

**HARNESSING SELF-INTEREST:  
MILL, SIDGWICK, AND THE EVOLUTION OF THE THEORY OF MARKET  
FAILURE**

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Revised Draft  
May 2006

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## **HARNESSING SELF-INTEREST: MILL, SIDGWICK, AND THE EVOLUTION OF THE THEORY OF MARKET FAILURE**

### **Introduction**

The theory of market failure brought analytical refinement to a centuries-old concern with the impact of self-interested behavior on economic activity.<sup>1</sup> The preclassical commentators looked for a means to coordinate or restrain the base effects of self-interested behavior and saw no means other than government regulation and religious control—both rather centralized, authoritarian, and pessimistic regarding the effects of self-interested behavior. The idea that self-interest could somehow work to the general welfare was essentially absent.<sup>2</sup> Adam Smith and the nineteenth-century classical economists saw the system of natural liberty harmonizing, to a greater or lesser extent, self-interest and social interest, allowing the market to function with a minimum of direct control by government. However, the marginal revolution and the development of neoclassical economics saw the pendulum swing back to a greater degree of suspicion about the effects of self-interested behavior. Specifically, as against the classical faith in the system of natural liberty and the attendant suspicion of state intervention, we see in the literature assertions of a rather extensive set of divergences that the market could not satisfactorily coordinate—market failures—and the argument that government could serve as an efficient coordinating force.

The onset of the marginal revolution also precipitated a change in the way that economists went about their *analysis of* the economic role of government. As William Baumol (1952, p. 154) has pointed out,

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<sup>1</sup> Medema (2003) provides a general overview of this topic.

<sup>2</sup> Courts, monarchs, and legislative bodies did begin to lay the legal foundations for a market economy in the 14<sup>th</sup> – 17<sup>th</sup> centuries.

With the Jevonsian revolution, French, Italian and English speaking authors were led, under the influence of positivist philosophy, to shy away from ethically normative discussion. Discussion of the duties of the state had generally amounted to a specification of the authors' preconceptions as to what ought to be, and this sort of analysis was not in keeping with the new approach.<sup>3</sup>

Writings on public finance no longer began with an elaboration of the appropriate role of government;<sup>4</sup> rather, they were confined to a discussion of how the revenues necessary for the operation of government should be garnered. The discussion of the appropriate role for government became bound up in the newly emerging welfare economics. But it was more than the positivist philosophy that drove the further developments here. Externally, economists of the late nineteenth and twentieth centuries saw the effects on society, both positive and negative, of widespread industrialization, and this caused some to begin a rethinking of certain aspects of the received view of the market. At least as important, though, was an internalist force: the *tools* of marginal analysis made possible derivation of market optimality conditions and thus the *demonstration* of the potential failings of the system of natural liberty. With this came the related demonstration of the possibilities offered by governmental policy actions for promoting, rather than diminishing, social welfare.

This essay attempts to show exactly how economics transitioned from the fairly non-interventionist approach of the classical tradition to the more interventionist orientation that characterized the early days of neoclassical economics. The argument here is that this was done via two relatively simultaneous changes in the analysis: first, in terms of “demonstrating” both a greatly expanded theory of the failure of the

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<sup>3</sup> See Buchanan (1960) and Medema (2005) for discussions of the Italian perspective.

<sup>4</sup> Sir William Petty's *Treatise of Taxes and Contributions* (1662) is an excellent early example of this method—one we see carried through in Smith's *Wealth of Nations* (1776) as well.

system of natural liberty (akin to what we today call “market failure”) as against the classical view, and, second, through a more markedly positive view of the possibilities of corrective policy actions by the state. The writings of John Stuart Mill and Henry Sidgwick mark a turning point in this line of literature, and this essay will show how their work represented a departure from that which came before, the forces that led them to their respective views on the subject, and the role these ideas played in the development of the more expansive role for government evidenced in early stages of welfare economics.

### **Nineteenth-Century Classical Economics: Pragmatism Meets Self-Interest**

The misleading nature of the caricature of the nineteenth century classical economists as die-hard proponents of laissez-faire who hold a homogeneous view of the economic role of government has long been evident to serious students of the history of economic thought.<sup>5</sup> Lionel Robbins (1952) has elegantly laid out the case for the reformist nature of the classical economists, who were critical of a number of the institutional arrangements of their time and highly optimistic that the insights of political economy could be used to point economic policy in a direction that would be beneficial to society. This new science would be an indispensable part of the policy-making process and help to arrest the more negative effects of partisan advocacy within that process.

The nineteenth-century classical economists, like Smith before them, were very cognizant of the virtues of the market as an allocation mechanism, but they also understood that the market could only operate satisfactorily—harmonizing actions of self-interested agents with the interests of society as a whole—within a framework of legal, political, and moral measures that facilitated certain forms of action while

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<sup>5</sup> For more extensive treatments of the classical view, see O’Brien (1975), Robbins (1952), and Samuels (1966). A more broad-based overview of fiscal theory can be found in Musgrave (1985).

restricting others. Yes, there is a hostility to government that is evidenced in varying degrees throughout classical economics, largely a legacy of Smith's harsh critique of mercantilism—a critique which continued pretty much unabated in the nineteenth century. But on the whole, classical political economy evidences a relatively pragmatic view of the economic role of government. Witness J.R. McCulloch's contention that "The principle of *laissez-faire* may be safely trusted to do in some things but in many more it is wholly inapplicable; and to appeal to it on all occasions savours more of the policy of a parrot than of a statesman or a philosopher."<sup>6</sup> Elsewhere, McCulloch notes, in a similar vein, that "The question is not whether any regulation interferes with the freedom of industry, but whether its operation is on the whole advantageous or otherwise ..."<sup>7</sup> Likewise, Nassau Senior argued that "the only rational foundation of government, the only foundation of a right to govern and a correlative duty to obey is, expediency—the general benefit of the community. It is the duty of a government to do whatever is conducive to the welfare of the governed."<sup>8</sup> And, at the end of the classical period, we have J.E. Cairnes' assertion that "The maxim of *laissez-faire* ... has no scientific basis whatever'; it is a 'mere handy rule of practice,' though 'a rule in the main sound'" (Sidgwick, 1885, p. 180).<sup>9</sup>

The point to be taken here is that, far from being anti-government apologists for the business class, the classical economists were concerned with what set of policies would promote society's best interests and were vociferously opposed to policies—like those of mercantilism, but also many others—that they believed served the interests of

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<sup>6</sup> J.R. McCulloch, *Treatise on the Succession to Property Vacant by Death* (1848, p. 156), quoted in Robbins (1952, p. 43).

