some of the most distinguished scholars were predicting capitalism's demise. In the 1940s Joseph Schumpeter published his classic *Capitalism, Socialism, and Democracy*, and Karl Polanyi his *The Great Transformation*. Both saw capitalism as a system whose time had passed, the former with regret and the latter with relief. The reasons for these predictions are, interestingly, somewhat different.

For Schumpeter, the reasons were twofold. First of all, he argued that the principal economic merit of capitalism had been the rapid and radical innovation the system spurred and supported, which was the basic factor behind the great improvements in living standards that had occurred under capitalism. However, he believed that, as a result of the advance of science, rapid industrial innovation no longer required the hurly-burly of competition and creative destruction, but could proceed in a planned and orderly way. Thus capitalist economic organization no longer was needed for economic progress. At the same time, the professional managers of industry and the scientists in R&D had little zeal for keeping competitive capitalism going as a system; their careers would be more secure and as comfortable under a different regime. This left the defenders of capitalism even more vulnerable to the attacks of intellectuals who saw many vices and few virtues in the system.

For Polanyi, market capitalism had been a disaster for the working classes and, while since the late 19th century wages had risen somewhat for those who had jobs, the Great Depression showed that capitalism remained a pernicious system. More (and here Polanyi's line is similar to that of Schumpeter), the Depression had weakened the support of the middle classes, and even business, for the system, and was leading them to look to taming it or transforming it so that it was less brutal.

Both authors saw the economic system of market capitalism as profoundly influencing the nature of broader society, and politics. Schumpeter saw the effects as largely positive, as encouraging individual creativity, freedom, and independence. Indeed, he associated the institutions of modern science with capitalism, and argued that liberal democracy was a fellow traveler, a position very close to that of F. A. Hayek. For these reasons he viewed what he saw as the inevitable decline of capitalism with regret.

Polanyi's great book, on the other hand, put forth the argument that the encroachment of markets into everyday life, and in particular the commodification of labor and land, had destroyed the cooperative and communal aspects that he saw as essential to a healthy civil society. He saw the defense of capitalism from the pressures of the working-class interests as a fundamental aspect of political regimes under capitalism, so that a true democracy was very difficult to achieve so long as capitalism held sway. Conversely, part of his argument as to why capitalism was dissolving involved exactly the extension of democracy despite the resistance of capitalism's defenders.

Neither author displayed any enthusiasm for the Soviet system that was taking shape at the time. But both clearly forecast an economic system that involved far more coordination among firms under governmental overview, much more government regulation of firms and particularly the labor market, more protection of the basic living standards of workers, and more planning, than the system that had come to be called capitalism.

It is apparent that the strong performance after World War II of the European and American economies surprised many people, and changed attitudes. Unemployment was low. The economic growth-rate was high and the lion's share of the population experienced rising living standards.

It was widely recognized that post-war capitalism was structurally different from pre-war in a number of dimensions. The roles of government had expanded significantly. Public spending on education, particularly higher education, had increased greatly, and so had government support of R&D. Unemployment insurance now was widespread and in many countries quite generous, as was social security. Many countries expanded the scope of national health insurance, or instituted new programs. Both France and the United Kingdom established governmental apparatus for reflecting on what investment allocation should be, and nationalized several key industries, although neither developed machinery for broad-scale industrial planning. The United States saw the passing of an 'employment' act and the establishment of a President's Council of Economic Advisors.

How much these system changes had to do with the strong performance of the economies in the quarter century after World War II still is an arguable matter. However, it is clear that many of the forecasts of Schumpeter and Polanyi regarding system change had come to pass.

One could ask whether the new system still was market capitalism. C. A. R. Crosland asked that question in his 1956 opus *The Future of Socialism*, and answered that the system was very different than it had been, and contained a number of elements long advocated by socialists, but still was not socialism. In *Beyond the Welfare State* (1960), Gunnar Myrdal also stressed the great change that had occurred and in effect took the position that, whatever it might be called, most of the problems of the old capitalism were resolved by the new system. Andrew Schonfield, in his *Modern Capitalism* written in 1965, took essentially the same position.

American scholars put forth a distinctively pragmatic perspective on these developments. Robert Dahl and Charles E. Lindblom in their great *Politics, Economics, and Welfare* (1953) proposed that the tasks of modern economies are complex and varied, and that different forms of governance and organization are appropriate to different ones. The book basically lays out the wide range of different ways the United States uses to organize different kinds of activities. Daniel Bell's *The End of Ideology* (1960) pointed out that, in the United States at least, no one was still arguing about the pluses and minuses of capitalism, but rather the discussion was about how to make it work well.

In the United States economists increasingly used the term 'mixed economy' and, when talking to each other, 'the neoclassical synthesis'. The basic themes were well articulated in the 1962 report of the new Kennedy administration's Council of Economic Advisors, which contained a number of the country's best known and most respected economists. Centerpiece in the formulation was the government's role in managing the macro aspects of the economy through fiscal and monetary policy; several years later the Republican president Richard Nixon would say 'We are all Keynesians.' Market organization was assumed to be the basic way of governing and managing industry, broadly defined. However, the theory of 'market failures,' to use a term I will unpack later, was very much part of the neoclassical synthesis. The provision of public goods, like national security and scientific knowledge, required public support and, in some cases, public undertaking. Externalities required regulation or a regime of taxes and subsidies. Antitrust policies needed to be pursued and natural monopolies needed to be regulated, and government needed to proceed actively to assure that the workings of the economic system did not generate unrelieved poverty. Michael Harrington's *The Other America* had a major impact on the thinking of the Kennedy and later the Johnson administrations, which led to the initiation of a 'war on poverty'.

These changes in economic policy or, more broadly, changes in the view of what capitalism was, and what was needed to make it effective, did not go unchallenged. By the middle or late 1970s there was considerable advocacy for rolling back many of the changes or, at least, blocking further moves in these directions. Mark Blyth has proposed, in his *Great Transformations, Economic Ideas, and Political Change in the Twentieth Century*, that there may be a natural cycle regarding popular opinion on the appropriate level and type of government regulation—and involvement more generally—in capitalism: a cycle that involves both policies and ideologies, with overshoot of the former leading to switches in the latter.

However, it is fair to say that the sea change in ideology on these matters reflected in the rhetoric and the policies of the Margaret Thatcher and Ronald Reagan administrations caught many people by surprise. The sharp changes undoubtedly had many causes. One was the deterioration of the performance of the American and European economies that set in in the early 1970s. This was associated with a continuing rise in government spending as a fraction of GNP, and many argued that this, and increased government regulation, was a root cause of the economic problems. In the UK there was growing hostility to what was perceived as undue power of labor unions. And clearly the collapse of the Soviet economy bolstered the advocates of market capitalism, of a relatively simple and raw variety.

The 1980s and 1990s saw a dramatic change in the intellectual writings about capitalism. Daniel Yergin and Joseph Stanislaw wrote about how the marketplace had won over the government in the battle for *The Commanding Heights*, and saw the outcome as a victory for the right cause, expressing few qualms that the issues might be more complex than the ideological arguments of the victors. Francis Fukuyama proclaimed *The End of History and the Last Man*, as a final victory for market capitalism (along with liberal democracy).

And yet, for all the attempts to roll back the reforms of the early post-war era and to return to a leaner and more basic capitalism, the actual systems remain extraordinarily complex and variegated. The welfare state has become a recognized part of modern capitalism, a mistaken idea in the minds of some, a necessary complement to the industrial side of modern capitalism to others, but certainly an arena of continuing policy argument. With growing recognition of the central role of technological advance in economic growth, and of science to technological advance, the old industrial policy debates have taken on new form, with a particular focus on the appropriate division of responsibility between government and private enterprise regarding the support of R&D. But the debate continues. The waves of deregulation and privatization that marked the 1980s have not ended the debate about whether for-profit firms can be trusted in contexts where competition is problematic or the good or service being provided is crucial to the well-being of the society or polity. The argument about how to protect the environment from economic activity is, if anything, intensifying.

