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CAPITALISM AS A MIXED ECONOMIC SYSTEM *

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<1>Introduction

Many factors are stimulating discussion and argument about what reforms are necessary if capitalist economies are to work effectively to meet human economic needs in the 21st century: concerns about global warming, the recent financial crisis, the continuing rise in the costs of medical care, stubborn pockets of poverty in many nations with high average incomes, and others. However, almost no one is seriously proposing that capitalism, as a kind of economic system, be abandoned, and something significantly different put in its place. That kind of argument died out with the end of the cold war. Today, there seems to be broad consensus that there are no real alternatives to capitalism.

But what is “capitalism” anyway? The now extensive literature on comparative capitalisms shows that the economies of countries that generally are considered to be capitalist differ in important ways. (Hollingsworth et al, 1997, provides a good general discussion. See also the chapters by Berglof and Odagiri in this volume.) Also, individual capitalist countries themselves obviously have changed greatly over the years.

However, there would appear to be two core characteristics broadly shared by all countries that call themselves capitalist. First, these economies make extensive use of market organization, broadly defined, to govern the production and distribution of goods and services. Second, this practice is supported by broad ideological agreement that market organization is the best way to govern economic activity.

A central argument of this essay is that, in countries that consider their economies basically capitalist, the conception that market organization is the best mode of economic governance is much simpler and more coherent than the complex and variegated way that economic activity actually is governed, which involves a wide range of non-market elements. This is both a source and a consequence of a continuing political debate about the appropriate governance of various economic activities and sectors.

--2—The Relatively Simple Ideological Conception of Capitalism

Let us consider the ideological conception first. In a capitalist economy, the general presumption is that for-profit business firms ought to be the principal economic agents

responsible for the supply of goods and services. Wants are regarded as primarily a matter of individual and household needs and tastes, and it is presumed that potential customers for goods and services ought to decide what they will buy and from whom on the basis of their own preferences, using their own money. Under the norms and expectations of capitalism, firms are assumed to interact and coordinate with customers, and also with suppliers of the inputs they need to operate, including labor, largely through markets. Along with the profit motive which keeps firms focused on what consumers want and to holding costs down, competition among firms is presumed to keep the prices firms charge in line with costs.

The widely held general conception of how capitalism ought to work does not rule out a significant role for government. Far from it. It is recognized that governments need to play an essential role in providing and protecting conditions under which markets can work well, by establishing and enforcing an effective legal structure, encouraging competition, and assuring the adequacy of needed infrastructure. However, the norms associated with capitalism rule out attempts at central planning, except under emergency conditions like war. Regulation generally is expected to be mild, and attempts by government to control market outcomes presumed to be limited.

It long has been recognized that a major part of the role of government in maintaining conditions under which market organization can work well involves responsible macroeconomic policies, and at least since the time of Keynes it has been understood that from time to time active fiscal and monetary policies are needed to prevent or turn around raging inflation or severe depression. At least since the early years after World War II, modern capitalism generally is seen as being compatible with government policies to keep down the incidence and severity of poverty, and to help people in distress who need help.

When the term “mixed economy” is used these days to characterize modern capitalist systems, people often have in mind the essential role of government in maintaining conditions under which markets can operate effectively, including active fiscal and monetary policies where necessary, and in providing a safety net. However, my focus in this essay will be on another sense in which modern economies are mixed.

The actual structure of modern capitalist economies is much more complex, and interesting, than the ideological picture of capitalism. While usually ignored in characterizations of the nature of modern capitalism, a wide range of economic activities, goods and services, and even broad economic sectors, are not governed through the kinds of markets modeled in the standard economics textbooks, but through quite different structures. Modern capitalist economies make extensive use of market governance. But they also make use of other forms of governance.

I am using the term “governance” to highlight what is at stake in choosing how economic activity is structured – who gets what and who pays, who has legitimate authority to do what, mechanisms of control –and to call attention to the fact that society has a choice about the matter, a choice that is ultimately political. I note that economists tend to see the structure of an economic sector as involving a demand side and a supply side, and in the discussion that follows I will distinguish between the demand and the supply side of governance.

Simple market organization along the lines of the economic textbooks is one form of sectoral governance, and clearly capitalist economies make much use of markets. However, market organization is far from ubiquitous and seldom is employed in pure form. While repressed in the conception of capitalism as a general economic system, once the focus of attention is brought to the level of meeting particular needs, of governing particular activities and sectors, this point can be immediately recognized.