<sup>7</sup> Quoted in O'Brien (1975, pp. 272-73).

<sup>8</sup> Nassau Senior, *Industrial Efficiency and Social Economy*, vol. ii, edited by S. Leon Levy, p. 302, quoted in Robbins (1952, p. 45).

<sup>9</sup> It is worth pointing out that the utilitarian wing of classicism, which includes Bentham and James Mill in the early part of the nineteenth century, was somewhat more overtly and self-consciously interventionist than the rest of classicism during that period.

particular groups at the expense of the larger population. In particular, their consumption-oriented view led them to the belief that freedom of choice was desirable for consumers, and that freedom for producers was the most effective means of satisfying these consumer desires. The impersonal forces of the market, working through the system of natural liberty, would then serve to harmonize these interests—or at least would do so to a greater and more beneficial extent than would other systems—and the most basic function of government was the establishment and enforcement of a system of law that would control, channel, and restrain certain aspects of individual action, and liberate and facilitate others, in such manner that the individual pursuit of self-interest would lead to the greatest happiness.<sup>10</sup> That is, the classical period saw the transformation of self-interest from something base whose effects should be negated by a wide-ranging program of governmental restrictions to a view of self-interest as a driving force toward increased economic welfare for all when channeled through the competitive market process<sup>11</sup>—most famously evidenced in Smith’s statement that “By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it” (Smith 1776, p. 423). Even a problem as seemingly severe as the population problem is kept in check, in Malthus’ (1798) system, by the operation of the forces of self-interest.

This presumption in favor of private enterprise in English classical political economy does not derivative simply, or perhaps even primarily, from a positive view of the system of natural liberty, or from the sort of “shallow optimism,” as Sidgwick puts it, that one sees in Frédéric Bastiat and his followers. Rather, the classical

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<sup>10</sup> This led Robbins to suggest that Smith’s “invisible hand” is actually government itself: it “is not the hand of some god or some natural agency independent of human effort; it is the hand of the law-giver, the hand which withdraws from the sphere of the pursuit of self-interest those possibilities which do not harmonize with the public good” (Robbins 1952, p. 56).

<sup>11</sup> This competitive market process was not independent of government in that, as Smith and others emphasized, legal institutions are necessary components of the market structure.

predisposition against interference stems from pessimism—in Sidgwick’s words, “a conviction that however by things might be naturally, direct interference by Government could only make them worse” (1885, pp. 181-82). This perspective is amply evidenced in Smith’s propensity to hammer on governmental attempts to channel resources in directions they would not naturally flow and carried through a century of classical political economy.

How, then, did the tide begin to turn?

### **John Stuart Mill, Individual Liberty, and the Problem of External Effects**

J.S. Mill’s perspective is emblematic of a continuity within the classical tradition reaching back to Smith but at the same time marks a transition toward an increasing recognition of market failures that became a centerpiece of the Cambridge school’s (and eventually neoclassical) welfare economics. The seriousness of the issue of the appropriate role for the state (within the economic sphere and without) and the contentious nature of the debate on this topic is, for Mill, both reflected in and a result of the fact that

There is ... no recognized principle by which the propriety or impropriety of government interference is customarily tested. People decide according to their personal preferences. Some, whenever they see any good to be done, or evil to be remedied, would willingly instigate the government to undertake the business; while others prefer to bear almost any amount of social evil, rather than add one to the departments of human interests amenable to governmental control (1859, pp. 20-21).

The absence of a generally accepted rule or principle for assessing usefulness of government action, says Mill, means that both sides are often wrong in their

assessments—“the interference of government is, with about equal frequency, improperly invoked and improperly condemned” (1859, p. 21).

Mill believed it absolutely necessary to have in place a rule for assessing the propriety of government interference, and his goal in writing *On Liberty* (1859) was to set out exactly this: “There is,” he says, “a limit to the legitimate interference of the collective opinion with individual independence: and to find that limit, and maintain it against encroachment, is as indispensable to a good condition of human affairs as protection against political despotism” (1859, p. 14). For Mill, the appropriate rule or limit is not arbitrary—there *exists* a limit to what is legitimate, and it is something to be *discovered*, not something to be worked out via the utilitarian calculus. And Mill is very explicit in setting out exactly what this limit is: “the sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number, is self-protection. That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others” (1859, pp. 21-22)<sup>12</sup> For government to intervene for a person’s own good, “either physical or moral,” does not fall within these limits.

As *On Liberty* was published between the 4<sup>th</sup> and 5<sup>th</sup> editions of Mill’s *Principles of Political Economy*, it should come as no surprise that this same view is front-and-center in Mill’s discussion of the role of the state in the *Principles*: “[T]here is,” he says, “a circle around every human being which no government ... ought to be permitted to overstep,” and, for him, this circle “ought to include all that part which concerns only the life, whether inward or outward, of the individual, and does not affect the interests of others, or affects them only through the moral influence of example” (1871, p.

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<sup>12</sup> Mill says that “the object of” his essay, *On Liberty*, is to assert this “one very simple principle” (1859, p. 21).



943).<sup>13</sup> Mill is clearly arguing here for freedom of individual action where externalities are absent. Where externalities do exist, however, the situation is altered: “Whenever ... there is a definite damage, or a definite risk of damage, either to an individual or to the public, the case is taken out of the province of liberty, and placed in that of morality or law” (1859, p. 147). Looking at this principle from the perspective of the individual’s obligation, “The liberty of the individual must be thus far limited; he must not make himself a nuisance to other people” (1859, p. 101). In those instances where the individual does not exercise sufficient forbearance to accomplish this, a potential role for the state arises.<sup>14</sup>

We can see Mill’s view of the matter depicted graphically using Figure 1. Here, there are two parties, A and B, each with their respective set of interests. Mill recognizes that A and B do not exist in isolation; in the intersection of these sets—the cross-hatched area—their interests are in conflict. For Mill, any portion of the \\\ shaded area within A is inviolable: there are no spillovers onto B from actions within this area, and hence no legitimate grounds for state interference with A’s liberty. In the cross-hatched area—where there are spillovers or collisions of interests between A and B—the situation changes. The protections afforded to individual liberty disappear and allow for the potential exercise of government interference with individual action.<sup>15</sup>