In my view, however, while for the most part the contemporary discussion of issues of macro-economic policy has broken from the ideological narrowness of the 1970s and 1980s, and recently there has been a renewal of attention to problems of poverty, that is less true regarding problems of sectoral economic organization. Too much of the current discussion of how to govern economic activity still proceeds within an intellectual frame that sees market organization of economic activity as far simpler than it actually is in many sectors, and unmindful of the wide range of economic activity that societies have chosen to govern through mechanisms other than the market. I think it important to get the complexity and variegation of market organization, and its limits, more clearly in view.

3. The case for market organization: the perspective from economics

I have noted that, while recently there has been a renewed capability to see some of the blemishes as well as the advantages, over the last twenty years, belief in the efficacy of markets has been unusually wide and deep by historical standards. Non-economists seem under the impression that economists have built a theoretically rigorous and empirically well-supported case for market organization. In this section I will argue that, in fact, the most commonly cited theoretical argument can support little weight, the empirical case is rough and ready, and the persuasive part of the argument is pragmatic and qualitative rather than rigorous and quantitative. And, in my view at least, the arguments for market organization that are most compelling are quite different than those contained in the standard textbook formulation. [5]

Since at least the days of Adam Smith, the Anglo-Saxon tradition of economic analysis has touted the virtues of the 'invisible hand'—profit oriented suppliers striving for customer purchasers on a competitive market. For the most part Smith's argument was qualitative, and supported by a set of empirical cases drawn from his own experiences and those of others. Also, in the present context, it is important to remember that Smith was making his case for market organization partly as argument against a particular alternative—mercantilism.

Modern economics purports to tighten up the logic of the argument. The theoretical case made for market organization in contemporary economic textbooks and treatises compares the performance of a stylized model market economy against a theoretical norm of Pareto optimality—a particular notion of maximal economic efficiency. If the performance of an economy is Pareto optimal, it is getting the maximal value of output

[5] The discussion which follows develops some of the themes I first introduced in my 1981 article on 'Assessing private enterprise: an exegesis of tangled Doctrine'.

from the resources and technologies available, given the distribution of purchasing power. (This is not the standard definition of Pareto optimality, but it is nearly an equivalent.) The textbook argument concludes that, given a package of assumptions, a competitive market economy meets that norm. However, while Nobel prizes have been awarded to economists for developing this theory, I would argue that it is a non-starter as a case for real-life market organization for several reasons.

The most common critique of this theory as an argument for the desirability of market capitalism, of course, is that even if capitalist economic organization achieves Pareto optimality, the workings of the system often are associated with very great inequalities in income distribution and pockets of abject poverty. Remediation under capitalism is blocked because the rich have the political power to veto polices that are not in their interests, even though it can be argued that such policies would significantly raise average well-being. The position the rich are defending may well be Pareto optimal, in that any changes that would make others better off would make them worse off, but that does not make it socially desirable or even acceptable. This, of course, was an important part of Polanyi's critique of capitalism.

In counter, it has been argued that many political economies that make extensive use of market mechanisms have been able to achieve relatively equitable income distributions, and to virtually eliminate poverty. The institutions of the modern welfare state have been quite successful at these tasks. The critics rejoin that it is exactly these institutions that are most under attack.

For the present I want to bypass this line of argument—I will pick it up later—and stay with what the theory is proposing, which is that market organization is economically efficient. The basic analytic issue is that the theoretical model of a market economy that satisfies the criterion of Pareto optimality clearly is very far away from actual market organization. Strangely, the implications of this for the whole broad argument have tended to be underplayed. Even if one stays close to that theoretical formulation, virtually all analysts would admit the presence of a variety of 'market failures', a topic I will take up in the following section. Once these are taken into the model, the theoretical market economy does not achieve Pareto optimality. And from there the whole standard theoretical strategy for arguing the case for markets unravels.

It unravels because, unlike Smith's discussion of the virtues of the invisible hand which did involve an explicit comparison, the contemporary theoretical textbook argument does not compare the performance of a (highly abstracted) market-organized economy with the theoretical performance of another (highly abstracted) kind of economic system. In particular, the argument is not that another kind of economic system could not also achieve Pareto optimality. Of course, if market organization does as well as is theoretically possible, there is no particular reason to consider an alternative. However, once the optimality argument falls away, there would seem to be no way to avoid comparing how market organization performs against alternative structures, even though this may be very hard to do.

The task is made especially difficult by the fact, which I have been stressing, that modern market capitalism (or any plausible alternative system) is very complex and variegated. The argument I am developing clearly is that it is exactly this flexibility that enables market organization to work tolerably well in a wide variety of contexts. But then, these factors absolutely need to be taken into account in any analysis which compares market capitalism against alternatives, or against some kind of an absolute scale.

Let us return, then, to the efficiency argument. I want to propose that the issues here are obscured rather than illuminated by the standard economic theory.

While real-life market economies certainly don't achieve Pareto optimality, most economists and many laypersons would argue that market organization and competition often do seem to generate results that are moderately efficient. There are strong incentives for firms to produce goods and services that customers want, or can be persuaded they want, and to produce at as low financial cost as is possible. There is a 'dynamic' version of, or supplement to, this efficiency argument. Under many circumstances competitive, market-organized economic sectors seem to respond relatively quickly to changes in customer demands, input supply conditions, and technological opportunities. To the extent that producing what customers value is treated as a plus, and so long as factor prices roughly measure opportunity costs, there is a strong pragmatic case for market capitalism on economic efficiency grounds, broadly defined, at least in certain domains of activity.

Critics of capitalism argue that the efficiencies of the system have been overrated, and that in fact capitalist economies are rife with waste. For one thing, the consumer wants satisfied by capitalism, are, to a considerable extent, created through advertising, and most real needs can be satisfied with much simpler products and services than capitalism delivers. For another, advertising itself, and the product differentiation among firms intended to induce consumers to buy their wares, takes up a lot of resources that could be put to far more productive use under a system that aimed to meet prevailing wants rather than create new ones. On the other hand, defenders of market organization argue that this point exaggerates the extent to which preferences can be manipulated, and that in any case the alternative of having some high authority judge what customers really want, or ought to want, is a far greater danger. It is clear that the debate here about the efficiency of capitalism shades off into the old argument about the virtues and vices of the culture of capitalism.

The strength of the case for and against letting individuals' decisions regarding how to spend their own money be the dominant mechanism for determining what wants are met also almost certainly depends on the context. It is interesting that in wartime, and virtually without protest, capitalist economies have adopted centrally coordinated mechanisms of resource allocation, procurement, and rationing. The rationale has been that such economic organization was essential if production was to be allocated to the highest priority needs, and conducted effectively. And by and large there is agreement that remarkable feats of production have been achieved under these arrangements.