National security is a canonical example of a broad national need where, on the demand side, society uses collective governmental processes, not market mechanisms, to decide how much to spend on what. Similarly regarding police services. The fact that demand is determined through governmental process of course does not mean that supply is governmental too. Industry is the provider of most of the equipment used by the armed forces, and the police. However, there also are certain activities or realms where supply is regarded as an innately governmental function. The armed services are organized and led through government. Providing and running the police system and the courts is another obvious example of public governing of the supply side as well as the demand side. The central role of government in assuring the physical security of its citizens is taken for granted, even in the most self consciously capitalist countries.

In virtually all countries the lion's share of provision of primary and secondary education, as well as its finance, is undertaken through public organizations. While in most countries there are private schools as well as public, and a number of families choose to send their children to them even if they have to pay to do so, the central role in education of public finance and public provision is generally accepted.

The provision of medical care is another "mixed" system in most capitalist countries, and one subject to continuing controversy. In virtually all high income capitalist countries most of medical care is paid for by insurance. In many there is often heated controversy about the appropriate mix of government run and funded versus private insurance, and the extent of subsidy of the latter. There also is dispute about the supply side, in particular regarding whether doctors and hospitals should be treated as independent economic agents or as part of a more unified system, and the extent to which the "market" for medical care should be under relatively detailed regulatory control. I note here, for elaboration later, that the medical profession tends to insist that the aim of doctors is to help patients, and that they should not be regarded as "profit maximizers" and hence there is no need for government regulation.

As the case of doctors serving patients highlights, in many activities and sectors the nature of the relationship between suppliers who earn their money selling goods and services, and their customers, does not look quite like the textbook model of market governance. Another example of a market organized set of activities that looks quite different from the textbook model is TV news broadcasting put on by commercial stations and networks, who do not make their money directly from viewers, but from advertisers who buy a piece of the broadcast time. At the same time the broadcasting of reliable and complete news is widely understood to be a public service, and hence erosion of advertising revenues that induce reduction in investments in reporting can be viewed as a potential public policy problem. Or consider professional sports, where the owners of franchises often demand subsidies from the communities whose name they carry, in addition to receiving money from both paying fans and TV channels.

More generally, it is important to recognize that many activities and sectors that generally are thought of as market governed in fact have a quite mixed governing structure. Thus both the products and production methods of pharmaceutical companies are regulated, and public moneys go into the basic research that pharmaceutical companies draw from in their development work. Many aspects of airline operation are regulated, the government operates the air traffic control

system, and airports are largely funded and often owned by public bodies. Most of the old “public utilities” still are quite regulated, and sometimes subsidized.

And it is a mistake to see the governance issue as strictly about markets versus government. Child care, an activity that absorbs an enormous amount of resources, is largely provided by family members, with market institutions and government both playing a subsidiary role. Not for profit organizations principally govern organized religion, and little league baseball.

Market organization is a widely used and useful governing structure. An important reason is that it can operate in a variety of different ways, and be supplemented by other mechanisms in a variety of ways. However, just as one size shoe does not fit all feet, a single mode of sectoral governance can not cope with the great variety of human activity. Modern economies are made up of many very different sectors governed in different ways. There is no way that a single form of organization and governance is going to be appropriate for all of them.

This essay is concerned with these kinds of issues and debates. A case can be made that a capitalist bias in favor of simple market organization of economic activity is, on net, a plus. It is biased towards a mode of economic organization that, in fact, has served effectively as a central part of the governing structure over a wide range of activities and sectors where there is general agreement that performance has been pretty good. It is associated with a 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, when pushed dogmatically, a pro-market bias can be counter productive.

The rest of this essay will be organized as follows. Section II will review the arguments in favor of market organization of economic activity. I will argue that they are more subtle and circumscribed than often proposed. Then, in Section III I turn to the economists market failure concepts and suggest that, while limited and somewhat biased, they do provide a case for a “mixed” economic system. Section IV considers the positive case for non market forms of governance of certain economic activities. In the concluding section in the light of the foregoing I consider various areas where the question of economic governance, in particular the appropriate nature and role of market organization and various alternatives, presently is under dispute.