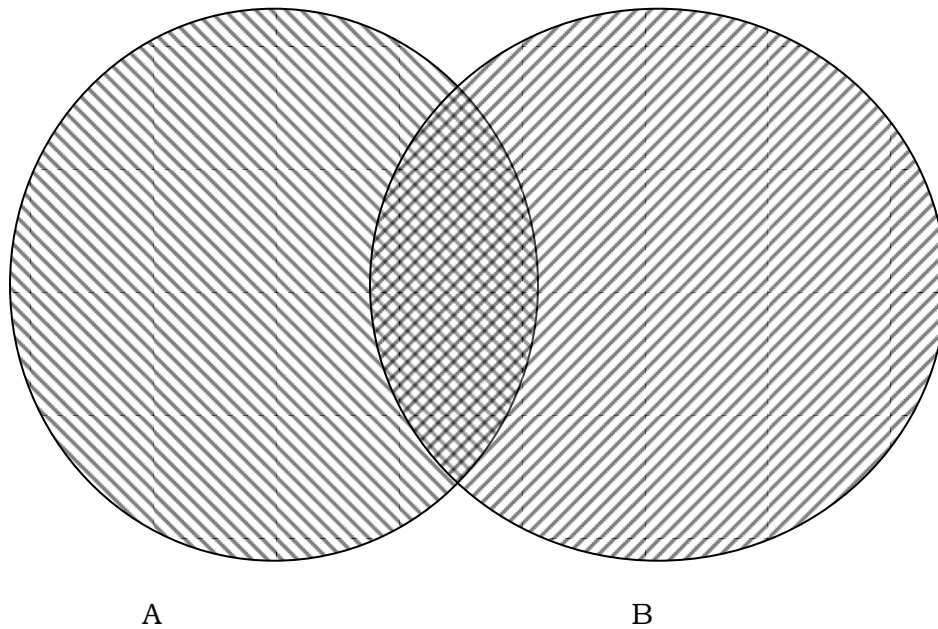
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<sup>13</sup> Mill’s *Principles* was originally published in 1848.

<sup>14</sup> Mill is not asserting this as a hypothesis to be examined and tested; rather, he says, it is an “indispensable” principle (1859, p. 134).

<sup>15</sup> Note that Mill fails to appreciate the reciprocal nature of the spillover issue (that one cannot label A or B as *the* cause of the harm)—a point made forcefully by Coase (1960) a century later.

Figure 1



Mill is cognizant of the ubiquity of these external effects, in the sense that a gain for A sometimes (even often) implies a loss for B:

In many cases, an individual, in pursuing a legitimate object, necessarily, and therefore legitimately causes pain or loss to others, or intercepts a good which they had a reasonable hope of obtaining. Such oppositions of interest between individuals often arise from bad social institutions, but are unavoidable while those institutions last; and some would be unavoidable under any institutions (1859, p. 169).

The issue, then, is not one of eliminating these spillovers, for that is impossible. The problem is one of determining how society should deal these spillover effects in their various manifestations.

What is particularly worth noting in Mill's prescription here is that the severity of his strictures against violations of individual liberty in the *absence* of externalities is

*not* applied symmetrically to intervening in situations where externalities *are present*. It “must by no means be supposed,” he says, “because damage, or probability of damage, to the interests of others, can alone justify the interference of society, that therefore it always does justify such interference” (1859, p. 169). In terms of Figure 1, then, the mere existence of a conflict between A’s and B’s respective interests—the cross-hatched area where the two circles overlap—is not in itself, then, sufficient to justify government intervention.

Here, then, we see Mill’s utilitarian side coming to the fore, with implications for those on *both* sides of the debate over the limits of state action. In discussing the limits of laissez-faire, Mill brings in for criticism both “supporters of interference ... content with asserting a general right and duty on the part of government to intervene, whenever its intervention would be useful” and “the *laissez-faire* school,” which would restrict the operation of government to “the protection of person and property against force and fraud.” For Mill, such trite offerings do not work simply because the issue of the appropriate boundaries for government action “does not ... admit of any universal solution” (1871, pp. 941-42).

Where, then, is the line drawn between acceptable and non-acceptable government interference in the presence of such spillovers? It is here that the pragmatic nature of nineteenth-century classicism, most amply evidenced in its utilitarian strain, comes out perhaps more strongly and explicitly in Mill than in any of his predecessors or contemporaries. The criterion for the boundaries of the appropriate functions of government, he contends, is not strict or a priori, but rather “expediency”:

the admitted functions of government embrace a much wider field than can easily be included within the ring fence of any restrictive definition, and that it

is hardly possible to find any ground of justification common to them all, except the comprehensive one of general expediency; nor to limit the interference of government by any universal rule, save the simple and vague one, that it should never be admitted but when the case of expediency is strong (Mill 1871, p. 800).

A simple suggestion, an assertion, or a bit of evidence that government intervention can improve the situation, then, is not sufficient; the case must be a “strong” one.<sup>16</sup>

One class of spillovers that Mill rules out of bounds for government on expediency grounds are those that naturally and inevitably occur within the context of a competitive market system. Life, according to Mill is often a zero-sum game, as in, for example, when A gets the job and B does not. But, he says, society correctly “admits no right, either legal or moral, in the disappointed competitors, to immunity from this kind of suffering; and feels called on to interfere, only when means of success have been employed which it is contrary to the general interest to permit—namely, fraud or treachery, and force” (1859, p. 169-70).

Mill’s “necessary” functions of government, where the case for expediency is obvious, are much broader than simplistic discussions might indicate. Indeed, he says, the “protection against force and fraud” supporters are espousing “a definition to which neither they nor any one else can deliberately adhere, since it excludes ... some of the most indispensable and unanimously recognized duties of government” (1871, p. 941). In addition, of course, to duties such as national defense and the provision of protective justice, they range over laws governing the many facets of inheritance, property, and contracts; the protection of those unable to look after themselves; the coining of money; the establishment of a standard set of weights and measures; the

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<sup>16</sup> We shall return to the rationale behind the “strong” qualifier below.

paving, lighting, and cleaning of roadways; provision and improvement of harbors and lighthouses;<sup>17</sup> making surveys in order to have accurate maps and charts; and the construction of dykes and embankments. Mill argues that another class of government actions is opened up by virtue of the fact that people are not always the best judges regarding things such as education, whether for themselves or their children, and he makes both the individual and the positive externality arguments in support of public provision of education (1871, pp. 953-54).

