Economists and the Analysis of Government Failure: How Cambridge Did and Did Not Anticipate Chicago and Virginia

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I. Introduction

The year 2010 marks the 50th anniversary of the publicatoin of Ronald Coase's classic essay, "The Problem of Social Cost" (1960). Coase's goal in this article, and in subsequent works such as "The Lighthouse in Economics" (1974), was to point out what he considered to be the fundamental flaws in the neoclassical theory of market failure. These flaws took several forms, but central to Coase's critique was the idea that economists neglected to seriously consider the ability of government to carry out the policies of market failure correction contemplated by the economists' theories, a neglect that was fundamental to any analysis of regulation. Coase summed up these sentiments in his assertion that in economic analysis "we find a category 'market failure' but no category 'government failure'" (1964, p. 195). Significantly, Coase laid much of the fault for this at the feet of A.C. Pigou and the larger Cambridge welfare tradition, the tradition in which neoclassical welfare economics—including the theories of externalities and public goods—was grounded (Coase 1960, pp. 28-42; Coase 1974, pp. 357-60, 372-76).

"The Problem of Social Cost" was an early salvo in the "government failure" literature, fundamental to much work on the economic analysis of law, that developed in part as a response to or reaction against a perceived shortcoming in welfare economics: the absence of a theory of governmental behavior that would work in tandem with the extant theories of consumer, producer, and market behavior.[1] The lack of such a theory, it was argued, led economists to commit what Harold Demsetz (1969) labeled the "nirvana

[1] The exceptions generally noted here are the work of Knut Wicksell (1896) and the Italian public finance tradition, which embodied models of government behavior, both efficiency-oriented and "failure"-oriented. On the Italian school, see, for example, Buchanan (1960) and Medema (2005).

fallacy"—comparing existing (imperfect) institutions with what an idealized government could achieve and from this deducing that government can perfectly resolve market imperfections. James Buchanan saw this problem as pervasive and, like Coase, linked it to the Cambridge school: "Since Sidgwick and Marshall, and notably since Pigou's *The Economics of Welfare*," he said, "economists have accepted the presence or absence of external effects in production and consumption as a primary criterion of economic efficiency" and suggested that these inefficiencies "can be reduced or eliminated by the shift of an activity from market to political organization" (1962, p. 17). Buchanan went on to argue that the various governmental policy measures advocated by economists are "[i]n almost every case … assumed to be within the realm of the genuinely attainable" and that objections to this on political grounds are met with the response that the economist's task "is not that of the politician, that he does not appropriately concern himself with the political feasibility or workability of his proposals" (1962, p. 18).

It is no accident that both Buchanan and Coase refer back to the Cambridge school, given its central place in the development of neoclassical welfare theory. Indeed, Cambridge has long been portrayed as the interventionist counterpart to the more market-affirming Chicago and Virginia schools. While there is indeed plenty of evidence that neoclassical welfare theory was often guilty of the nirvana fallacy,[2] there is good reason to question the accuracy of applying these sentiments, as Coase and Buchanan did, to the originators of the Cambridge tradition—Henry Sidgwick, Alfred Marshall, and A.C. Pigou—and their views of the political process.[3] What we will argue here is that the

[2] See, for example, the surveys of externality theory in Mishan (1971) and of externality and public goods theory in Cornes and Sandler (1996).

[3] We leave aside Keynes because, though he was in many ways a true product of the Cambridge tradition, sharing many of the values of those considered here, our focus is on market failure and welfare theory, and Keynes's inclusion thus would raise a host of additional issues, consideration of which would detract from the main thesis of the paper.

central texts of the Cambridge tradition evidence a clear sense of the potential limitations and inefficiencies of the political process that were later developed, albeit in more systematic fashion, in the government failure literature, and in law and economics and public choice analysis in particular. In doing so, we will show how the criticisms of the Cambridge approach for failing to deal with the political process are misguided and at the same time show how and why the Cambridge view diverges from that associated with the Chicago and Virginia schools, in spite of their strong similarities.

The issues raised here go beyond the history of economic analysis. The current economic situation has led economists and policymakers alike to question the ability of markets to satisfactorily coordinate self-interested behavior in a variety of contexts, and with this have come calls for increasing government oversight of the market and a revisiting of the approach to public economics and welfare theory that dominated economics for much of the twentieth century. What is often missing from these discussions, however, is the concerns about state action that were central to the early working out of neoclassical welfare analysis—concerns that were subsequently lost in the elaboration of the post-war theory of market failure.