The experience with wartime planning sometimes has led some analysts to propose that a number of the mechanisms used then would vastly increase economic efficiency during peacetime. However, most knowledgeable analysts have argued against that position, strongly. It is one thing to marshal an economy to concentrate on a central set of consensus high-priority demands over a short period of time, as in wartime production, or in the early years of the communist economies where the central objective was to build up a few basic industries. It is something else again to have an economy behave reasonably responsively and efficiently in a context of diverse and changing demands, supply conditions, and technological opportunities, over a long time-period. The experience with central planning in the ex-communist countries, after the era had passed when building up standard infrastructure sufficed as a central goal, bears out this argument.[6]

However, I would propose that the argument behind the scenes here is much more complex than, and in fact different from, the standard textbook argument that profit maximizing behavior of firms in competitive market contexts yields economically efficient results. It hinges on the multiplicity, diversity, and unpredictable changeability of wants, resources, and technologies in modern economies that experience shows defy the information processing and resource allocating capabilities of centrally planned and controlled systems, and also presumes that the chances of appropriate responses to changed conditions are enhanced when there are a number of competitive actors who can respond without going through a process requiring approval for proposed action by some central authority, or gaining the approval of a large number of people before acting. Hayek, and the modern 'Austrian' economists (e.g. Kirzner, 1979), have stressed the ability of market economies to experiment, to search for unmet needs and unseized opportunities, and argued that centralized systems are very poor at this.

Notice that the argument here is partly about the advantages of the incentives and mechanisms associated with market organization, and partly about the disadvantages built into a centralized control system. Many people find this case for market organization compelling, and in accord with the evidence both about capitalist economies and the old planned ones. This argument, however, is only loosely related to the theoretical argument about the Pareto optimality of a stylized market economy.

Many observers have proposed that it is in dynamic long-run performance, rather than in short-run efficiency, that market capitalism reveals its greatest strength. As Marx and Schumpeter have stressed, capitalism has been a remarkably powerful engine of economic progress. And here too one can make a rather explicit comparison. Indeed a good case can be made that a central reason for the collapse of the old communist economies was their inability to stay up with, and take advantage of, the rapid technological progress that was going on in market economies.

But again, the characteristics and capabilities of market organization that contribute to technological progress are very different to those that relate to static efficiency, and the textbook normative model. Indeed Schumpeter made a great deal of those differences. Many commentators on Schumpeter have proposed that Schumpeter did

[6]Lindblom's discussion of these points in his *Politics and Markets* (1977) is especially good.

not believe that, in modern capitalism, competition was important. That is not correct. Rather, his argument was that the kind of competition that mattered was not the sort stressed in the economics textbooks, but competition through innovation. The capitalism of his *Capitalism, Socialism, and Democracy* was an effective engine of progress because competition spurred innovation. This theory places high value on pluralism and multiple rival sources of invention and innovation. However, under this view of what socially valuable competition was all about, the presence of large firms, with R&D laboratories as well as some market power, was welcomed, despite the fact that such a market structure diverged from the purely competitive one associated with the static theorem about Pareto optimality.

Earlier I noted that Schumpeter argued that, as science had become more powerful, the unruly and inefficient competition of capitalist systems would no longer be needed for industrial innovation, which increasingly could be planned. History has showed him to be very wrong on this point. Centrally planned systems often have achieved strong success in allocating R&D resources where the objectives were sharply defined and the likely best routes to success quite clear. The Manhattan Project and Project Apollo are good examples. However, for the most part potential innovators are faced with the problem of guessing just how much users will value various innovations they might introduce, and also of judging how easy or difficult it would be to develop various alternatives. The answers to these questions seldom are clear. Further, well-informed experts are likely to disagree on the answers. Under these usual conditions, the competitive pluralism of market-organized R&D systems is a great advantage.

It can be argued that, at least in recent years, the strong performance of market capitalist economies on the industrial innovation front also has a lot to do with features of modern capitalist economies not highlighted in Schumpeter, in particular public support of university research. The innovation systems of modern capitalist economies are mixed and complex. However, the pluralism, flexibility, and competition that mark market capitalism are essential aspects of any effective innovation system

I find the Schumpeterian view of the advantages of market organization compelling, and believe that, to a considerable extent, the folk theory of the advantages of markets is implicitly Schumpeterian, rather than neoclassical. The value of capitalist economic organization is that it provides a powerful engine of progress. I note that the arguments here about the costs of placing constraints on the system, for example stringent regulation, relate to the rigidities that regulation may cause in a context where considerable experimentation is what is needed. Similarly the arguments about the failures of a centralized system are not so much about static inefficiencies as about the lack of incentive to innovate and the difficulties in supporting multiple competing efforts that mark such systems. Here the folk theory about what market organization is good for may be better than the standard arguments in neoclassical economic theory.

In concluding this section it is relevant to recall that Schumpeter greatly admired the cultural and political values and structures that he saw induced and supported by capitalist economic organization. In contrast, Polanyi detested what he thought capitalism did to people and values, as well as the allocation of political power he believed was needed in order for capitalism to be viable. It is apparent that the arguments for and against market organization, and capitalism more generally, are concerned with some issues at distance from evaluations of performance on strictly economic grounds, whatever the latter might mean. Both Schumpeter and Polanyi believed that capitalism could not survive politically, at least in its raw form, because of widespread distaste for its social consequences. Clearly many of the post-World War II reforms were attempts to mitigate those consequences.

Which brings the discussion back to the question 'What is modern capitalism?' And what are the alternatives? Years ago it was reasonable to compare capitalism and various aspects of its performance against communist systems, but this is no longer a relevant comparison. Today no one is seriously proposing an economic system that does not make extensive use of markets. The real issues today relate to the mix of markets with other forms, in different economic activities and sectors. And here, while a number of people have in effect put forth the proposition 'the more of market and the less of other things the better,' I know of no convincing argument to support that proposition.

4. The positive case for a mixed economy

Why is there so much in the way of non-market elements in modern capitalist economies? Contemporary advocates of a purer form of capitalism are prone to argue that they are the result of mistaken policies, and the political power of private interests. Without denying that modern capitalist economies are littered with boons to particular groups which are highly wasteful for the system as a whole, my argument, of course, is that many of these non-market elements are essential to make the economic system work decently well, and to assure support of its basic structure under democratic institutions.

In this section I consider, and try to bring together, several different bodies of theory presenting arguments for a mixed economy. By far the best known and most elaborately worked out of these is the 'market failure' theory of modern economics. I begin my discussion by considering this theory. I believe its categories are illuminating and helpful; however, the theory has certain fundamental limitations, which I also will bring out in my discussion.

I then consider several other bodies of theory which have very different starting points and orientations. One collection of such theories is concerned with analyzing the functions of the state. Another collection starts with the community. While market failure theory argues for other forms of governance on the grounds that there are certain things that market organization cannot do well, these other theories are oriented to the value in their own right of these other sorts of governing structures.

4.1 Market failure theory

It is clear that most high-level argument about how to use market organization effectively, where market organization needs to be supplemented by other mechanisms, and where market organization simply works poorly, is conducted using the economists' market failure language.[7] The standard categories of market failure—public goods, externalities, information impactedness, monopoly problems, and (in some treatments) income distribution problems—serve to structure and constrain much of the policy discourse. Indeed since the 1960s, when this theory became solidly incorporated in mainline economics, virtually every new President's Council of Economic Advisors has walked through this list in its maiden annual Report to Congress and the American people, as part of its articulation of the economic policies its administration was proposing to implement.

Market failure theory takes as its benchmark the theory I discussed earlier that, under the set of assumptions about behavior built into neoclassical economic theory, and given a particular set of other context assumptions, market governance of economic activity yields Pareto optimal outcomes. The orientation of market failure theory is to context conditions that upset that result. The efficacy of the 'demand side' machinery of market organization would seem to depend on the extent to which a good or service benefits only, or at least largely, a particular individual or group that purchases it; the 'public goods' and a portion of the 'externalities' conceptions characterize contexts where this is not the case. There also is the issue of whether or not users have the knowledge to effectively evaluate the alternatives provided by the market. The efficacy of the 'supply side' machinery would seem to depend on the extent to which the money costs facing firms for the various actions they might take reflect the real costs to society of that action; a good portion of the externalities argument is about contexts where this is not the case. Also, while competition often can be expected to regulate the behavior of firms in the interests of customers and citizens; in contexts where particular firms have great market power, this mode of regulation may not do the job.