Mill finds it important to distinguish between two forms of government action: the authoritative, in which certain types of conduct are prescribed or proscribed, and the non-authoritative, where government provides, for example, advice, information, services, institutions, etc. which are thereby available but do not impinge upon freedom of choice and action. Pre- and pro-scription, he argues, have “a much more limited sphere of legitimate action” and require “a much stronger necessity”—specifically, the harmful spillover effects—to justify them (1871, p. 942). This, then, is the rationale for Mill’s belief that that government should not monopolize education. Similarly for public charity, colonization, scientific exploration, and the maintenance of a learned class. These are functions that, as with public works, substantially further the interests of society but which, he argues, will not be provided in sufficient amounts through voluntary mechanisms.<sup>18</sup> But the utility of state action does not mean that society could not benefit from the presence of private alternatives to the

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<sup>17</sup> On the lighthouse example, see note 26, below.

<sup>18</sup> The reader may notice a terminological tension here between the negative consequences of self-interested action and the notions of “negative” and “positive” externalities. It bears emphasizing that the limitations of natural liberty—market failures, if you will—pointed to by Mill (and, as we shall see, by Sidgwick) fall into both negative externality and positive externality (including public goods) categories. In both cases, however these problems derive from *negative* aspects of self-interested behavior. Thus, for example, the free-rider problem is a “negative” force giving rise to underprovision of goods with “positive” external effects.

government-sponsored activities, and as such the state should not, he said, endeavor to monopolize these functions.

Nor, according to Mill, is the application of government to many of those generally accepted tasks necessarily as circumscribed as some allege. Even things supposedly as simple as the “enforcement” of property and contract are, in fact, quite extensive in nature. In the case of property,

It may be imagined, perhaps, that the law has only to declare and protect the right of every one to what he himself has produced, or acquired by the voluntary consent, fairly obtained, of those who produced it. But is there nothing recognized as property except what has been produced? Is there not the earth itself, its forests and waters, and all other riches, above and below the surface? These are the inheritance of the human race, and there must be regulations for the common enjoyment of it. What rights, and under what conditions, a person shall be allowed to exercise over any portion of this common inheritance cannot be left undecided. No function of government is less optional than the regulation of these things, or more completely involved in the idea of civilized society (1871, p. 797).

The situation with contracts is quite similar. Mill says that, in actuality, “governments do not limit their concern ... to a simple enforcement” of that which is the product of voluntary consent. Rather, they “take upon themselves to determine what contracts are fit to be enforced” (1871, p. 798). What Mill is offering here is at least as much a philosophical discussion of the law-making function of government as it is a normative discussion of appropriate tasks for the state. That is, once one admits of the need for government enforcement of property and contract, the range of activities necessarily opened up to government action, Mill says, is very extensive.

In attempting to determine whether a given situation merits state intervention, one is left to wonder why a utilitarian like Mill would argue that simple expediency is not sufficient. Why, that is, must the case for expediency be strong? The answer, for Mill, lies not so much in the virtues of private activities as in the limitations of the state. In spite of his relatively extensive elaboration of legitimate governmental functions, Mill contends that government is poorly organized to carry out many of the tasks that people would wish it to undertake, and that, even if it were well organized, the related information issues and incentives are such as to make private efforts superior to governmental ones in carrying out many tasks (1871, pp. 945-47). Some of the underlying reasons for this are spelled out by Mill in *On Liberty*. For example, he does not dispute the popular belief government jobs do not “hold out sufficient prospects of emolument and importance to attract the highest talents ....” (1859, p. 199). He certainly does not see democracy as any sort of panacea, given that “the general tendency of things throughout the world is to render mediocrity the ascendant power among mankind” (1859, p. 118). The result, then, is “the government of mediocrity,” and this leads to nothing more than “mediocre government.” That having been said, Mill is not keen on having the best and the brightest filling governmental positions either. Such people are limited in number, and having them in government posts in large numbers would eliminate the important outside check on government that these people could provide. The end result, he argues, is that things would not necessarily be any better than under “government by the mediocre.” And even where one can get good people, he says one must still be concerned about excessive limitations being placed on liberty (1859, p. 202).

Mill’s conclusion about the prospects for effective governance, then, are quite pessimistic, at least as regards more or less democratic forms of government: “No

government by democracy or a numerous aristocracy, either in its political acts or in the opinions, qualities, and tone of mind which it fosters, ever did or could rise above mediocrity ...” To rise above mediocrity, he says, requires following the lead of “One or Few” possessed of great wisdom (1859, p. 119). This brings us back, then, to the utilitarian grounding of his views here: “the strongest of all arguments against the interference of the public with purely personal conduct, is when it does interfere, the odds are that it interferes wrongly, and in the wrong place” (1859, pp. 149-50).<sup>19</sup> This same pessimism about the ability of government intervention to make matters better rather than worse extends to his *Principles of Political Economy*. One sees it reflected in his contention that a society should restrict “to the narrowest compass the intervention of a public authority in the business of the community,” and that the burden of proof should fall “on those who recommend, government interference.” The summary version of Mill’s view of the matter is unmistakable in its message: “*Laissez-faire*, in short, should be the general practice: every departure from it, unless required by some great good, is a certain evil” (1848, p. 950).