II. Sidgwick's "Choice of Evils"

Henry Sidgwick stands at the headwaters of the Cambridge welfare tradition. He took John Stuart Mill's classical utilitarian framework for the analysis of market failures and gave it a marginalist cast while at the same time offering a different view of the role of the state in response to situations of market failure.[4]

[4] A comparison of Mill and Sidgwick's respective treatments of market failure and the economic role of government can be found in Medema (2007a); see also Medema (2009a, chapter 2). Sidgwick also applied the utilitarian calculus to crime and punishment and so is something of a bridge between the work of Bentham and that of Gary Becker. See Medema (2007b).

In his essay on "Economic Socialism" (1886), Sidgwick identified two basic categories of market failure: those instances where the pursuit of self-interest does not generate the wealth-maximizing result, and those situations in which self-interest *does* generate the wealth-maximizing result but in which that result is inconsistent with the larger social interest.[5] For Sidgwick, however, the fact that market outcomes are not always wealth-maximizing or otherwise in society's best interests did not in itself mean that government intervention is necessarily the best course of action. "[I]n human affairs," he said, "we have often only a choice of evils," and while private activity may yield less than satisfactory results at times, "it is possible that governmental interference might on the whole make matters worse" (1886, p. 206). Sidgwick expressed a similar sentiment in his *Principles of Political Economy*: "It does not of course follow that wherever laisser-faire falls short governmental interference is expedient; since the inevitable drawbacks and disadvantages of the latter may, in any particular case, be worse than the shortcomings of private enterprise" (1901, p. 414).[6]

In support of this view, Sidgwick pointed to several "drawbacks and disadvantages" associated with government intervention.[7] First, the expanding scope of governmental operations adds to the patronage possibilities at the disposal of government agents, and this, in turn, raises "the danger of increasing the power and influence capable of being used by government for corrupt purposes" (1901, p. 414).

Second, legislative actions are heavily influenced by the desire to please special interests groups, which leads to "the danger … that the exercise of [the legislature's] economic functions will be hampered and perverted by the desire to gratify influential

[5] Elsewhere, Sidgwick (1901, Book III) elaborated an extensive list of such market failures.
[6] The first edition of Sidgwick's *Principles* was published in 1883.
[7] See also Sidgwick (1897, pp. 167-68).

sections of the community—certain manufacturers, certain landlords, certain classes of manual laborers, or the inhabitants of certain localities" (1901, p. 414).

Third, Sidgwick questioned the ability and willingness of legislators to govern in the national interest, particularly in light of his belief that politicians take positions to attract votes, rather than seeking votes based on exogenously determined positions. Sidgwick's discussion brings to mind the concept of the vote-maximizing politician and the pork barrel process when he says that

> when legislation is in the hands of a representative assembly, the more the functions of government are extended in a socialistic direction, the greater becomes the risk that contested elections will exhibit an immoral competition between candidates promising to procure public money for the benefit of particular classes and districts (1897, p. 167).

Note that Sidgwick was also making what amounts to the Leviathan argument here—that the growth of the state feeds on itself to promote more growth via the competition for votes in the political process.

Sidgwick was also concerned about the influence of imperfect information on the political process. He was critical of what he called "wasteful expenditures" made "under the influence of popular sentiment."[8] Here, he argued, legislators can exploit voter myopia in order to garner support from the electorate at low cost. The basic problem, said Sidgwick, is one of information and perspective: the general population, "however impatient of taxation, are liable to be insufficiently conscious of the importance of thrift in all the details of national expenditure" (1901, p. 414). He also said that people are much more likely to know what is in their best interests, and to undertake courses of

[8] Sidgwick did not provide us with a definition of "waste," a concept which has a fairly precise meaning in the modern public choice literature. As such, the modern definition may or may not apply here.

action to facilitate that, than is Government (1897, p. 144). And even as progress in society was introducing a degree of complexity that could make it more difficult for individuals to discern what is in their best interests, Sidgwick was not confident that government could do any better (1901, pp. 416-17).[9]

While Sidgwick tended to focus on potential problems within the political arena, he was not unaware of those associated with government bureaucracy. He expressed particular concern about the inefficiencies that come with the continued expansion of the range and complexity of government activities, especially on the supervisory front (1901, p. 414). Sidgwick also pointed to the lack of incentives for government workers to properly carry out the functions assigned to them: "the work of government," he said, "has to be done by persons who—even with the best arrangements for effective supervision and promotion by merit—can only have a part of the stimulus to energetic industry that the independent worker feels." Private sector workers "may reasonably hope to gain by any well-directed extra exertion, intellectual or muscular, and most fear to lose by any indolence or neglect," whereas these stimuli are largely lacking in the public sphere (1901, p. 415).[10]

So, while Sidgwick did point to a fairly wide range of phenomena that he considered market failures, he came down in the end saying that, "on the whole, there seems no doubt that even where the defects of *laisser faire* are palpable and grave, they may still be outweighed by the various disadvantages incident to governmental management of industry" (1901, p. 416). Reflecting the marginalist framework within