Because this body of theory is so well known, I can be brief here in presenting the standard account of the basic market failure categories. Rather, my emphasis will be on the blurry edges of the standard categories, and on some cases that seem to strain the underlying economic theory more generally. In my view, a large share of the current controversies about the role of markets falls into these areas.

4.2 Public goods, latent public goods, and collective values

Economists use the public good concept to flag a class of goods and services where the benefits are collective and communal rather than individual and private. Under this body of conceptualization, a 'pure' public good has two attributes. One is that, unlike a standard private good, such as a peanut butter sandwich, which can benefit only one consumer (although of course it can be split and shared), a public good provides atmospheric benefits that all can enjoy. In the language of economists, public goods are non-rivalrous in use. Your benefiting from a public good in no way diminishes my ability to benefit. The second attribute is that, if the good or service is provided at all,

[7]Of the many expositions of the many facets of market failure theory, I find Stiglitz's (1986) especially fine. See also Lipsey *et al.* (1998: ch. 18).

there is no way to deny access to any person, or to require direct payment for access. Clean air and national security are standard examples of pure public goods. Scientific knowledge often is used as another example. For a neighborhood, the quality of access roads has some public good attributes.

There are several things to note about this conceptualization. In the first place, publicness is a matter of degree, in both dimensions. A defense force may protect some regions, but not others, and given a resource constraint the protection of one group of people may therefore be at the expense of the protection of another group. Thus defense is not completely atmospheric and non-rivalrous in use. On the other hand, if one lives in a protected region, protection cannot be withheld if a person does not pay up, although that person can be placed in jail for not paying taxes. In contrast, scientific knowledge does seem truly to be non-rivalrous in use; you and I can use the same fact or understanding at the same time. However, the creator of that knowledge may be able to patent it, and to sue anyone for using it without paying a license fee. Access roads are impure public goods in both respects. Heavy use slows down access, and signs that say 'private roads—no trespassing' can be posted and, to a limited degree, enforced.

Laypersons tend to associate public goods with the impossibility or difficulty of making those who benefit directly pay, and to recognize that adequate provision of such goods and services requires some kind of collective 'demand side' procurement machinery. Sometimes this can be provided through non-governmental organizations, financed by philanthropy or voluntary contributions. Thus many suburban neighborhoods have property owner associations that collectively decide on road maintenance, and collect dues from members. But for large-scale public goods of this sort we generally rely on government to pay the bill.

Using governmental machinery to decide what to procure and how to pay for it raises three different kinds of issues. First, there is the question of just how to decide how much is to be provided, in contexts where different individuals and groups may value the good or service in question very differently. There is the related question of how the money is to be raised, and who is to pay. In the nature of the case, collective choice is going to be controversial.

Second, collective choice machinery almost inevitably is going either to be cumbersome and costly, because many people and interests are involved and want to have a say, or somewhat arbitrarily simplified and curtailed. In order to keep the decision process manageable, it may be necessary to narrow down the alternatives that are seriously considered, and the interests that are given serious weight. The result may well be outcomes that are widely regarded as unjust or inefficient or both. But there may be no alternative to establishing collective demand machinery for goods where, if something is provided, no one can be made to pay for access.

Third, while government funding and decision making on the demand side certainly does not mean that the supply side needs to be governmental as well, the separation here is not quite as clean as some economists propose. The use of public funds means that government is responsible for assuring that supply is reasonably efficient and responsive to the demand. The most effective way to organize supply may well be through procuring from competitive for-profit firms. But when the government spends public money on something, relatively close government overview of the suppliers, if not direct government provision, is virtually inevitable politically.

While the lay conception of public goods seems oriented to inability to make users pay directly, I prefer to reserve the term ‘public good’ for goods and services that are, to a considerable extent, non rivalrous in use. This, and inability to block access or to force *ex-post quid pro quo* payment, often go together, as in the cases of clean air and defense. Here the lay conception and mine overlap. In such cases, as noted, there is no alternative to collective provision machinery.

However, there is a wide range of goods that are non-rivalrous in use, or nearly so, in the sense that the cost of making them available to additional users is zero or very small, but access to them can be denied and users made to pay up before they gain access. I have called these ‘latent’ public goods. Prominent on the list of latent public goods I would include those that provide information or knowledge: science, technology, TV signals, databases. To a considerable extent these are non-rivalrous in use, but access can be barred to those that don’t pay a fee. Parks and roads also have characteristics of latent public goods, up to a point. So do many of the products of public utilities, like electricity and telephone service, where the cost of additional use is generally very small, but users can be made to pay. For-profit suppliers can make money providing them by requiring that users pay up at a level that covers average cost plus a margin for-profit. This is a real option.

For market enthusiasts, this generally is the preferred way of organizing and governing these activities. However, while often overlooked in the discussion, there is a downside to governing an activity with latent public good properties this way, because some uses and some users where the good has possibly significant value almost surely will be shut out, even though the real incremental cost is zero or close to zero. The costs associated with this exclusion may be modest; or they may be very large.

The recent tendency, that I mentioned earlier in this essay, to bring more of science under the domain of market governance, through the vehicle of allowing patents on scientific findings that have the promise of being useful, is an interesting and important case in point. The proponents of this development argue that bringing more of science under the market will increase the resources and energy devoted to fields where there is promise of practical payoff. The opponents of bringing basic research more under the market have argued that science proceeds most effectively and cumulatively when those who do science are part of a community where open publication and access to research results is the norm, and rewards are tied to recognized contributions to the communal scientific effort.[8] From this point of view, the costs of bringing science into the market and establishing property rights on the results of scientific research could be very high,

[8]Many years ago Merton (1973) made these points elegantly. More recently they have been elaborated by Dasgupta and David (1994). Kealey (1996) is perhaps the best known contemporary advocate of rolling back the non-market system, and replacing it by a market.

warping incentives away from fundamental research and pulling them towards areas where practical payoffs were apparent, and restricting access to a latent public good whose full exploitation requires that many minds be involved in further development of the ideas and techniques. Their argument, therefore, is that it is important to continue public funding of science, even in areas where for-profit firms are active, and to try to hold back patenting of basic scientific results.

Public decision making machinery, and funding, of latent public goods, with access open or at nominal cost to potential users, avoids the costs of freezing out some uses and users for which the real cost of extending service is zero or very small. But it does entail the real cost of putting in place and operating collective decision making machinery, where there may be little agreement as to how much should be provided, and the fractious issue of who is to pay the taxes.

I want to conclude my discussion of 'public goods by flagging an issue regarding how their benefits ought to be conceived. Economists tend to treat public goods as if the individuals in society benefit from them in roughly the same way that they benefit from the private goods they procure and use. Thus clean air is viewed as providing better breathing for individuals, a strong national security position as reducing the risks to individuals, new scientific understanding as increasing the chances of a cure for cancer, etc. In many cases this is quite reasonable.

However, it is apparent that some people care about the quality of air, and water, and the security of wildlife, in areas where they never intend to be, and are willing that their taxes be somewhat higher if that will help fund a better environment. National security is an integral aspect of foreign policy, and many citizens support a particular foreign policy not because of any direct benefits to them of a conventional sort, but because they believe it is right. Citizens may support government funding of science even if they see no real chance of their benefiting directly in terms of better goods and services down the road, and even if they doubt they will be able themselves to understand the findings of research, but simply because they believe that advancing knowledge is an important human objective. The values at stake here seem different in kind than the utility that an individual might get from a nice steak.