<1>The Case for Market Organization

Since the days of Adam Smith, British and American economists generally have touted the virtues of the “invisible hand” of market organization. The contemporary argument has two different strands. One is that market governed economic activity tends to be responsive to consumer wants and is relatively efficient. The second is that capitalist organization provides a remarkably powerful engine of progress. The case I will develop, not surprisingly, is that the desirability of market organization strongly depends on the kinds of values associated with the goods and services produced by an economic sector, and the nature of supply conditions.

<2> Market Organization and Economic Efficiency

Modern economics has embellished Adam Smith’s argument in favor of markets with a formal theoretical argument that, under certain assumptions about the behavior of economic agents, and certain context conditions, market organization yields economic outcomes that are optimal in some sense. The position I take here is that this theoretical argument is not very helpful in guiding thinking about how market organization actually works, or illuminating where market organization is a desirable mode of economic governance, and where it is not.

It is not helpful because, on the one hand, no one really believes that the neoclassical model is a close approximation to how a market economy actually works. On the other hand, real market economies are much richer institutionally than the simple model, and thus theoretical arguments (for example those contained in market failure theory) may not be an indictment against the actual market economies that we have. It is important to recognize, therefore, that analysis of the plusses and minuses of governing structures that make significant use of markets has to rest on a mixture of the rather rough empirical comparisons plus efforts at sensible, if somewhat ad hoc, theorizing.

Looking at the matter from this perspective, while market organization as it actually is almost surely never achieves outcomes that are optimal, most economists and many lay persons would argue that market organization and competition often does seem to generate results that are moderately efficient. There are strong incentives for firms to produce goods and services that paying customers want, or can be persuaded they want, and to produce at as low financial cost as

is possible. Also, under many circumstances competitive market organized economic sectors seem to respond relatively quickly to changes in customer demands, supply conditions, and technological opportunities. Thus to the extent that producing what customers demand is treated as a plus, and so long as factor prices roughly measure real social costs, there is a strong pragmatic case for market organization, broadly defined, on economic efficiency grounds, at least in certain domains of activity.

But whether market governed economic activity does or does not generate economic behavior and outcomes that are desirable clearly depends on the context. There is, first of all, the question of whether the important values at stake are adequately represented in what individual customers want and are willing to pay for. The TV news broadcasting case mentioned earlier is highly interesting in this respect. Whether news broadcasting can make money depends on how potential advertisers view alternative media, which in turn is related only loosely to the value TV watchers place in getting news they regard as complete and reliable through that media. On the supply side, the conditions may or may not be right for competition to develop and be sustained. How many airports are needed to serve a metropolitan community effectively? And of course there also is the question of whether the costs attended by producers adequately reflect social costs.

In some contexts the notion that market organization yields relatively efficient outcomes is quite plausible. In other contexts it is highly problematic.

<2>Why Not Top-Down Planning?

The kind of economic governance needed would certainly seem to depend on the nature of the salient needs. Thus when engaged in a massive war effort (as World Wars I and II) capitalist economies have largely abandoned market governance and adopted centrally coordinated mechanisms of resource allocation, procurement, and rationing. The rationale has been that such economic governance 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 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 problems experienced by central planning regimes in the old communist countries after the era had passed when building up standard infrastructure sufficed as a central goal, bears out this argument. (For a classic discussion of these matters see Lindblom, 1977.)

Some of the advantages of market organization show up clearly when the comparison is with central planning. However, I would propose that the argument behind the scenes here is much more complex, and in fact different, than 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 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. It also involves the argument 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 (for example Kirzner, 1979), have stressed the ability of market economies to experiment, to search for unmet needs and un-seized opportunities, and argued that centralized systems are very poor at this.

The empirical evidence suggests that this is true. However, central planning is not the only alternative to pure market organization. Modern capitalist economies have developed and operated a wide variety of alternative and mixed forms.

<2>A Schumpeterian Perspective

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 argued, capitalism has been a remarkably powerful engine of economic progress. And here too we can make a rather explicit comparison, at least with central planning. 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 economics.