[9] Sidgwick cited as an example here sellers pedaling products that seem useful but really are not, and that consumers would not tend to purchase if they had good information about the products.
[10] Sidgwick went on to say, though, that this also applies to joint stock companies, and he even suggested that government may have better means than some private concerns to get around these incentive problems, in that it has the ability to "reward conspicuous merit by honours and distinctions," as well as offering greater employment security (1901, p. 415).

which he was operating, Sidgwick contended that the various "costs" that he has pointed to must be weighed against the benefits to determine the appropriateness of government intervention. And, even when intervention *is* in the public interest, this interference, he said, should be as mild and as narrowly drawn as possible while still accomplishing its set goal.[11]

Although Sidgwick raised many issues central to modern public choice concerns, he parts company with the modern view when he suggests that there is good reason for long-run optimism regarding the possibilities of government intervention. Sidgwick believed that "moral and political progress [in society] may be expected to *diminish*" the extent and severity of the shortcomings that he has been discussing (1901, p. 416, emphasis added), which will increase over time the range of activities that government can carry out in a manner superior to market forces. While Sidgwick is silent on the specifics here, the background to this hope was presumably the British experience of reforming the Civil Service by measures such as recruiting through competitive examinations. The accuracy of Sidgwick's optimistic prognostication—which, as we shall see, was later echoed by Marshall and Pigou—is beside the point for present purposes. What matters is that Sidgwick is here arguing that the appropriate scope for government action depends on the government's competence: in short, he is not viewing the government as an omniscient maximizer of social welfare.

[11] Political considerations are also in the background to Sidgwick's discussion of redistribution of income. He offers utilitarian arguments for egalitarian redistribution but draws back, on the grounds that once the government had embarked on this, it would likely be taken too far (Sidgwick, 1901, p. 565).

III. Marshall and "the Money Value of Political Power"

In contrast to Sidgwick and Pigou, Marshall did not devote a great deal of attention to the theory of economic policy. As a consequence, his remarks on the role of the political process in economic affairs were usually written in response to concrete issues of policy on which he decided to comment or offer advice. As trade policy and socialism were very much in the air during Marshall's professional life, it is perhaps not surprising that a goodly amount of his commentary on the role of the state takes place against these backdrops.

Marshall believed that the expansion of industry and trade since the middle ages had both positive and negative implications for the ability of government to be able to manage economic affairs in the public interest. On the positive front, given the vast expansion of economic activity during this period, "The *possible* functions of Government expanded almost obtrusively in many directions" (ibid). On the other hand, we did not see a corresponding expansion of state action because "the great increase in the complexity of the problems of industry" was accompanied, "for the time at least," by only a "small an increase in the mental capacity of Government for dealing with them" (1923a, p. 42).

A second effect of economic progress, according to Marshall, was that it put the common people in a position where they were "not very far inferior in shrewdness, and constructive ability to the ruling classes" (1923a, p. 42). The practical import of this development was that the advantage the common man had over government officials because of "the more intimate knowledge possessed by each of his own circumstances, and the technical problems of his own work" was only increasing. This, said Marshall, made it likely that industry and trade would develop most advantageously if left to take their own course (1923a, p. 42). This increase in the capabilities of the common people relative to the ruling class brought about “a slow increase in the power of the people to govern the Government that governed them” and thus provided some degree of check on state action (1923a, pp. 42-43).

Like Sidgwick, Marshall claimed that “Almost every extension of Government activity brings with it good and evil, both economic and political” (1923a, p. 496). What particularly concerned him were politically motivated proposals for significant changes in economic policy. These, he said, “are likely to bring about results which will not be satisfactory from the economic point of view, and will perhaps introduce morbid elements into politics.” The chief problem that Marshall saw arising from the interplay of economic and political forces was the incentive for corruption, which was a recurring theme in his discussion of the political process. For example, in a memorandum prepared for the Treasury on trade policy in the early 1900s,[12] Marshall said that he had learned from his 1875 visit to the U.S. that protection was in practice very different from the ideal described by protectionists. Protective policy became intricate, and “in becoming intricate it became corrupt, and tended to corrupt general politics” (Marshall 1926, p. 394).[13] He considered that this “moral harm far outweighed any small net benefit” (ibid). In England, by way of contrast, Free Trade had reduced “the money value of political power,” a process that would have been reversed had the movement for Tariff Reform (raising tariffs so as to be able to offer preferential treatment to the Empire) been successful (Marshall 1926, p. 395).

[12] The history of this document, the first draft of which was lost in the mail, is discussed by Groenewegen (1996). It was concerned with issues of imperial preference and the use of tariffs as a weapon in bargaining with other countries (Groenewegen 1996, p. 300).