### **Henry Sidgwick and the Dismantling of the System of Natural Liberty**

Mill’s forays into the realm of externality-related problems with the system of natural liberty and the effects of self-interested behavior received further development at the hands of Henry Sidgwick. Sidgwick considered self-interest a centerpiece of human motivation, noting in his *Principles of Political Economy* that “the motive of self-interest does work powerfully and continually” (1901, p. 402). Because of this, he was a vociferous defender of economists’ use of the assumption of self-interested action by

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<sup>19</sup> This leads Mill to the belief that “the practical principle in which safety resides, the ideal to be kept in view, the standard by which to test all arrangements intended for overcoming the difficulty, may be conveyed in these words: the greatest dissemination of power consistent with efficiency; but the greatest possible centralization of information, and diffusion of it from the center” (1859, p. 204).



economic agents. While he went to some lengths to rebuff the critics who suggested that promoting self-interested action was a *normative goal* of English political economy, he also maintained that self-interested action—e.g., in the way of attempting to sell for the highest price the market will bear or attempting to buy at the lowest possible price—is not “blameworthy” (1885, p. 183). In fact, he was very much aware of its utility in the economic sphere, to the point where “the difficulty of finding any adequate substitute for it, either as an impulsive or as a regulating force, is an almost invincible obstacle in the way of reconstructing society on any but its present individualistic basis” (Sidgwick 1901, p. 402).<sup>20</sup>

Even so, Sidgwick does not find the results of the operation of self-interest to be an unmitigated good, nor does he find any basis for claims of such in classical political economy—at least that of the non-vulgar variety. However, he was well aware that extreme laissez-faire views were in the air:

There is indeed a kind of political economy which flourishes in proud independence of facts; and undertakes to settle all practical problems of Governmental interference or private philanthropy by simple deduction from one or two general assumptions—of which the chief assumption of the universally beneficent and harmonious operation of self-interest well let alone (1885, p. 171).

Sidgwick had little use for this brand of political economy, suggesting that it should be “banished to the remotest available planet” as soon as possible (1885, p. 171).

Sidgwick is quick to point out, though, that the roots of this vulgarity are not to be found in Smith, whose “advocacy of natural liberty in no way binds him to the perpetual and complex opposition and conflict of economic interests involved in the

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<sup>20</sup> Sidgwick’s *Principles* was originally published in 1883. References given here are to the third edition, which was published in 1901.

unfettered efforts of individuals to get rich” (1885, p. 172).<sup>21</sup> He does, however, lay some of the responsibility at the feet of Ricardo and his “more abstract and purely deductive method” (1885, p. 173), a method in many ways at odds with what Sidgwick considered his own more empirically-oriented approach (about which more below).

While Sidgwick believes that self-interest has tremendous utility in the economic sphere he does not believe that the system of natural liberty functions optimally in all times and places. Even if one grants that individuals *are* the best judges of their own interests, he says, “it by no means follows that an aggregate of persons seeking each his private interest intelligently, with the least possible restraint, is therefore certain to realise the greatest attainable happiness for the aggregate” (1897, pp. 144-45). Sidgwick identifies two general categories of divergence between private and social interests: those where laissez-faire’s wealth-maximizing results are not in society’s best interest because there is more to life than wealth, and those where laissez-faire does not even generate the wealth-maximizing result.

In the former case, he points out that “the universal practice of modern civilized societies has admitted numerous exceptions to the broad rule of *laissez-faire*.” For Sidgwick, these exceptions include (i) the protection of those who cannot see to their own self-interest, such as the mentally infirm and children, with the result that we have, for example, regulations regarding children’s education and employment;<sup>22</sup> (ii) measures that deal with issues of physical or moral well-being, such as “sanitary regulations, restrictions on the sale of opium, brandy, and other intoxicants; prohibitions of lotteries, regulation of places of amusement; and similar measures”

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<sup>21</sup> Indeed, Sidgwick says that to suggest Smith proffers “a dogmatic theory of the natural right of the individual to absolute industrial independence ... is to construct the history of economic doctrines from one’s inner consciousness” (1885, p. 173).

<sup>22</sup> See also Sidgwick (1901, p. 425).

(1886, p. 203); and (iii) policies designed to rectify problems with the distribution of income (1886, pp. 202-205).

Sidgwick also sees a number of situations where laissez-faire is *not* wealth maximizing. The problem, he argues, is that the underlying conditions necessary for the system of natural liberty to work the wealth-maximizing magic so often attributed to it do not correspond, in many instances, to actual economic circumstances. The result is that “even in a society composed—solely or mainly—of ‘economic men,’ the system of natural liberty would have, in certain conditions, no tendency to realize the beneficent results claimed for it” (1901, pp. 402-403). Sidgwick cites monopoly as one important example of this problem. His concern here is not just that monopoly reduces output and increases price, as against a competitive market, but also that the monopolist, by virtue of its privileged position, may not have any incentive to invest in the development of more economical production techniques.

Another prominent set of examples Sidgwick cites in support of this argument deals with the use of natural resources, including the potential depletion of mines, fisheries, and plant species, and the diversion of waterways necessary for irrigation and “the supply of motive power.”<sup>23</sup> He begins by pointing out that in a “*perfectly ideal* community of economic men all persons concerned would doubtless voluntarily agree to take the measures required to ward off such common dangers.”<sup>24</sup> In reality, however, “the efforts and sacrifices of a great majority are liable to be rendered almost useless by the neglect of one or two individuals” (1901, pp. 409-410, emphasis added)—a problem he illustrates by applying the then-emerging marginal analysis to the common pool fisheries problem:

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<sup>23</sup> See Sidgwick (1897, p. 147; 1901, pp. 409-13).

<sup>24</sup> See also Sidgwick (1886, p. 207). The parallel to Coase (1960) should not be lost on the reader.

Take, for instance, the case of certain fisheries, where it is clearly for the general interest that the fish should not be caught at certain times, or in certain places, or with certain instruments, because the increase of actual supply obtained by such captures is overbalanced by the detriment it causes to the prospective supply. Here—however clear the common interest might be—it would be palpably rash to trust to voluntary association for the observance of the required rules of abstinence; since the larger the number that voluntarily abstain, the stronger becomes the inducement offered to those who remain outside the association to pursue their fishing in the objectionable times, places, and ways, so long as they are not prevented by legal coercion (1901, p. 410).

This issue of “overusing” natural resources is one facet of two larger issues that Sidgwick sees as potentially serious sources of problems with *laissez-faire*.

The first of these problems is the failure to properly account for the interests and needs of future generations because self-interested economic agents do not take account of the full social impact—positive or negative—of their activities (1901, pp. 412-13, 475-76).<sup>25</sup> For example, a project involving a large present outlay but with benefits (in excess of costs) that accrue only in the distant future may not be undertaken because those who wish to undertake the project lack sufficient capital, while those possessing such capital would refuse to lend or invest because they could not themselves appropriate a sufficient share of the resulting long-term gain. A similar line of reasoning applies to parents, some of whom are unable to see what is in the

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<sup>25</sup> Sidgwick repeatedly emphasizes that the scope the general happiness, good, or welfare encompasses the interests of both present and future generations, and he also argues that this interpretation is held by “the great majority of persons” (1897, p. 38).

long-run best interests of their children and thus will be inclined to under-invest in their education.