But the characteristics and capabilities of market organization that contribute to technological progress are very different than those that relate to static efficiency, and the textbook normative model. Indeed Schumpeter made a great deal of those differences. Some commentators on Schumpeter have proposed that he did 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 (1942) was an effective engine of progress because competition spurred innovation. His theory placed high value on pluralism and multiple rival sources of invention and innovation. However, under Schumpeter's view of what socially valuable competition is all about, the presence of large firms, with R and 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 market induced economic efficiency.

It is now clear that, writing in the 1930s, and greatly impressed with the major role played by large corporations in technological advance over the preceding decades, Schumpeter underplayed the continuing role of new firms in the process. However, many contemporary views of the sources of invention and innovation tend to play down the continuing role of large companies in the advance of many technologies and economic sectors.

In any case, while sectoral structures differ, in virtually all of them I find persuasive the argument that the pluralism, flexibility and competition of modern capitalism are important ingredients of an effective innovation system.

But on the other hand, 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, for example public support of university research and training. Earlier I noted the importance of publicly funded research to technological progress in pharmaceuticals and medical technologies more generally.

Both electronics and aircraft development have received major government R and D support, and for many years the US Department of Defense provided the most aggressive market for new technologies in these fields. (For an extended analysis see Mowery and Nelson, 1999.) Put another way, an important reason why modern capitalism is such an effective engine of progress is that the system is in fact a very mixed one, with non-market elements playing an important role in innovation in almost all fields. A capitalist system that relied solely on market organization would not be nearly as effective. Which leads us to the literature on “market failures”.

<1>The Positive Case for a Mixed Economy: Market Failure Theory

A large portion of high level argument about where market organization works effectively, and where market organization works poorly, is conducted using the economists' market failure language. (For a fine articulation see Stiglitz, 1986.) Market failure theory takes as its benchmark the theory I mentioned earlier that, under the set of assumptions about behavior built into neo classical economic theory, and given a particular set of 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 limitations of market organization as a governing structure for an activity or class of goods or services can stem from the nature of the demand. The case of public goods is a canonical example. It can come from characteristics of the supply side, as in the case of natural monopolies. The problem of governing the provision of goods and services that involves the creation of externalities can be a demand side or a supply side problem. So too the problem of limited or asymmetric information or required specialized expertise.

<2>The Public Goods Bestiary

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 like 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 benefitting from a public good in no way diminishes my ability to benefit. The second attribute is that, if a public good or service is provided at all, 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 how this conceptualization maps onto real goods and services. First of all, in many cases 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 therefore may 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, although a 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 who uses it without paying a license fee. Access roads can become crowded and worn with use, and neighborhoods may try to limit access.

Second, and partially related, many goods and services are partly private and partly public, in the sense that there is identifiable benefit to particular individuals, who can be made to pay for access, and at the same time broad atmospheric benefits from the availability or provision of the good or service. Education is a prominent example. Urban mass transport is another.

The example introduced earlier, of news provided by newspapers and TV networks, and developed through investigative reporting, is another interesting case in point. The availability to a community of reasonably complete information clearly is necessary if citizens are to have the knowledge they need to act intelligently as citizens; in this sense the development and promulgation of news provides an important public good. But newspapers are private organizations, who may not always aim to maximize profit, but who certainly need to be able to cover costs to survive. As noted earlier, newspapers make their income from two private good aspects of their publications. One is the value of news to individuals who choose to buy the paper rather than obtaining news through other means. The other is the value to advertisers of

spreading their message to readers who, in many cases, find the advertisements an annoyance. TV news programs are almost totally dependent upon the latter to bring in the money to cover their costs.

Third, in many cases the public benefits are associated with beliefs about what is appropriate for a society or a polity. 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. There surely is a lot to this point of view.

However, it is apparent that some people care about the quality of air and water, and the security of wildlife, in areas they never intend to visit, 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. Many citizens in a democracy support funding for universal education not because they, or their children, will take advantage of public schools, or because they believe it will reduce the incidence of crime that can affect them, but because they believe that universal free education is a necessary condition for equality of opportunity in a society. The values at stake here seem different in kind than the utility that an individual might get from a nice steak.

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. For this reason, for many goods and services the argument is not about whether innate publicness requires public funding to assure a decent level of provision, but rather about whether the good or service should be made available to all, on reasonable or nominal terms, with public moneys footing the bill. That is, a considerable part of the debate is about what goods and services “ought to be public”.