[13] This is repeated verbatim in Marshall (1923b, pp. 219-220).

In fact, Marshall seems to have considered corruption endemic to trade policy. Rent seeking was certainly a culprit, as those who stood to gain from such policies tried to manipulate policy making to their benefit. These policies also impacted the officials who administered them by "increas[ing] their temptations to use public authority for the purposes of private gain" (1923a, p. 43). Marshall believed that tariffs were imposed to do little more than gratify powerful interest groups (1926, p. 379), and this underlies his emphasis that protection, once imposed, was difficult to remove (Marshall 1923b, pp. 218ff). Indeed, the historical record convinced Marshall that such problems were nearly impossible to avoid, and that corruption tends to increase when there is "much money to be gained by political influence" (1923a, p. 43). So strong were Marshall's feelings on this score that his policy recommendations in support of free trade rest not on the theoretical apparatus he built to analyze trade, but on government failure arguments.

Marshall's discussion of the nationalization of the railways provides an excellent illustration of his concerns about the problem of rent seeking.[14] Marshall points out that, under nationalization, rank and file railroad workers will be able to exert so much pressure through the voting booth that "political considerations" will govern decisions when those decisions ought to instead be made on "technical grounds." In such cases, the "the interests of the population as a whole" will be wrongly sacrificed to the special interests of one segment of the population (1923a, p. 494).[15] Part of the problem here is that the political motivations of legislators are an impediment to sound policy, as legislators are controlled not by their constituents but by powerful interest groups

[14] Marshall's discussion of the nationalization of railways relies heavily (and approvingly) on a paper read by Mr. Acworth at the 1912 Congress of the Royal Economic Society.

[15] He contends that the owners of the railroads will benefit because "the State seldom buys a property without paying more for it than it is worth," and the owners know this. Moreover, railway officials have no cause for worry because most of them will end up with salaries that are at least as high and positions that are somewhat more prestigious (1923a, p. 494).

(Marshall 1926, p. 396).[16] However, it is not only the politicians who are to blame, according to Marshall, nor is he ambiguous about the results: "If particular groups of the people look on the polls, as opportunities for advancing their own sectional interests, rather than for rendering an upright and dutiful service to the State, the Mother of all," he says, "then the nation as a whole will become less noble, weaker and ultimately poorer …" (1923a, p. 495).

Like Sidgwick, Marshall also expressed concern about problems raised by the presence of imperfect information on the policy front—in particular, politicians' habit of exploiting informational asymmetries for their own benefit, especially via the masking of costs. He felt that politicians tend to shade the truth, selecting facts which fit their case but ignoring those that support the other side, in order to have their way without losing the support of the electorate. This, according to Marshall, is one of the factors that distinguishes the politician from the businessman, for whom *economic* factors are dominant. For example, there are certain risks which businessmen will take into account, but which are "apt to be neglected" when political considerations dominate economic ones (1923a, p. 496).

Marshall also lamented the propensity of legislators to put into place policies where the costs are spread sufficiently widely so as not to attract notice, even as the benefits are concentrated among a small group of interested parties:

> Unfortunately the experience of many centuries shows that a policy, which will confer a considerable benefit on each of a compact group of traders or producers, will often be made to appear to be in the interest of the nation; because the hurt wrought by it, though very much greater in the aggregate

[16] Marshall cites the German Reichstag as an example of this problem.

> than the gain resulting from it, is so widely diffused that no set of people are moved to devote much time and energy to making a special study of it. Its advocates speak with zeal and the authority of expert knowledge. But they are bad guides, even if unselfish and perfectly upright: for a policy that makes for their peculiar profit is invested in their eyes with a deceptive glamour.
>
> (Marshall 1917, pp. 329-30)

Policy-related costs, then, are often underestimated by the public because they are not obvious. Marshall sees this occurring on the trade policy front, where one of several reasons why inappropriate tariffs would be levied is that it is easy to know who benefits from a tariff, whereas those who suffer are harder to identify (1926, p. 390). Not surprisingly, Marshall believes that government is more likely to be "vigilant" when costs are easily traceable than when they are not (1923a, p. 671). He suggests that State management has the most to offer in areas consisting of "routine operations" that are carried out very much in the public view, and where there is little capital expenditure, so that expenses and actual undertakings correspond very closely—such as with the postal service (1923a, p. 668).