A second problem pointed to by the common pool example is that of the “incentive to cheat,” which can manifest itself in a variety of ways in the context of voluntary association, including the overuse problem and the free-rider problem. The power of this incentive is sufficiently large that “it would be dangerous to trust” voluntary agreement or association for the accomplishment of functions of public importance, whether of a traditional public goods variety or more non-traditional (but no less important) tasks such as flood protection for low-lying areas and the protection of “useful animals and plants” against disease (1897, p. 150). Of course, there are also many instances where private enterprise will not provide goods and services in the necessary amounts because of the inability to appropriate sufficient returns to justify the investment—for example, lighthouses, forests (with “their beneficial effects in moderating and equalising rainfall”), worker training, scientific discoveries, and inventions (1901, p. 406; 1897, p. 148).<sup>26</sup>

Sidgwick finds that freedom of action has other limitations as well. One party’s actions may well interfere with the freedom of other parties—such as in the realm of property, where “use” can often give rise to negative spillover effects. Freedom of contract, too, may result in harmful effects to third parties—individuals or society as a whole—and may also violate other existing laws, or even lead to voluntary slavery, which, he argues, is not in society’s economic best interests (1897, p. 90; 1901, pp. 405-406).

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<sup>26</sup> We see here, as in Mill, a mention of the lighthouse as a good that cannot be provided through the private sector. The empirical validity of this assertion was challenged by Ronald Coase (1974), whose argument was, in turn, clarified to some extent by David Van Zandt (1993). See also Medema (1994, chapter 5) and O’Brien (1998, pp. 31-33). Richard Musgrave (1985, pp. 2-15) provides a useful overview of the history of public goods theory.

What, then, are the implications of all of this for the role of the state within the economic system? One approach, and the one much in evidence in the classical literature, is the laissez-faire approach, which Sidgwick defines as “the rule of ‘letting people manage their own affairs in their own way, so long as they do not cause mischief to others without the consent of those others’” (1897, p. 137n). Here, the limits of government activity involve satisfying the “individualistic minimum,” which consists of security of person, property, and contract, and ensuring non-interference among persons absent compensation (1897, pp. 42, 79).

This individualistic minimum contrasts with what Sidgwick refers to as “socialistic” interference. Not to be confused with socialism or collectivism, this interference consists simply of “any limitation on the freedom of action of individuals in the interest of the community at large, that is not required to prevent interference with other individuals or for the protection of the community against the aggression of foreigners” (1897, pp. 42-43). These actions have the effect of narrowing “the sphere of private property and private enterprise by the retention of resources and functions in the hands—or under the regulation—of Government as representing the community” (1897, p. 153).

As Sidgwick goes to some lengths to point out, teasing out the meaning of and content which society should give to these categories is no mean feat. For example, while arguing that infliction of avoidable damage on another party presents a *prima facie* case for government enforcement of compensation, Sidgwick recognizes the difficulty of making such judgments owing to the reciprocal nature of these external effects: preventing harm to one party restricts the freedom of action of another party. Not surprisingly, given his utilitarian approach to these issues, Sidgwick contends that the extent to which one party should be free from interference of the other “can

only be settled by a careful balance of *conflicting inconveniences*” (1897, p. 69, emphasis added).<sup>27</sup>

Sidgwick’s concerns about the less-than-clear-cut nature of the individualistic–socialistic distinction can be further illustrated by examining the issue of fraud prevention—a task which, as he points out, clearly seems to fit within the individualistic minimum. On the one hand, society has any number of fraud prevention rules in place:

To prevent the flesh of diseased animals from being disguised as the flesh of healthy animals; to prevent would-be surgeons or apothecaries from pretending to have obtained certificates of qualification which they have not really obtained; to oblige employers who may have contracted to pay wages in goods to supply such goods in strict accordance with contract as regards quality and price (1897, p. 135)

And, he says, “all this is clearly and directly individualistic” (1897, p. 135). Yet, he continues, there are forms of fraud prevention that would be seen as violations of the individualistic minimum—such as if the government “absolutely prohibits the purchase of food it deems unhealthy, the consultation of a physician it deems unqualified, the adoption of methods of payment it deems unfit.” In these cases, Sidgwick argues, the state’s actions fall squarely within the realm of the “paternal” (1897, p. 135).

There are, however, other alternatives for dealing with these types of information problems—ones in which, as Sidgwick notes, government can take steps that will prevent deception without incurring charges of paternalistic interference: “it

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<sup>27</sup> Once again, the commonality with Coase (1960) is worth noting. These remedies, Sidgwick says, should be sufficient both to fully compensate for harm done and to prevent these harms in the future (1897, p. 110).

may take measures to remove the ignorance of consumers as to the dangerous qualities of commodities offered for purchase,—or the ignorance of labourers as to the dangerous nature of the instruments which their employers require them to use,—without compelling anyone to act on the information thus supplied” (1897, p. 135-36). This, of course, parallels Mill’s category of non-authoritative interference, discussed above. Whether the government’s actions are considered to be individualistic or socialistic thus comes down to the method that it employs in its attempt to prevent the harm. By employing “measures to remove ignorance,” the government fulfills the task of protecting individuals from harm caused by the actions of others, but still allows these individuals assume the relevant risks if they so choose. Prohibitions, by way of contrast, involve the government making people’s choices for them. For example, by restricting the depletion of natural resources, government fulfills its duty of “representing the community [present and future] to prevent the bounties of nature from being wasted by the unrestricted pursuit of private interest” (1897, p. 147).<sup>28</sup> The determination of the extent and limits of this, including of the scope of private vs. common property is “a matter which has to be settled by the aid of special experience on a balance of conflicting considerations” (1897, p. 77).

It is “an anachronism,” says Sidgwick, “to not recognize fully and frankly the existence of cases in which the industrial intervention of Government is desirable, even with a view to the most economical production of wealth” (1885, p. 175).<sup>29</sup> But

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<sup>28</sup> See also Sidgwick (1901, pp. 475-76).