To give some other examples, many citizens in a democracy support funding for universal education not because they or their children will take advantage of public schools, but because they believe that universal free education is a necessary condition for equality of opportunity in a society. Similar reasons may lie behind their support of a legal system where all persons on trial have access to good lawyers. Many facets of the current debate about how to assure the well-being of the nation's children also have this cast. The orientation is to the question 'What kind of a society are we?' From this point of view, the well-being of a nation's children is an important atmospheric public good.

Whether a good or service has significant public good properties clearly depends on how the benefits it yields are viewed. In the cases above, the benefits that are seen as 'public' are not easily analyzed in terms of the standard kinds of benefits that are the focus of standard economics. Rather, their 'publicness' resides in values defined in terms of perceptions about what makes a society a decent and just one. We will see analogous issues under the 'externalities' rubric. Getting them clearly in view will require getting beyond market failure theory, and will be my topic later in this section.

4.3 The externalities problem: bringing broader interests to the governing structure

The externalities concept of economists is meant to refer to by-products of economic activity that have negative or positive consequences that are not reflected in the prices or other benefits and costs perceived by those who engage in the externalities generating activity. Environmental contamination is an obvious example of a negative 'externality,' and a clear case where there is a value at stake in the operations of an activity, with no one to represent and fight for it, at least in the simple model of market governance put forth in economic textbooks. In a famous article written some time ago, Ronald Coase argued that, if property rights are clear and strong, and the number of interested parties relatively small, in fact markets can deal with these kinds of problems. Those who value clean air or water simply can 'buy' behavior that respects those values from the potential polluter. The problem arises when those who care about the values which could be neglected are dispersed. In this case some kind of collective-action machinery is needed to bring them in. A good way to think about regulation, or a tax on pollution, is to see these measures as the result of governmental actions that have brought in a broader range of interests to the governing structure of an activity or sector.

However, the costs and the inefficiencies here can be considerable. Government regulation involves collective-decision machinery, and has all the problems and limitations discussed above in the context of collective decision-making regarding the provision of public goods.

Clearly the general problem here is to delineate the range of interests which should be represented, their relative influence, and the mechanisms through which they operate to make their values felt. The latter can range from public interest advertising, or boycotts, which can proceed without direct access to governmental machinery, to lawsuits which involve general governmental apparatus, to particular pieces of special regulation and associated control machinery. Much of the public controversy is about the latter.

As regarding the benefits from public goods, it is conventional in economics to think of the costs of an externality as objective, and, in principle at least, measurable and amenable to having a market-based value placed on them. However, in many cases this is not quite the case. The concerns about an 'externality' held by particular groups may be quite subjective. Above I gave as an example the interests of certain groups in preserving particular species, or wilderness areas, that they never themselves would directly experience. Or consider regulation or prohibition of the sale of drugs or guns. This can be rationalized as dealing with an externality. However, it is apparent that many people who strongly support the position that drugs should be prohibited do not feel particularly threatened by drug-related crime, but rather take that position because they believe that drug use, by anybody, is wrong. Or reflect on prohibitions on prostitution.

The belief that a particular activity or action is wrong points to different governance issues and mechanisms than the belief that the activity or action in question simply causes costs to third parties. The debate about how to control pollution is illuminating in this regard. Most economists take the position that polluting generates external costs, and that an appropriate policy response is to impose a tax on pollution that internalizes those costs. Polluters can respond by cutting back on their pollution or paying the pollution tax. For many environmentalists, the idea that a pollution tax is an alternative to prohibition of pollution is not acceptable, because polluting is wrong and should not be done. While this latter point of view may be a bit ridged, it is not incoherent, and needs to be understood.

To a large extent prohibitions on certain activities, that economists might be inclined to rationalize as attempts to deal with externalities, reflect notions on the part of some people and groups regarding what is appropriate activity and what is not. A large part of the argument in this arena is about what values, and whose values, are to count, and through what mechanisms. It is hard to identify an activity, or a sector, where there are not some values at stake that go beyond the direct interests of the customers and the suppliers. On the other hand, the greater the number of interests and values that have to come to some collective conclusion before action is taken, or which have a veto power over change, the more cumbersome the governance system. The question, of course, is where to draw the line.

4.4 The issue of uneven expertise, and agency

Economists have become very interested recently in how asymmetric information, in particular differences in the information held by buyer and seller, complicate the workings of markets. I propose that a number of the current controversies about the efficacy of market organization, about regulation of markets, and about alternatives to market supply are connected with the asymmetric information problem or, more generally, the problem of uneven expertise. Many of these are associated with difficulties that the user of a service has in assessing the quality and appropriateness of what is provided, in contexts where the provider has relevant knowledge.

This problem clearly is fundamental in the arena of medical care. In view of the physician's expertise regarding diagnosis and prescription, and the obvious dependence of patients on the use of that expertise in their interest, the medical community long has professed that, while physicians sell their services on the market, they most emphatically do not try to maximize their profits, but rather prescribe in the patients' interests. The credibility of that claim is an open question, but professional ethics clearly can have an influence on behavior that tends to be neglected in standard models of market governance. To further complicate matters, with the rise of insurance, third-party payers found themselves in a position of doubting whether physicians paid enough attention to costs, and worrying about whether physicians, in fact, weren't trying to maximize their own incomes. These multi-interest potential conflicts, in a context where the expertise largely resides with the physician, lies at the heart of several current controversies regarding how to govern the medical care system.

The question of how parents can assess the quality of a child-care center, and the care their child actually is getting, is a fundamental one in the current controversies regarding regulation of day care. The question of whether parents, and children, can assess educational alternatives effectively, or whether professional teachers and education administrators know best, is a nontrivial one in the current discussion about vouchers. Recent changes in the rules have permitted pharmaceutical companies to advertise directly to potential users, a change from the earlier regime where this was not permitted and advertising had to be directed to doctors. Many observers worry that this is unleashing demands for pharmaceuticals that are inappropriate or even dangerous to the health of the individuals who respond to an advertisement by pressing their physician for a prescription.

On the other hand, in both of these cases it can be argued that individual customer choice can work decently well, if adequate information were made available, and that in any case paternalism is objectionable in its own right.

In some cases the issue here shows up in debate about necessary regulation, and mechanisms for regulation enforcement. In other cases the debate is about the proposition that, in circumstances where users cannot effectively judge what they are getting, market organization, with providers having a strong interest in profits, is an inferior way to govern in activity. There is an implicit, sometimes explicit, presumption that provision by a government agency, or by a not-for-profit organization, is a better way to go under these circumstances. Of course, whether this is so or not is an open question.

4.5 The problem of private monopoly

American economists are inclined to rationalize the use of antitrust legislation to prevent undue market power from arising, and regulation to deal with cases where there is natural monopoly, on the grounds that monopolists tend to charge too high a price. It is clear, however, that much of the force behind the policies to break up or rein in monopolies, or regulate them closely, has to do with people's concerns that arise when private bodies gain considerable power over their lives, a matter which may involve, but also may transcend, being forced to pay monopoly prices. Economists are inclined to rationalize the fact that governments have responsibility for governing national security, and the criminal justice system, to the fact that these activities yield 'public goods'. But it probably is at least as relevant that there is near consensus that it would be highly dangerous to place the power over these activities in private hands.