It is not just politicians/legislators who are the subject of Marshall's concern; he also identified several reasons why government bureaucracies produce undesirable outcomes. The first was that the Minister who is charged with overseeing a particular bureau, and upon whom final decision-making power rests, is also someone whose "knowledge of the technique of his Department is seldom so great." These officials have many other duties to occupy their minds and need to spend a great deal of effort on political machinations relating to policies that will maintain or enhance the position of their ministries. While this work is important for the Minister and for his ministry, says

Marshall, “in regard to his responsibilities as head of a vast business it is a grievous, if not disastrous hindrance” (1923a, p. 666). As a result, these Ministers are more likely than their private-sector counterparts to rely on the recommendations and advice of their subordinates. The private sector leaders, in contrast, devote all off their efforts to a more narrow set of issues concerned with their particular business (1923a, p. 666).

A second bureaucratic problem identified by Marshall is that the rank of the bureaucrats—the subordinates on whose advice the Ministers rely—is largely determined by seniority rather than ability. Marshall suggests that the seniority system was put into place because of fears that political influence would govern promotion absent a codified system like seniority (1923a, p. 496). Nor was Marshall optimistic that the situation would change, as, in his estimation, those who benefit from the seniority system see its advantages for themselves, and they weigh these personal advantages more heavily than the shortcomings that impact society as a whole (1923a, pp. 666-67).

Third, political control over bureaucracies and the ability to effectively monitor bureaucratic activities is often weak, and legislators will tend to rubber stamp bureaucratic decisions (Marshall 1923a, p. 670). And, he said, when politicians did attempt to exercise oversight over the bureaucracy, their motives—gaining votes from their constituents—and thus the results, were something less than optimal (Marshall 1890, p. 275) This, according to Marshall, would tend to produce “political immorality” (ibid, p. 276).

When one combines Marshall’s concerns about the behavior of politicians with his suspicions about the functioning of the bureaucracy it should come as no surprise that he believed that Government action was inimical to progress. Indeed, it was private enterprise, not government, that had been responsible for rising productivity, he said. This was a view that Marshall expressed on multiple occasions and in very strong terms. Witness this statement, from his 1907 essay on "Economic Chivalry":

> Government creates scarcely anything. If Governmental control had supplanted that of private enterprise a hundred years ago, there is good reason to suppose that our methods of manufacture now would be about as effective as they were fifty years ago, instead of being perhaps four or even six times as efficient as they were then. (Marshall 1907, p. 338)

For someone attracted to socialism,[17] this was a remarkably blunt and unambiguous statement. Why Marshall took this position is evident from his commentary on the possibility of nationalizing the railways, discussed above.

What gives Marshall's discussion of these issues an air that seems dated in relation to modern government failure theory is his emphasis on the variability of human character and the ability of men (he normally meant men, not women) to rise above narrow considerations of self-interest. Marshall believed that the environment strongly influenced character, and that some men could be trusted to act in the public interest, whereas others could not. Marshall saw the pervasiveness of corruption playing a major role in Adam Smith's (1776) suspicions regarding state action and spoke directly about the low moral state of government in Smith's time. However, said Marshall, Smith "had no means of anticipating the vast increase in the resources of Government, and in the honesty of public officials which began in the nineteenth century" (1923a, p. 45).[18] During Mill's lifetime, "the probity, the strength, the unselfishness and the resources" of government increased (ibid., p. 335), enabling it to do more. Causes of this included

[17] See, for example, Marshall's letter to Lord Reay of November 12, 1909 (in Pigou 1925, pp. 461-65).

[18] Marshall goes so far as to suggest that "Adam Smith's doctrine, carefully interpreted, supports [government's] active intervention in many affairs in an age in which it has acquired the power and the will to govern the people wisely; and the people have acquire the power and the will to govern their Government with knowledge, discretion and restraint" (1923a, p. 719).

Parliamentary reform (ending what historians know as "the Old Corruption"), the spread of religious zeal, the improvement and spread of literature, and even the rise of co-operation.

Marshall contended that the ability of government to beneficially intervene increased at an even more rapid clip after Mill's death. In addition to the spread of general education and "a general surplus of energy over that required for earning a living" (1907, p. 336), Marshall pointed to technological factors such as "shorthand reporting, the electric telegraph, and the improved printing press," which, he said, "have given strength to the general movement towards higher ethical standards." This, in turn, "has been steadily cleansing Parliament, and invigorating Governmental departments (Marshall 1926, p. 395). Good communications and the free flow of information, then, reduce the potential for corruption.

Thus, said Marshall, we have come to a point at which "the power of the people to govern the Government that governed them … was destined to become so large and far-reaching, that many tasks may now reasonably be entrusted to Government in the twentieth century which would have been grossly mismanaged in the first half of the nineteenth: thus a certain new tendency to a widening of the appropriate functions of Government gradually set in" (1923a, pp. 42-43).