<sup>29</sup> Sidgwick argues that the shortcomings of private enterprise justify government interference with the provision goods that he categorizes under the heading “machinery of transfer” (things that facilitate transactions and exchange). Here, Sidgwick makes a more sophisticated case than that extant in the literature for governmental provision of traditional public works including roads, canals and railways, telegraph and postal services, and light and water, as well as the provision of currency, banking and insurance services for the poor, and the collection and dissemination of statistical information.<sup>29</sup> Not only is government, according to Sidgwick, “peculiarly adapted to provide” these services; in doing so, it becomes the *facilitator* of commerce and the market rather than an impediment to it (1901, pp. 438-39).



the fact that market outcomes are not always wealth-maximizing or otherwise in society's best interests does not mean, for Sidgwick, that government intervention is the best course of action. "[I]n human affairs," he says, "we have often only a choice of evils, and even where private industry fails to bring about a satisfactory result, it is possible that governmental interference might on the whole make matters worse" (1886, p. 206).<sup>30</sup> In support of this, Sidgwick points to several "drawbacks and disadvantages" associated with government intervention: (i) government using its power for corrupt purposes; (ii) the desire to please special interest groups; (iii) "wasteful expenditures under the influence of popular sentiment" that arise because "the mass of a people, however impatient of taxation, are liable to be insufficiently conscious of the importance of thrift in all the details of national expenditure"; (iv) the supervisory problems with the expansion of the range of government activities; (v) the cost of the of taxes associated with these operations of government; and (vi) the lack of incentives for government workers to properly carry out the functions assigned to them (1901, pp. 414-15; 1897, pp. 167-68). Sidgwick argues that these "costs" must be weighed against the benefits to determine the appropriateness of government intervention, and, even when intervention is in the public interest, this interference should, he says, be as mild and as narrowly drawn as possible while still accomplishing its set goal.

Even with these drawbacks, however, Sidgwick believes that the extent of the failure of public and social interests to coincide is such that we need to "regard governmental interference as not merely a temporary resource, but not improbably a normal element of the organization of industry" (1901, p. 414). In these cases, "the

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<sup>30</sup> Sidgwick expresses a similar sentiment in his *Principles*: "It does not of course follow that wherever laissez-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).

general economic presumption in favor of leaving social needs to be supplied by private enterprise is absent, or is balanced by strictly economic considerations on the opposite side” (1886, p. 206). But reflecting Sidgwick’s view that self-interest channeled through markets is the best single system society has yet been able to devise, he goes on to point out that this interference “is here only recommended as a supplementary and subordinate element” (1897, p. 146).<sup>31</sup>

In spite of the various negative attributes of state action identified by Sidgwick, he does not share the degree of all-encompassing pessimism exhibited by Mill and the larger classical tradition toward the possibilities of government intervention. In fact, Sidgwick suggests that in the long run “moral and political progress [in society] may be expected to *diminish*” the extent and severity of the shortcomings associated with government intervention (1901, p. 416, emphasis added). This, in turn, will increase over time the range of activities that government can carry out in a manner superior to market forces. This long-run optimism is most strikingly expressed in his assessment of socialism. While of the mind that collectivism would, at the time of his writing in the late nineteenth century, “arrest industrial progress” and bring about “equality in poverty,” he saw something potentially quite different for the future:

It is, I think, quite conceivable that, through improvements in the organization and working of governmental departments, aided by watchful and intelligent public criticism—together with a rise in the general level of public spirit throughout society—the results of the comparison [between individualism and

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<sup>31</sup> A further issue that arises is that, in many cases, the “*economic* considerations” at stake are inconsequential. As a result, “the final decision” as to the expediency of many regulations “does not fall within the sphere of political economy and cannot be arrived at by strictly economic methods” because “life and death are goods which it is not possible to estimate at a definite pecuniary value” (1901, p. 424). Interestingly, though, Sidgwick does allow that “all reasonable persons would admit that at a certain point the machinery for saving even life and health may become too costly,” and thus “the practical necessity of balancing these goods in some way against wealth cannot be avoided” (1901, p. 424, n.1).

collectivism] will at some future time be more favourable to governmental management than they hitherto have been (1897, p. 159).

The question of the accuracy of this prognostication—which, by the way, was later evidenced in Pigou (1912, 1932) as well<sup>32</sup>—is less important for present purposes than its contrast with the classical view and its seeming conflict with Sidgwick’s stated empirical approach to these issues.

### **Utilitarianism, Optimism, and the Flight from Natural Liberty**

In Mill we see continuity with the classical tradition in his discussion of the state and, especially, his dim view of the prospects for government intervention.<sup>33</sup> However, we see a major break from the classical system in his expansive view of the failings of the system of natural liberty. In the transition from Mill to Sidgwick, we have added to this a major shift in the view of the state away from the classical perspective. Via this two-stage process, then, we arrive, by the late 19<sup>th</sup> century, with a view of the respective efficacies of natural liberty and the state that is in some sense 180 degrees opposed to the perspective that was dominant during the classical period.<sup>34</sup>

Mill’s theory of market failure and accompanying view of the role of the state is heavily grounded in his utilitarianism. This allows him to move the debate beyond the “handy rule of thumb” pragmatism to a grounded criterion for government intervention. That having been said, his is not a full-blown utilitarianism. Liberty absent negative spillovers is inviolable for Mill, and utilitarian demonstrations that

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<sup>32</sup> It may surprise the reader to hear that one finds a similar optimism about the prospects for governmental reform evidenced in Smith’s discussion in *The Wealth of Nations*. This was later to bring a harsh rebuke from George Stigler (1971/1982).

<sup>33</sup> In this sense, Mill’s perspective was more of a piece with the non-utilitarian branch of classicism than with that of his father and Bentham.

<sup>34</sup> Note that I qualify this with “in some sense” to emphasize that the transition was not anything like so great as to be labeled “socialist.” However, we had moved back to a pre-classical view in the sense that the state was seen as a more overtly necessary player in the process of reigning in the base effects of self-interest.

government could enhance welfare by violating individual liberty are not, regardless of extent, sufficient to justify government intervention. For Mill, there is a universal rule for *non-interference*, but not for *interference*: utilitarianism comes in, and only comes in, in the presence of harmful spillover effects.