These propositions may strike some liberals in the Anglo-American tradition as somewhat odd. The heart of that position has been that strong government is the dominant danger to individual freedoms, and that placing activities under market governance, therefore, serves to increase freedom. The implicit assumptions here, of course, are first, that concentrations of private power will not in general arise under market governance, and that second, when they do, they are less threatening than government power to individual freedoms. However, I propose that, in many areas, that is just what the debate regarding the appropriate roles of market and non-market elements in the governance of an activity is all about.

I propose that concern about the lack of accountability to the public of private power over inputs that many people believe are of vital importance to them lies at the heart of the current debate about how to govern what used to be called public utilities—activities such as telephone services, electricity generation and distribution, urban water supply, the railroad system, urban mass transport. These used to be regarded as 'natural monopolies', in the sense that it was believed that service would be provided more efficiently under a unified supply system than under conditions of multiple suppliers and competition. In the United States traditionally they were left in private hands but tightly regulated; in other countries they often were governed as 'public enterprises'. In either case, with the public utility classification went an imperative to provide access to all potential users on terms that were regarded as fair. And the public utilities were understood to be publicly accountable for their actions.

The widespread move toward deregulation and privatization represented a strong shift toward market governance of these activities. Privatization has been associated with a rise in the number of complaints that the service in question no longer is being made available at fair terms to all users, and that pricing now is mostly determined by what the firm regards as most profitable, which is inequitable. In a number of cases, the competition that had been hoped would materialize from deregulation has not materialized. And where competition has come into play, there often have been other problems.

While the orientation of much of the economists' writings about monopoly is towards the costs to customers of market power, which would be diminished if more competition were possible, there is another strand that recognizes that in some circumstances competition itself can cause trouble. There is an extensive literature on public utilities, where competition may not be an unmixed blessing.

In some sectors, like those providing telephone service, or producing and distributing electricity, the advantages of coordination among different parts of the overall system are very great. Under regimes of regulated private supply, or government ownership of supply, where competition is suppressed or constrained, coordination was easy to achieve. Under deregulation, it clearly is a gamble whether rivalrous companies can be induced or forced to cooperate and coordinate on vital maters, while remaining competitors. Thus there may be a real tension between allowing local telephone companies to set up competitive long-distance phone services, and requiring them to grant local access to other long-distance services. Getting managed health care organizations to share patient information when a customer shifts from one to the other has not proved easy.

The question of how to make cooperation and coordination on certain matters compatible with competition on others is a tricky one in market organized sectors. The need for cooperation and coordination, plus the proposition that competition is not needed as part of the governing structure, or is positively harmful, is often used to argue that market organization and governance is not appropriate in a particular activity or sector.

4.6 The peculiar bias of market failure theory

I want to conclude this survey of market failure theory by pointing out a bias built into that theory. By the way it is formulated, market failure theory carries a heavy normative load to the effect that markets are preferred to other forms of governance systems, unless they are basically flawed in some sense. Thus the only reason why government should provide for national security and protect citizens from crime is that markets cannot do these jobs very well. Parents need to take care of children because of market failure. As one reflects on it, the argument that we need government because markets sometimes 'fail' seems rather strange, or at least incomplete. Can't one make a positive case for government, or families for that matter, as a form that is appropriate, even needed, in its own right?

4.7 The functions of the state

Values of the collective. And of course there is an ancient body of theorizing that puts forth a positive case for government. In much of its early incarnation, and some of its more recent, the state is viewed as the structure through which values are defined at the level of the community, and decisions regarding the community as a whole are made. Reflect on Plato's discussion of *The Republic*, or Hegel's discussion, where the good state is defined in terms of the quality of its justice and the character of its citizens. This formulation of the role of the state of course does not resolve the issue of differences among individuals who comprise the state. Indeed disputes about values are likely to be even more heated than disputes involving choices that affect economic interests differently. And the issue of how to decide may be even more contentious. Plato saw the answer in government by philosophers. For better or worse, modern societies are stuck with democratic process.

A liberal position on how to deal with value differences within the population would be to keep the state out of it, and to try to avoid forcing the values of one group to be imposed on another. But in many cases there is no way to do that. Abortion either is legal or it is not.

This theory clearly captures a lot of the flavor of contemporary debates about matters like rights to life and rights to chose, the commitment of a society to ideals of equal opportunity and fairness, or whether the aims of foreign policy should include protection of religious freedoms in other countries. Arguments about these matters involve beliefs about appropriate collective values, or values of the collective, that transcend those of particular individuals. Under this theory, in these areas at least the state, which defines the collective, is the natural vehicle of governance in contexts where a collective position on something has to be taken one way or another. In these areas the state may choose to use markets to further some collective values, but the purpose being served is a public purpose, and the responsibility for furthering it ultimately is a state responsibility.

Providing the context for fruitful civil life. Another, but not mutually exclusive, body of theorizing about the state focuses not so much on collective values, but rather sees the state as the necessary vehicle to set the context for fruitful private lives and actions. From at least the time of Hobbes and Locke, theories about the need for a strong state have involved, centrally, the proposition that an effective state is needed for individuals to lead secure, decent, and productive lives. Originally this body of theorizing had little to do with economics, much less the role of the state in market economies. Thus Hobbes' case for a strong state to establish and enforce a clear body of law was posed in terms of the need to avoid the 'war of every man against every man'. While this case involved security of property, this was not its central orientation. With Locke, the orientation is more towards security of property, but his great writings were before capitalism emerged as a recognizable economic system.

The argument for a strong state here is an argument for a single ultimate source of legal authority and police power. In the language of market failure theory, it is a natural-monopoly argument as well as a public-good argument. But the orientation to these issues in the political philosophy literature is that these are natural basic functions of the state, and do not simply fall to the state by default because of some market failure.

In his *The Wealth of Nations*, Smith built on these ideas and specialized them to the market economy he saw as working in Great Britain. He ascribed the backwardness of countries like 18th-century China largely to the vulnerability of possessions to theft or simply to being confiscated by those in power. To have incentive to produce for the market, craftsmen needed to be confident that they would reap what they would sow. Trade required contracts in which the traders had confidence, and that required a body of supporting law and a tradition of law enforcement that would not simply obey the interests of the wealthy and powerful.

In Smith's day not much physical, as contrasted with political and legal, infrastructure was needed to make markets work. Assuring national defense and public safety and law enforcement, of course, required resources dedicated to those purposes. There were roads and canals, which government either could itself build and maintain, or franchise to private parties. While Smith included in his functions of government the support of education, his case involved at least as much the importance he assigned education as a factor supporting civil society as the role he perceived formal education playing in the operation of the economic system more narrowly defined.

Responsibility for the provision of economic infrastructure. As technology advanced and economic systems became more complex, the physical and legal infrastructure needed for the effective operation of market economies became more complex and variegated. Establishing the telegraph and railroad systems required government action, if not necessarily government finance and operation. With the emergence of the organic chemical product industry and the industrial research laboratory in the last part of the 19th century, effective patent law became important as a precondition to profitable R&D in a number of industries. Education became more important economically and, in industries like those producing fine chemical products, firms needed scientists with a Ph.D. level of training. Earlier I briefly discussed the legal and physical infrastructures, provided by government, that support the modern airline, pharmaceuticals, and automobile industries.

The belief that the state has principal responsibility for assuring the provision of needed basic infrastructure, or public services, has a long-standing tradition in the law and in legal thinking. Of course the question of what is infrastructure that needs to be provided for markets to work well, and what markets themselves can be expected to provide, often is not an easy one. But this issue is not generally argued out strictly under the concepts of market failure theory. Thus consider activities such as maintaining a system of contract law, building and maintaining a road system, and supporting the development of basic scientific knowledge. These activities can be viewed as public goods, in the sense of market failure theory, with the market failure stemming from the fact that their benefits are collective rather than individual, and hence that for-profit firms would have great difficulty collecting for their provision on a conventional market. Or they can be considered as 'needed infrastructure', that governments are, by their functions, responsible for getting provided. While the former theory sees the reason for government provision or overview and control in the inability of markets to do an adequate job, the latter sees provision of such goods and services as a central responsibility of government, even if they could be provided through market mechanisms. And where market mechanisms in fact are used as part of the machinery for provision, the latter perspective sees government as still responsible for overseeing the operation, at least to some degree.