There are significant costs involved in employing public choice machinery instead of or supplementary to market demand side machinery. There is, first of all, the question of just how

to decide how much is to be provided, in contexts where individuals and groups may value the public provision of the good or service very differently. There is, second, the question of who is to pay. Because of the number of individuals and groups that may try to have a say in these matters, the process of decision making is either going to be very time consuming and cumbersome, or pruned back and simplified in a way that will certainly outrage certain parties. The outcomes of collective demand generating processes are inevitably going to be considered by some to be unfair and inefficient. But if a good or service has strong innate public good properties, or is deemed by some as something that ought to be public, this argument is inevitable.

On the other hand, newspapers and public news broadcasting, both of which presently are having difficulties in covering their costs, highlights that there also are problems and dangers of leaving the production and promulgation of important public goods to market incentives associated with private good attributes that are tied to them. As suggested above, a wide range of goods have some public and some private good attributes. And there inevitably is going to be dispute about whether, or to what extent, their provision should be left to the market, and the appropriate role of other forms of financing.

<2>The Problem of Natural Monopoly and the Need for Public Control

The “publicness” of a good or service raises issues of demand side governance. Natural monopoly poses supply side governance problems.

American economists are inclined to rationalize the use of antitrust 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, or adopt public sector provision, has to do with people's concerns that arise when private bodies gain considerable power over their lives, concerns that may involve but also may transcend being forced to pay monopoly prices. Economists are inclined to rationalize that governments not only fund but directly control activities related to 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 have control over these activities be 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 to individual freedoms than government power. 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 activities and services 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 like telephone service, electricity generation and distribution, water supply both for rural and urban users, 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.

I think that to ignore this aspect of the debate about how to govern these sectors is to miss the point. However, as with the issue of regulation to deal with externalities, which we will consider next, the key question of regulation of industries where monopoly or a highly concentrated structure is inevitable, is where to draw the line.

<2>The Externalities Problem: Bringing in 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 benefits and costs attended to by those who engage in the activity generating the externalities. 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 (1960) 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 governance machinery that has brought in a broader range of interests and values bearing on decision making in an activity or sector than would be there under simple market organization.

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 appropriate influence, and the mechanisms through which they can 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.

It is conventional in economics to think of the costs of an externality as like the costs of deprivation of a private good, or in terms of expenses needed to remedy damage, as for example extra laundry costs, or the extra time it takes to get to a clean lake when the near one is polluted. However, I believe that, as with the case with public goods, externalities issues in many cases do not fit this mold.

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. As I noted earlier, for many people protecting the environment is a matter of moral concern, a belief

that certain values ought to be enforced, and very little about cutting down their own laundry costs or protecting the lake they swim in.

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. And the wider the range of regulation prohibiting or mandating certain things or behaviors, the smaller the range of individual freedoms. The question, of course, is where to draw the line.

<2>Asymmetric Information, Specialized Expertise, and the Problem of Trust

Economists only recently have begun to pay attention to problems of economic organization and governance that come about when those on one side of a transaction possess information, or have expertise, that those on the other side do not have. Clearly this kind of asymmetry is very wide spread across the spectrum of economic activities, and concern about its potential abuse the source of much of the regulation one sees in modern economies, and in some prominent instances strong arguments that market organization, even strongly regulated, is not a suitable form of governance.

Thus the producer or seller of a good often knows much more about its characteristics, including its quality, than the potential buyer, and may have incentive not to divulge that information. The market for used cars is an example often used by economists. The result can be disappointed purchasers, or the reluctance of potential purchasers who would be glad to buy a reliable used car to enter into transactions for fear of ending up with a lemon, or some of both. While less stressed in the economic literature on this topic, the problem is present, along with the opportunity for abuse, in relationships where one side has professional expertise and the other side does not and in the normal run of things will follow professional advice regarding what to do. Doctor patient and financial advisor client relationships are obvious cases in point.

In wrestling with how market organization can cope with this kind of problem, economists have put considerable emphasis on the importance of good long run customer relationships and reputation for the sustained profitability of firms as an effective discipline on supplier behavior. Where customers tend to have long term relationships with their suppliers, and

reputations for reliable or shoddy work or goods tend to get around to potential new customers or customers who are open to changing suppliers, there is some force in this argument. And there are non governmental organizations like The Better Business Bureau that are intended to make business reputations more reliable and accessible, or at least to give potential customers more confidence. In capitalist economies there is a clear ideological inclination to let mechanisms like these deal with the problems, and to avoid detailed regulation. However, particularly where customers can be harmed by products designed and produced in ways that save the seller money, there also is regulation.