The problem, according to Marshall, was that, though the potential for government had increased, the complexity of the tasks facing it had increased even further. Moreover, all of these advances in governance and Marshall's optimistic view of the possibilities offered by them do not seem sufficient to overcome what seemed to him almost inherent problems in the operation of government. In spite of all of these gains, he says,

> it seems to remain almost as true now, as in former times, that the heavy hand of Government tends to slacken progress in whatever matter it touches; and finally that 'business influences are apt to corrupt politics; and political influence are apt to corrupt business.'" (1923a, p. 672)

While some believed that committees made up of experts could rise above these problems, Marshall argued that even using expert committees does not guarantee the best results, in that these committees will take outside advice, and this advice often reflects biases and vested interests (1923a, p. 671).

IV. Pigou and the "*Prima Facie* Case" for Intervention

Though Sidgwick and Marshall played an important role in developing the analysis of market failure that became central to neoclassical welfare theory, the analysis reached full flower in the work of A.C. Pigou, whose *Wealth and Welfare* (1912) and *Economics of Welfare* (1920/1932) provided the foundation upon which the modern theory of market failure was erected. Pigou's case for government intervention is well known: it was first laid out in *Wealth and Welfare* and repeated in his subsequent writings on the subject. It subsequently became the target of criticism by Coase (1960) and others. The most well-known statement of the case comes from *Economics of Welfare*, where Pigou said that "[i]n any industry, where there is reason to believe that the free play of self-interest will cause an amount of resources to be invested different from the amount that is required in the best interest of the national dividend, there is a *prima facie* case for public intervention" (1932, p. 331). The question, of course is what this actually implies for policy.[19]

[19] See also Pigou (1935): When "private self-interest, acting freely, subject only to the ordinary forms of law, does not lead to the best results from a general social point of view, there is … a *prima facie* case for

The political element weighs heavily for Pigou in determining whether and how the *prima facie* case translates into practice. Pigou touched on this briefly in *Wealth and Welfare*,[20] noting that "The case … cannot become more than a *prima facie* one, until we have considered the qualifications, which governmental agencies may be expected to possess for intervening advantageously in this class of matter" (1912, p. 247). Pigou sounds a theme later emphasized by Coase[21] when he argues that idealistic characterizations of government are not helpful in evaluating these qualifications:

> It is not sufficient to contrast the imperfect adjustments of unfettered private enterprise with the best adjustments that economists in their studies can imagine. For we cannot expect that any State authority will attain, or even whole-heartedly seek, that ideal. (1912, p. 248)

He cited sectional interests, corruption, and politics as factors that would cause policy to fall short of the ideal given by theory. In an essay on "State Action and Laisser-Faire," Pigou elaborated on the implications:

> In order to decide whether or not State action is practically desirable, it is not enough to know that a form and degree of it can be conceived, which, if carried through effectively, would benefit the community. We have further to inquire how far, in the particular country in which we are interested and the particular time that concerns us, the government is qualified to select the right form and degree of State action and to carry it through effectively. (1935, p. 124)

Ascertaining the qualifications of government, in turn, has several components.

State action" (1935, p. 124).

[20] It is repeated almost verbatim in *Economics of Welfare* (1932).

[21] See, for example, Coase (1966, p. 100; 1988, pp. 19-20, 28-30).

First, the attitude of the citizens toward government action is of great import, as any actions are more likely to be effectively implemented and carried out if they have substantial public support. Second, there is the issue of the "quality" of the decision-making body that will be determining the form and extent of state action. At this point one can hear in his remarks strong echoes of Marshall's and Sidgwick's skepticism about the capabilities of the state to successfully resolve these market failure problems. Pigou said that the quality of the decision-making body will be a function of:

> the intellectual competence of the persons who constitute it, the efficacy of the organisation through which their decisions are executed, their personal integrity in the face of bribery and blackmail, their freedom from domination by a privileged class, their ability to resist the pressure of powerful interests or of uninstructed opinion (1935, p. 125).

The basic problem, according to Pigou, is that "Every public official is a potential opportunity for some form of self-interest arrayed against the common interest" (1912, p. 248). The financial stakes that accompany many policy proposals are incredibly high and make "Logrolling and lobbying" "powerful forces" that "are certain to be called into play" (1935, p. 126). Because of this, politicians are "subject to great pressure from persons who can control votes," a problem that is made all the more difficult by the fact that the lobbying groups are also the sources of politicians' campaign funds (1912, p. 248). Moreover, the growth of government enterprises generates substantial new bureaucracies and "the employment of tens of thousands of additional public servants," which, in turn, means increased patronage for party leaders (1912, p. 248). All of this makes the quality of the individuals who make up the governing body of the utmost import for sound policy. Unfortunately, says Pigou, the unseemly aspects of interest-group pressure tend to deter upright people from entering politics, which only serves to further loose the forces of corruption. The results of the political process thus will likely be skewed, in that the efforts of the state are “most likely to be invoked successfully by the strong,” regardless of what is actually in the best interests of society (1935, p. 126).