Mill's belief that utility is "the ultimate appeal on all ethical questions" (1859, p. 24) tells us that he places individual liberty on a plane above ethical debates and beyond subjection to the utilitarian calculus. Such is not the case for economic activity, however. Trade fits into the utilitarian category because it is "a social act": "Whoever undertakes to sell any description of goods to the public, does what affects the interest of other persons, and of society in general; and this his conduct, in principle, comes within the jurisdiction of society ..." (1859, p. 170). As Mill points out, the social nature of economic activity had long been recognized, and had functioned as the rationale for the extensive regulation of economic activity throughout the ages.<sup>35</sup> Only "after a long struggle" did the benefits of free trade become more clear and cause a fairly dramatic change in thinking on this matter—as worked out in classical free-trade doctrine.

What we have in Sidgwick is a well-developed view—one that he considered empirically-based<sup>36</sup>—both of the limitations of self-interested action operating through the market and of governmental attempts to improve on these outcomes. Here, simplistic and a priori approaches to questions of the role of the state give way to a thorough-going utilitarianism—one in which "the ultimate criterion of the goodness of law, and of the action of government generally, is their tendency to increase the general happiness" (1897, p. 39). In terms of figure 1, above, there is no region in which government intervention is inappropriate or off limits in an a priori sense. In

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<sup>35</sup> See, e.g., Gordon (1975) and Medema (2003).

<sup>36</sup> But see O'Brien (1998).

Mill's system, for government to intervene for a person's own good, "either physical or moral," is completely out of bounds. Sidgwick, in contrast, argues that while individualism is often consistent with utilitarianism, it is utilitarian concerns that are paramount. And, he says, from a utilitarian perspective larger societal interests sometimes trump the dictates of individualism.<sup>37</sup> The fact that people are at times are unable to see their own best interests or to take adequate care of themselves justifies, in his view, certain paternalistic actions on the part of government—hence the need for health regulations on foodstuffs, the licensing of physicians and other occupations, workplace safety regulations, and so on (1901, p. 425). As such, Sidgwick evidences a much greater consistency in his utilitarianism than does Mill.<sup>38</sup> In part because of this, but also because of his less negative view of government agents, Sidgwick is also willing to allow for a much more expansive role for the state than is Mill.

The source of Sidgwick's critical attitude toward the a priorist and abstract deductive approaches to examining the working of the system of natural liberty and the potential for improvements via the policy process lies his utilitarianism,<sup>39</sup> and it is thus not surprising that Sidgwick would see things beginning to move in a better direction with the development of a more empirically grounded approach to these policy issues. The empirical turn is best exemplified, he maintains, in the work of Mill, who made things "more balanced, qualified, and empirical," and more in tune with modern science (1885, p. 174). Sidgwick also find empirical support for his position in the general mood of the day, where, he says, the "drift of opinion and practice is in the

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<sup>37</sup> See Sidgwick 1907, pp. 444-45).

<sup>38</sup> John Rawls speaks to the greater consistency in the utilitarianism of Sidgwick as against Mill in the "Foreword" to the 1981 reprinting of Sidgwick (1907).

<sup>39</sup> At one point, he describes himself as a "mere empirical utilitarian" (Sidgwick 1886, p. 211).

direction of increasing the range and volume of the interference of government in the affairs of individuals ..." (1897, p. 143).<sup>40</sup>

In spite of his negative assessment of Ricardo's abstraction and his own belief that he could not himself be charged with "overrating the value of abstract reasoning on economic subjects, or regarding it as a substitute for an accurate investigation of facts" (1885, p. 171), Sidgwick does not deny that there is a role for abstract theory in policy analysis. While the appropriateness of government interference in any particular case requires an examination of the various facets of the actual problem as it arises and cannot be resolved by appeals to abstract theory, abstraction can provide a framework for thought and analysis. It may, he says, "supply a systematic view of the general occasions for Governmental interference, the different possible modes of such interference, and the general reasons for and against each of them, which may aid practical men both in finding and in estimating the decisive considerations in particular cases" (1885, p. 176). It can show when the "drawbacks" referred to above are likely to be least, and how they might be minimized, as well as when returns to private provision are not sufficiently large or where private and public interests are likely to collide.

In fact, Sidgwick suggests that abstract reasoning, far from supporting the laissez-faire orthodoxy, points in the same direction as his own approach: "the general presumption derived from abstract economic reasoning," he says, "is not in favour of leaving industry altogether to private enterprise ... but is on the contrary in favour of supplementing and controlling such enterprise in various ways by the collective action of the community" (1901, p. 417). This analysis shows that the flaws in the system of

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<sup>40</sup> He does note, however, that much of this expansion has to do with the protection of individuals from the effects of the actions of others, and to that extent can be seen as consistent with individualism (1897, p. 143).

natural liberty mean that “various kinds of interference with industry ... may be necessary or expedient” for dealing with industry issues such as cartels and monopolies, as well as “for the due protection of life, health, physical comfort, freedom, and reputation of individuals from harm inflicted, intentionally or otherwise, by private persons” (1901, p. 423).

## **Conclusion**

Mill and Sidgwick both came at the question of the economic role of government from a utilitarian perspective and, in doing so, took the pragmatic view well (and increasingly) beyond that of the classical economists of the first half of the 19<sup>th</sup> century. Mill set himself apart from his classical forbearers in attributing a much more expansive set of limitations to the system of natural liberty, but he shared with them a dim view of government agents and a resulting pessimistic view of the ability of government to improve on market performance—to the extent that the case for the “expediency” of intervention had to be *strong*. Sidgwick ascribed an even greater set of failings to the system of natural liberty than did Mill. And, while Mill refused to subject individual liberty absent negative spillovers to the same utilitarian analysis as when spillovers were present, Sidgwick, in marked contrast, went all the way with utilitarianism and evidenced a great deal more optimism about the efficacy of government intervention.

Not long thereafter, A.C. Pigou (1912, 1928, 1932) took all of this a step further, grafting the analysis of the potential for market failure evidenced in Sidgwick to the emerging technical toolkit of marginal analysis.<sup>41</sup> The next few decades saw the fleshing out of Pigou’s analysis as part of the development of neoclassical welfare economics, which demonstrated with steadily increasing analytical rigor the conditions

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<sup>41</sup> See, e.g., Medema (2006).

necessary for market optimum, the factors and forces that would cause market outcomes to diverge from the optimum, and the means by which governmental action could correct these market failures. The qualms regarding the ability of government to actually accomplish the correction of market failures, so much in evidence in classical economics, had all but disappeared. The role of government *vis-à-vis* the market was no longer an a priori set of assertions, nor an opinion based upon casual empiricism; instead, it was considered to be demonstrable in a “scientific” sense.

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