Professions, like those involved with medicine, the law, and accounting, generally have codes of ethics and of good practice that those in the profession are supposed to abide by. Where expertise is associated with a body of knowledge that can be tested, or with professional training, there often are government sanctioned license requirements. These measures, and the belief that in general professionals adhere to them, do provide support for trust by clients of doctors and lawyers that they will be treated competently and honestly.

As noted earlier, the medical and other professions claim trust in market organization of the services they provide is justified because their members are not aiming to maximize their own incomes or advantage, but to serve their clients as best they can. Recognize that this defense of market organization of medical care here certainly is not the case put forth in the standard economic text books where the profit orientation of firms is viewed positively. In any case, the professions generally strongly resist detailed government overview and regulation, and in many cases control the licensing system that regulates admission to membership, on the grounds that they are effective in governing themselves. And by and large they have been successful in preserving much of their autonomy.

However, particularly after a scandal has come to light, there are strong pressures for regulation of the profession involved, and of the transactions they engage in. And it is common for the legal system to be used by clients who feel they were hurt or cheated. As the anger of the US medical profession about what they consider unreasonable mal practice suits suggests, it may not be in the interest of a profession to avoid some formal government regulation of what it does.

It is apparent that belief that for-profit organizations, or individuals who are believed to be mostly motivated by hope of profit, are not to be trusted to have the customer's or client's interest at heart, is a prominent reason why the supply side of many activities is largely made up

of public or not for profit organizations. As noted, the public education system of many countries involves not only public financing, but also publicly run schools. Most of the “private” schools that are in the system are not-for-profit. In most countries the lion’s share of day care for young children is provided through government or non profit organizations. The recent debate in the US about how far health insurance plan under government auspices ought to be extended involved centrally the question of whether, through regulation, for profit insurance plans could be relied on not to overcharge or cheat patients. Similarly there is considerable appeal to many people of not for profit organizations that provide medical services.

The evidence is not clear that, where for profit organizations operate in sectors of this sort, as they do in education, child care, and hospital care, that these treat their customers any worse, as a general rule, than do organizations that are nominally not for profit or public. But while those steeped in the beliefs and norms of capitalism continue to push for more use of markets in these and similar areas of activity, for many people market organization, at least of the sort described in the economic text books, is something to be avoided, or tightly regulated.

<2>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, 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 can't 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?

<1>The State, the Society, and the Economy

The use of terms like Political Economy and Social Economy signal that economic systems are tightly intertwined with the institutions and activities of government and society. My

argument in this section is that an important reason why capitalist economies are mixed economies is that economic institutions do not stand alone, but rather interact with and shade into the institutions of government and community.

<2>Functions of the State

Economists have an inclination to see the role of the state primarily in terms of legal and physical structures that are needed to provide the basis for an effective economic system, and deal with various kinds of “market failures”. This is a very different view of the role of the state than the arguments debated in the long history of philosophical theorizing on the subject.

In much of its early incarnation, and some of its more recent, the state is viewed in this literature 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 in 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 in values among individuals who comprise the state. Indeed disputes about values are likely to be even more heated than disputes involving choices that affect individual or group 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. A war is declared or it isn't. All citizens have access to medical care or some don't.

The theory that the state is the vehicle through which a nation defines and enforces collective values clearly captures a lot of the flavor of contemporary debates about matters like rights to life and rights to choose, the commitment of a society to ideals of equal opportunity and fairness, and whether there should be universal health insurance regardless of ability to pay. As I proposed in the earlier discussion of public goods, arguments about these matters involve beliefs about appropriate collective values, or values of the collective, that transcend those of particular individuals. Under this theory 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.

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 is posed in terms of the need to avoid violence and anarchy. 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.

By the time of Locke, political philosophy was paying increasing attention to the rights of citizens of a state, rights that on the one hand were concerned with protecting individuals from the state, but on the other hand were rights that were to be enforced as well as respected by the state. Thus under the democratic theory that gradually developed, 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. I note that in seeing the state as responsible for the defining and enforcement of certain universal citizen rights, this branch of political philosophy was merging with the strand seeing the state as the vehicle for defining and enforcing collective values.