For Pigou, it is practical concerns of a political nature, rather than “any abstract plea for laisser-faire in matters of trade,” that speak most loudly against government interference. This is nicely illustrated in his discussion of public versus private management of industry. Public management, he said, would generally be less efficient than private management: commercially weak public enterprises would be protected from competition, perhaps by subsidies; public managers would take too few risks; and public enterprises will not be the optimal size, for their size will be determined by the size of the political units running them (1912, pp. 277, 281, 284). These problems with public enterprise have to be balanced against the inefficiencies likely to arise under monopoly or monopolistic competition and the difficulty of balancing supply and demand when there is government regulation of private industry (1912, p. 288).

Pigou followed Marshall in believing that, although government in Adam Smith’s day was corrupt, inefficient and capable of achieving little, the 150 years since Smith had seen the rise of “governing authorities … enormously better equipped for successful action” (p. 126). Referencing Marshall’s “Economic Chivalry” essay, Pigou attributed this at least in part to increased levels of education and to the “surplus energy” that was made possible by increases in the technology of production, and he praised both the Civil Service for its “high capacity and unquestioned public spirit” and the politicians for their absence of personal corruption (p. 126).[22]

[22] See also Pigou (1912, p. 249).

Yet, while the quality of the individuals serving on the political front was improving, Pigou was not so naïve as to suggest that governing bodies had reached anything like perfection. In particular, he pointed to four shortcomings that characterize representative assemblies. First, elected officials are chosen for a host of reasons unrelated to economic regulation, and there is thus little reason to expect that they have any particular competence for intervening in industry. Second, the make-up of these assemblies tends to fluctuate a great deal over time, depriving society of the benefits of experience and, with that, what may be more desirable levels of policy continuity. Third, municipal size and appropriate economic size may be vastly different and thus attempting to set up a public enterprise on the same scale as the municipality may lead to major inefficiencies. Finally, these assemblies are political in nature and thus subject to "injurious forms of electoral pressure" of the types we have mentioned above (1912, pp. 249-50).

While the legislative option is problematic, Pigou argued repeatedly that recent advances in governance structures offer a way around these problems.[23] Specifically, he argued that quasi-governmental entities—he mentioned Public Service Boards and Commissions—that are not directly subject to political control offer a means of avoiding some of these problems that was not present in times past. While members of general governmental bodies are elected for a host of reasons often unrelated to the regulation of industry, the specialized boards and commissions offer the opportunity to appoint members whose abilities are well-suited to the regulation of industry. The continuity problem and the influence of electoral whims can be resolved by appointing these individuals for longer terms of service than are standard for elected officials. This would

[23] See Pigou (1912, p. 250; 1932, pp. 333-35; 1935, p. 127).

have the further beneficial effect of insulating them from electoral pressures (1932, p. 333-35; 1935, p. 127). In *Wealth and Welfare* (1912, p. 249), Pigou said that “This important fact implies that there is now a greater likelihood of interference, in any given case by any given governmental authority, proving beneficial than there was in former times.”

V. Conclusion: After Cambridge, Why Chicago and Virginia?

The government failure movement was born in part as a reaction against neoclassical welfare economics. The charge was that the neoclassical approach put forth an interventionist program on both the micro and macro sides while lacking any theory of the political process. As such, the analysis neglected to account for the difficulties that attend the policy-making process, and which could render such interventions damaging to the public interest. What we have shown here is that this caricature is largely erroneous as regards the Cambridge school, which, partly because of Coase’s critique of Pigou, has come to be seen as the most significant exemplar of neoclassical welfare economics.[24] From Sidgwick, through Marshall and Pigou, we see neither a neglect of government nor the portrayal of an omniscient and beneficent government that will deftly right the perceived wrongs of the market. Rather, the Cambridge school evidenced a profound awareness of the potential pitfalls of and inefficiencies associated with the political process, including those related to logrolling, special interests, rent seeking, bureaucratic behavior, and the like. Where the Cambridge approach parts company with Chicago and Virginia is in their optimism regarding the improvability of government, grounded in the potential offered by certain reforms in the institutional structures of political decision

[24] The unfamiliarity of this claim is the reason why we have documented our paper so heavily with quotations.

making. There was a strong sense that these reforms had, through the nineteenth century, facilitated efficiency by mitigating certain of the problems associated with the political process.[25] However, Sidgwick, Marshall, and Pigou never confused improvability with the possibility of reaching a social optimum.