4.8 The role of community and extended empathy

Neither market nor government. Several of the theories of the state referred to above rest heavily on the concept of a natural community, a group of individuals, families, and more extended social structures, tied to each other by community bonds. Under this conception, the state is the vehicle through which the community makes collective decisions and takes coordinated collective action, when that is appropriate. But from another point of view, it is clear that much of the decision making and action taking of the community does not involve state-mediated collective action. Indeed, assuring that the state not interfere too much in the life of the civil community has been a central issue in Anglo-American political theory.

I argued earlier that one can see the economy as an aspect of community life. From this perspective, the economy is the term used to denote and focus attention on the activities of the community that use scarce resources to achieve human purposes. It is clear that much of economic activity in this broad sense does not involve markets, in the standard sense of that term. Indeed, socialists have not been alone as seeing markets as as great a danger to the civil community as the state.

Adam Smith is mostly known today, particularly among economists, for his *The Wealth of Nations*. There he stressed the value of the 'invisible hand' of market mechanisms. The orientation of his *Theory of Moral Sentiments* was quite different in a number of ways. There he stressed the extended empathy that humans in a community have for each other, along with, of course, feelings of rivalry, and sometimes of hostility. Extended empathy can be a powerful ingredient in a governing structure, and in some cases an ingredient that can be deemed vital for effective governance. But extended empathy is not what markets are about.

Thus, to pick up on an earlier theme, the family is the standard governing structure for child care, and for many other economic activities, not because of simple 'market failure', but because the family can be counted on (mostly) to hold the extended empathy towards its own and related children that seems essential to good care. Similarly, there are a wide variety of other activities involving members of the community where neither formal government nor markets play a central role in the governing structures, but rather neighborhood groups, voluntary associations, clubs, etc.

A quarter century ago Richard Titmuss made the argument that voluntary giving of blood was a far superior way of organizing blood supply than a system that paid people for giving blood.[9] The latter system, Titmuss argued, led to the obtaining of contaminated blood (for example from persons who had hepatitis) because the motive for giving was money rather than helping people, whereas the former system was to a considerable extent self-policing, because the motive for giving was a desire to help. The Titmuss thesis led to a rash of arguments about the limits as well as the advantages of extended empathy as a way to govern supply, as well as about the advantages as well as the problems of using the market. A similar argument today is playing out in a number of arenas.

The arguments about how basic scientific research should be organized that were discussed earlier are similar in spirit. The case of the opponents of market organization is that the incentives and culture of market organization are antithetical to the progress of science. And there certainly are those who disagree.

The state as protector of the community. Karl Polanyi was one of a long line of social analysts who saw the extension of markets as an enemy of society, a destroyer of communal modes of governance. This is not a 'market failure' argument. It is an argument that markets should be fenced off from certain kinds of activities.

The reality, but even more the myth, of the community structure that was undermined by market capitalism included first, that the community took care of its own, and second, that each community member, depending on his or her status, had certain rights as well as certain obligations. With the rise of the modern state, formal gov-

[9]The recently reprinted version of Titmuss contains several additional essays by contemporary writers that review the controversy raised by the original discussion.

ernment gradually took on responsibility for taking care of its citizens, and for guaranteeing their basic rights. Over time, arguments about the appropriate domain of such rights have moved from political rights, to economic rights.

Thus under traditional democratic theory, all citizens of a state ought to have the right to vote, to equal treatment under the law, and a variety of freedoms of action regarding personal matters. Access to these basic rights of citizenship were seen as something that should not be rationed through markets, and for which government had a fundamental responsibility. During the 19th century, government also came to be charged with protecting those who were regarded as too weak to protect themselves from market arrangements that would hurt them; thus child labor laws were passed, and laws limiting hours of work for certain classes of labor. A right of all citizens to a free public education, up to a minimal level at least, gradually came to be recognized. The core arguments of modern welfare state theories add to these venerable political and protective rights, a set of rights to access to certain kinds of goods and services. This decoupling of access to a considerable range of goods and services from normal market process is the hallmark of the modern welfare state.

For traditional liberals it is somewhat strange to hear arguments to the effect that the state is needed to protect civil society from the tyranny of markets. From this point of view the governmentally structured welfare state involves the foxes taking care of the chickens. In any case, it should be clear that, under the theory behind the welfare state the governance argument is not about particular market failures but about basic rights of humans in society, which is not the same thing. This latter point of view, of course, poses the challenging question of how one draws up the list of things that should be available to all, or rather how one makes the cut off.

Note that the issue here, and indeed the basic argument that government is responsible, has a family resemblance to that associated with the position that government is responsible for needed infrastructure. The difference is that the orientation is not so much to what is needed to make the economy work, as to what is needed to make a society viable. Also, note that in both theories there is a strong notion of collective values. While the base values in this theory are associated with individual well-being, the notion that society is simply a collection of individuals and families who have their own independent wants and purposes misunderstands this perception of what human societies are. Solidarity is a word often used by advocates of this position. From another (sometimes closely related) tradition, we all are our brothers' keepers.[10]

But, as the critics of the welfare state note, if much of the goods and services people want is made available to them as a right, then incentives for work, and for entrepreneurship, are damped. While the modern welfare state has damped down the political opposition to capitalism that Schumpeter feared would bring down the system, there is the threat here of killing the goose that lays the golden egg.

I want to conclude this section by noting, indeed highlighting, that the various

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[10]Esping-Anderson (1990) provides a broad and incisive picture of the modern welfare state in different countries. See also Goodin *et al.* (1999).

factors and arguments considered here militating against simple market governance are not simply creatures of the theories of particular social scientists. They are imbedded deep in prevailing folk theory about problems with markets, the appropriate roles of government in a democracy, and the needs of civil society. This part of general folk theory is at odds with that part that sees our economy as a simple market economy and likes it that way. Much of the current debate about where markets are and are not appropriate reflects this real tension.

Of course, from another point of view the issue here can be seen as determination of the appropriate domain of the economy, where market governance is the norm, versus the polity and the society, where other governance systems are the norm. But this formulation does not make the problem go away. There simply are no clean lines between these domains. Indeed their overlaps are large.

5. Capitalism as an evolving system

In my view, Karl Marx and Joseph Schumpeter had a sounder appreciation of the key virtues of capitalist economic organization than does modern neoclassical economics. They stressed the dynamic innovativeness of the system. I have argued that the organization and governance of the activities that give modern capitalism its dynamism is more complex than generally understood. In particular, important parts of the system involve non-market structures. However, clearly the pluralism and competition of market organization continue to provide a vital part of the power of the capitalist innovation engine.

As the examples used in this essay illustrate, in many cases innovations put pressure on prevailing governance systems, or themselves involve changes in these systems. I am following in an old tradition when I argue that devising new modes of economic organization, new governing structures, undoubtedly is the most difficult and painful aspect of economic change. Yet the problem is unavoidable.

Since a central aspect of a governance structure involves the mechanism that determines what interests and values count, it is easy to see why debate about appropriate governing structures often is contentious. And the question of who is responsible for supply, and under what set of rules, often involves contenders with strong interests in how that question is resolved. Reflect on the conflicts involved in proposals for a ‘patients’ bill of rights’ in dealing with managed-care organizations, or in proposals for a voucher scheme for publicly funded education in which private firms could compete for students.