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 could 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 gradually got established. 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. Solidarity is a word often used by advocates of this position. From another (sometimes closely related) tradition, we all are our brothers keeper's.

The orientation to these matters in the political philosophy literature is that they are natural basic functions of the state, and don't simply fall to the state by default because of some kind of market failure. And where market mechanisms are used as part of the machinery for provision, this perspective sees government as still responsible for overseeing the operation.

Earlier I called attention to significant differences across nations in the range of activities and sectors that are governed largely through market mechanisms. I propose that an important factor behind these differences, as well as one that often is central in the debates going on within a country, is strongly held differences among individuals and groups regarding the appropriate roles of the state. The nations that make most extensive use of only lightly regulated markets tend to be ones, like the United States, where there has been a long tradition of seeing the state as a danger to individual liberties. On the other hand, nations that have the most extensive welfare states tend to be ones where government is more trusted.

<2>Economics and the Community

Several of the theories of the state referred to above rest heavily on the concept of a natural community of individuals and families, with the units linked 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.

Adam Smith is mostly known today, particularly among economists, for his The Wealth of Nations. There he stressed the value of self interest in motivating and guiding individual human action in ways that actually benefited the larger community. The orientation of his Theory of Moral Sentiments is quite different in a number of ways. There he stressed the extended empathy that humans in a community have for each other. Extended empathy can be a

powerful ingredient in a governing structure. But extended empathy is not what markets are all about.

It is clear that the community, or parts of it, rather than the market, or the government, provides the governing structures for a wide range of activities that use resources to provide desired services, and in that sense are economic activities. Thus to pick up on an earlier theme, the family is the standard governance structure for child care not because of simple “market failure”, but because the family can be counted on (mostly) to hold the extended empathy towards its 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. These include organizations like the boy scouts and the girl scouts. I note that, except for inputs they use that are bought on markets, these activities do not show up in the standard economic accounts, like GNP. But they definitely are economic activities in the sense that they use resources, if largely unpaid, to meet needs.

Much of charity is provided by community organization. Where financial resources are required, voluntary contributions generally play a significant role. Formal organizations may be involved, but they will be chartered as not-for profit organizations rather than as for-profit firms. They may obtain some of their funding from the sale of goods and services. In recent times many such organizations have been the recipients of government funds. But a hallmark of such organizations is an explicit rejection of what might be called commercial values, as well as resistance to government control.

Karl Polanyi was in 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 because they are operated much better under communal governance, in one its various forms.

<1>Economic Organization and Governance as a Continuing Challenge

At the start of this essay I proposed that the conception and norms of capitalism, in particular the faith that market organization is the best way to govern economic activity, are much more unified and coherent than the actual organization of economic activity in countries

that consider themselves capitalist. The latter is marked by great variation in the way different activities and sectors are governed. While in countries regarded as capitalist market organization plays a powerful role in the governance of many economic activities, there also are many activities that are governed largely through non-market mechanisms. I also have argued that few activities or sectors are pure market or non market. Most involve a mix of market and non market elements.

Further, governance of an activity or sector, or at least its fine structure, in many cases is not something that is determined once and for all. Rather, at any time there tends to be a number of arguments going on regarding how particular sectors should be organized and governed. The particular foci of these controversies can differ significantly across countries. But in these first years of the 21st century, there are several arenas where many countries are struggling with proposals for reform.

One of these stems from growing awareness of and broad agreement that something should be done about global warming. I note that, while the particular focus and the strength of this concern are relatively new, much of the current discussion and argument can be seen as having grown out of the more general and variegated concerns that emerged in the 1960s about the adverse environmental impacts of economic activity. The general diagnosis of the problem is, and has been, that the prices determining the financial costs of certain economic activities, and the goods and services with which they are associated, do not reflect the environmental costs of that activity. The proposed reforms are, and have been, a combination of regulation, adjusting prices and costs so that they better reflect those environmental costs, and public support of R and D and other investments to speed the development of more environmental friendly technologies.