Interestingly, the Cambridge optimism about the improvability of government has its parallels in Adam Smith. Smith, of course, was very critical of the politicians of his day, and many of his criticisms are echoed in both the Cambridge tradition and contemporary government failure theory. Smith did not, however, see this as an inevitably permanent condition; rather, he felt that behavior could be improved via education. As George Stigler has put it, Smith's "attitude toward political behavior was not dissimilar to that of a parent toward a child: the child was often mistaken and sometimes perverse, but normally it would improve in conduct if properly instructed" (1971b, p. 142). Stigler, who considered the self-interest assumption a hallmark of the *Wealth of Nations*, chastised Smith for apparently failing to recognize that political agents, too, are self-interested in their behavior, and that the link between self-interest and political decision making is not severed by education. In essence, Stigler was criticizing Smith for not being a prototype public choice economist.[26]

Stigler's criticism of Smith offers some insight into why the contemporary theory of government failure does not share the Cambridge school's optimism regarding the possibilities for government, even though the spread of education and the various governance-improving reforms pointed to by Sidgwick, Marshall, and Pigou are very

[25] It bears noting that the rationale behind this sentiment, too, evidences a recognition of the types of incentive-alignment issues that were later to concern law and economics and public choice scholars.
[26] Stigler was not willing to allow that Smith's failure here could be explained by the fact that everyone else, too, looked at political behavior in non-self-interested terms; Smith, he says, "is a better man than everyone else." (1971b, p. 143), and so should be above such slip-ups. We take no position here about whether Stigler is correct in his beliefs about the role of self-interest in Smith's system, but see Medema (2009b) for a discussion of the heterogeneity of Chicago views of Smith on this score.

much in evidence today. At the heart of the matter is the current view of agents—including those operating in the political sphere—as rational maximizers. Rational maximization is said to pervade political behavior, and this basic motivation is not affected by education, position, or circumstance. The Cambridge economists, in contrast, operated with a different view of the individuals involved in government and private economic institutions. This view is not formalized and hence their results appear to modern economists to be inadequately theorized.[27] Where the modern theorist sees agents as rational maximizers, the Cambridge economists, and above all Marshall, saw human motivations as heterogeneous and formed by the environment in which men found themselves. What the Cambridge literature essentially posits is politicians who are subject to pressures because of their place in the electoral process. While not denying that self-interest is a fundamental human motivation, it was thought that education and moral values could cause men to take decisions that were in the public interest—though this process was not completely reliable. We can see this non-homogeneity of motivations in Pigou's discussion in *Wealth and Welfare*. Having laid out his views on the shortcomings of political agents and processes, he goes on to say that "The force of this argument for non-interference by public authorities is, clearly, not the same at all times and places, for any given kind of public authority will vary in efficiency and sense of duty, with the general tone of the time" (1912, p. 249), It was an elitist view, where educated, Anglo-

[27] Marshall, the dominant figure in the Cambridge School, made it clear that the scope for formal theory was very limited, and that it was unsafe to draw policy conclusions from it. The Cambridge School's analysis of the political process and its effects on policy, therefore, did not rest on formal analysis, and they also did not use the theoretical models and techniques that have allowed public choice economists to reach more clear cut conclusions—the same models and techniques, ironically, that neoclassical welfare economists used to "demonstrate" market failure. It is not clear how far this is because they did not have access to the theoretical techniques on which contemporary government failure results rest, or because they chose not to make the assumptions that these results would require.

Saxon men were seen as able to achieve things that other races and classes were not able to achieve, a view that is rightly alien to modern economics.[28]

The Cambridge optimism about the prospects for state action has more to do, though, with the perceived insulation of civil servants, or bureaucrats, from electoral pressures, the use of experts, and the ability of the expert to rise above political concerns. The economic theory of bureaucracy, of course, suggests that the absence of electoral pressures is no barrier to inefficiency; expert and non-expert alike respond to incentives in predictable ways. Likewise, the capture theory of regulation, developed by Stigler, Peltzman, and others in the 1970s,[29] suggests that there is less reason for optimism about these appointed commissions of specialists than the Cambridge view indicates.

What emerges, then, is that the difference between the Cambridge economists and their modern counterparts in Chicago or Virginia was not that the former were guilty of committing the "nirvana fallacy," or that they were naïve about political processes. The differences lie in the facts that Chicago and Virginia developed techniques for analyzing political processes that were not available to the Cambridge economists. The rational choice approach and its assumption of stable preferences was central here, effectively ruling out the idea that public interest could supersede self-interest in the calculations of political actors and that political reforms, education, and the like might be mechanisms for facilitating this. That is, though Cambridge, Chicago, and Virginia shared an understanding of the potential for wide-spread government failure, the implications of the rational choice approach to regulatory and political processes led economists associated

[28] Sandra Peart and David Levy (2005) provide an analysis of these phenomena in nineteenth-century economics.
[29] See, e.g., Stigler (1971a) and Peltzman (1976).

with the Chicago and Virginia traditions less optimistic that government failures could be overcome.

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