The problem is difficult not just because of competing interests and values, but also because of real uncertainties, the better term might be ignorance, regarding the consequences of adopting one governance scheme or another. Given the analytic limitations of the social sciences, or the complexity of the subject matter, or both, it simply is impossible to foresee reliably the consequences of a patients’ bill of rights, or a voucher scheme for public education.

Further, for better or for worse, decisions that lead to the establishment of, and changes in a governance structure almost always are made in a highly decentralized manner, and much of the action is by private parties doing things they think are in their best interest. In many contexts, these actions amount to making or modifying a market. Thus the current modal structure and the range of variants of managed-care organizations are largely the result of decisions made by, on the one hand, organizations seeing potential profit in managed care, or striving to reorganize their managed care operation so as to make it profitable, and on the other hand, individuals and organizations with a responsibility to fund health care making their decisions regarding with whom to do business. As the example illustrates, the markets that emerge often are much more complex than the model in the textbooks. But the willingness of capitalist political economies to let change occur in large part through the initiative of individual parties, means that market structures tend to emerge or modify in response to new situations. This, of course, is the principle theme of Hayek and the modern Austrians.

In this case and others the evolution of public programs and policies are an important part of the story. Indeed the ratification of a governing structure or changes in it ultimately is a political decision, even if that decision is not to pass any new law. However, the way issues arise and are dealt with in a democracy, policy is made and remade piece by piece. Thus today the US Congress is treating the issue about patients' rights and the issue about coverage of pharmaceuticals costs as if they were separate issues. And there is a clear preference in such political processes where possible not to harm private initiatives.

Some analysts would blame the problems societies have had at developing coherent and effective governing structures for such areas as medical care, or the Internet, on this fragmentation. However, from another point of view this fragmentation and the serial nature of the policy making process has protected us from grand coherent plans, the reach of which extends well beyond what can be well predicted.[11] While *ex ante* analysis can serve to rule out certain proposals as obviously inadequate in certain areas, the development of governance structures for various activities has to rely to a considerable extent on evaluation of experience with attempts to reform.[12]

It would be nice if experience with prevailing systems and their variants provided sharp clear feedback of what is working and what is not, so as to guide the next round of adjustments. However, even putting aside that the interests and values of different parties might lead them to evaluate the same thing differently, and even where there is agreement that the current regime is unsatisfactory in certain ways, it may be extremely difficult to identify just what aspect of the current regime is causing the problem, or how to fix it. While *ex post* evaluation of a reform may be somewhat easier than *ex ante* prediction of the effects of that reform, it still is very difficult.

[11]The dangers of detailed planning, and attempting to carry out policy by plan, in contexts where understanding is limited, have been stressed by Hayek and by Lindblom.

[12]Rivlin's discussion (1971) of the failures of planning and the need for *ex post* evaluation of social programs is highly relevant in this context.

In such a context, a general broad belief in the efficacy of market organization undoubtedly is a plus. As I argued earlier in this essay, for a wide range of industries and activities hardly anyone is arguing that we should abandon the basic elements of market governance. And market organization has, in fact, served as an effective core governing structure over a wide range of activities.

However, I also have argued that there are two different facets of American folk theory bearing on the economic governance issue. On the one hand, there clearly is strong general faith in the efficacy of market organization. On the other hand, there is awareness and recognition, if usually on a case-by-case basis, that simple market organization does not always work well, and sometimes needs to be supplemented, or restrained, or even fenced out.

In the various cases brought up in this essay I believe that simple lean market organization is not going to provide an acceptable governance structure. My assertion here is a positive one, a prediction, rather than a reflection of my normative judgements, although obviously I am sympathetic with those who would protest simple market governance in these areas. My argument is that, despite the wide and strong hold of prevailing folk theory about markets, other parts of our collective belief system will cause a critical coalition to block simple market governance in these areas.

Some scholars of political economy would respond by saying they agree, sadly, that interest group politics is strong stuff in a democracy and that, as Theodore Lowi and Mancur Olson argued a long time ago, special interests can lead democratic societies to a set of policies that together make nearly everybody worse off. In a number of the cases above the interests resisting market organization are supplier interests. Thus public school teachers resist vouchers. Hospital doctors and administrators resist being faced with a set of rules and paper work requirements associated with being governed by a for-profit managed care organization. Pharmaceutical companies resist price regulation, or government policies likely to lead to that, for obvious reasons. And there are obvious particular user interests as well. People who need pharmaceuticals do not like paying high prices. Parents want access to quality ‘affordable’ child care.

But I believe there is more to these issues than special interests at odds with each other and with the good of society as a whole. There is good reason to be concerned about how to assure adequate care of infants and young children in a society that welcomes and values mothers in the workforce, and good reason to doubt that a satisfactory solution can be achieved through an unfettered market, although there surely are divides regarding how much and what kind of public finance and regulation are appropriate. Very few people who know anything about the matter believe that, with the improved ability of scientists to patent their results, government support of scientific research no longer is appropriate, although there is no consensus regarding where to draw the lines regarding funding responsibility, or regarding what should and shouldn’t be patentable. The question of how to govern, finance, organize, and regulate the American medical care system has been a bothersome issue for many years. Over the past two decades various attempts to introduce, or return to, more market elements have met with mixed success, and only a few zealots now argue that a pure market solution would be satisfactory here.

One can propose that the problems in these areas stem from the fact that they are not really standard economic activities, and therefore not ones where one should expect simple market governance to work well. From that point of view, the attempt to govern them through markets has been a mistake They clearly do not fit the simple economic model, and stand outside of the core economy, where markets generally are appropriate.

But a major point of this essay is that, if one looks closely, a wide range of human activities that employ a large share of the economy's resources diverge from what is considered standard economic activity. The lines between the economy and the polity and the society are not easy to draw cleanly. In many cases the debate is basically about whether a particular good or service should be considered an economic commodity, or something else. And often the argument is not about using the market alone or not at all, but about what mix of market and non-market governance is appropriate.

Also, some of the problem areas I have flagged would generally be regarded as at the core of the economy, by most people's conception. As noted earlier, while no one is seriously arguing that the market be completely abandoned as part of the governing structure for the electrical and telephone systems, there are serious arguments about how much regulation is needed, and reason to believe that some of the deregulation that has been done was misconceived. The Internet came into being based on technologies the government largely had funded, and has developed since then largely on the basis of entrepreneurial, market-oriented private initiatives. No one is arguing that the market not be an important part of the governance structure we end up adopting for the Internet. On the other hand, many in the current system are fiercely protective of their free market rights, and resentful of even the hint that some regulation, or maybe a lot, is needed. But such regulation is coming. The question is, what kind and when?

For these and the other examples used in this essay, and many other cases of the same ilk, the option of simple market governance is simply unrealistic. Strong articulation of that as a real alternative will make it more difficult to arrive at a satisfactory governance structure, but a simple market one will not be acceptable. Given that market organization in fact is an effective governance structure for a wide range of economic activity, there is broad value in a folk theory that strongly supports market organization as a general norm. However, it would help if the way we understood our economic system recognized how variegated it really is, and were more sensitive not simply to the strengths, but also the complexities and limitations of markets.

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Some readers will recognize that I am revisiting here some of the issues I discussed nearly a quarter-century ago in my *The Moon and the Ghetto*. My point of view here has many overlaps with those expressed by Hodgson in his *Economics and Utopia*, by Kuttner in his *Everything for Sale*, and by Lindblom in his *The Market System*.

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