I want to highlight that today's proposed reforms would not eliminate market organization from the set of structures governing the activities in question, or even diminish significantly the role of market processes. The regulatory reforms for the most part would augment a set of regulations that already are there. The proposed public R and D support programs would augment and stimulate rather than replace private R and D. And part of the new proposed policies would be the creation of a new market, one for licenses to pollute. Put another way, the economic activities and sectors to which the new policies are directed were already "mixed". The proposals for reform involve a change in that mix.

Another arena where there is continuing argument about how to reform governance structures is medical care. The argument is most heated and the proposals for reform most significant in the United States, but similar arguments are going on in many other countries. But again, the policy discussion is about a sector that already is very mixed in its governing structure. Despite the arguments of some parties in the dispute in the US, the reforms recently passed should not be viewed as taking a sector that has been governed largely by the market and turning it into a government run sector. The organization and governance of medical care in the US long has involved government funded and run programs that pay for a significant fraction of the care for some groups, public support of the research base for efforts to develop new medical treatments and artifacts, and significant elements of regulation. This will continue to be the case after reform.

As I noted earlier, countries that consider their economic systems basically capitalist can differ greatly in the extent to which they rely on market organization for the governance of certain activities. Medical care is a prominent case in point. Unlike the United States some other “capitalist” countries largely fund medical care through a government run central payer system, and in some, like the United Kingdom, provision of medical care is under government auspices. However it is fair to say that in all of these countries governance of medical care involves a mix of market and non market elements.

I note that financial institutions, another arena where efforts at reform are going on in many countries, also long has been a very mixed sector or collection of sectors. In all countries there is a public or quasi public central bank. Commercial and investment banks themselves, and institutions that provide mortgages, are private and for-profit in all capitalist countries, but are subject to a complex set of regulations. The focus of reform here is on those regulations, which many believe the recent financial crisis showed to be inadequate. But again no one is proposing to nationalize the full banking system, or to remove the market as part of the governing system. The proposals are to change the mix of an already very mixed system.

This is not to argue that, because virtually all economic sectors have a mixed form of governing structure, there are no differences across sectors in the extent to which the market plays a role, or in beliefs about the role market governance should play. While the question of what kind of regulation is needed is very much on the agenda, there are no arguments to eliminate the central role of market organization and competition in governing the commercial

banking sector. While governments have bailed out automobile companies when they otherwise were set to fail, no-one is arguing that, in the normal run of things, market competition should not be the principal determinant of what companies thrive and which ones have to go out of business in that industry. On the other hand, while there is considerable lobbying in the United States for vouchers and charter schools, there is hardly any support for the notion that the government should get out of funding and structuring much of education, and simply let the market take over. While there is controversy regarding what kind of work defense departments should procure by contract with private companies, no one is arguing for privatization of the armed services per se.

But at the margins at least the relative balance of market and non market elements in the governing of these different sectors can and has changed over time, and often is a matter of contentious dispute.

Devising and implementing structures to govern its key activities and sectors are among society's most difficult and continuing challenges. In countries that consider themselves capitalist, there is a strong presumption that market organization should be used as much as possible. But as the cases described above illustrate, in fact there is continuing dispute about the role of market and non-market elements in the governance of various economic activities, even in countries that consider themselves staunchly capitalist.

Arguments about appropriate governing structures for an activity or a class of goods and services are difficult for many reasons. In the first place, there often are significant conflicts of interest and differences in views regarding the salient values at stake. Since a central aspect of a governing structure involves the mechanisms that determine what and whose interests and values count, it is easy to see why this may be a contentious issue. The question of the governance of key economic sectors and activities often is tightly bound up with issues of the economic well being of different groups. Thus the recent U. S. debate about health care reform was largely about how to make health care accessible to poor Americans at reasonable cost, and who was to pay for this. Not so far behind the scenes various professional groups – doctors, nurses, managers of hospitals, insurance company executives – were making arguments that would support their economic interests.

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. The additional costs of extending health insurance are virtually impossible to predict with any precision. 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 market for allowances to emit various quantities of greenhouse gasses.

It would be nice to 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.

In such a context, a general broad belief in the efficacy of market organization probably is, on net, a plus, given the broad experience societies have had with market organization and the alternatives. However, if that faith is held dogmatically, that can be a problem. An important reason why modern capitalist economies have worked reasonably well is that they have developed economic systems that, in fact, are very mixed. It is important that they not so blind themselves ideologically that they lose the capability to continue to do that.

Chapter 11 References

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