PIGOU'S "*PRIMA FACIE* CASE": MARKET FAILURE IN THEORY AND PRACTICE

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I. Introduction

The idea that the pursuit of private interests may not redound to the larger social interest has a long history in economic thinking.[1] This line of thinking began to coalesce into an analysis of market failure in the second half of the nineteenth century, a process that culminated in Pigou's analysis of private and social net products in his *Economics of Welfare*. *The Economics of Welfare*, in turn, laid the foundation for the development of the orthodox theory of market failure in the middle third of the twentieth century. The resulting advances showed the restrictive nature of the conditions for optimality and, as a result, the pervasiveness of market failure. With this came demonstrations of how governmental policies could be put in place to achieve optimality. The last third of the century witnessed the rise of some significant controversy on this score, as the work emanating from members of the Chicago and Virginia schools—e.g., James Buchanan, Ronald Coase, Milton Friedman, Robert Lucas, George Stigler, and Gordon Tullock—caused a reexamination of the relations between state and economy at both the micro and macro levels.

This evolution, and thus the history of the theory of market failure, rests on a particular view of Pigou's contribution in *Economics of Welfare*, and, as we shall argue in what follows, the Pigovian—or orthodox—theory of market failure[2] developed in a different direction than that

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1 See Medema (2003) for a survey.

2 When we speak of "market failure" here, we are referring to what is traditionally called "allocation" failure, as reflected in the theories of externalities and public goods in particular. For a discussion of the larger welfare approach of Pigou and the Cambridge tradition, see the several recent works on this subject by Roger Backhouse.

laid out by Pigou himself because it neglected the larger underpinnings of Pigou's analysis in *The Economics of Welfare* (1932).[3] This treatise, which reveals both an extensive array of market failures and prescribes government policies for correcting them, has been cited by both friends and critics alike as the basis for a neoclassical approach to market failures that was rather overtly interventionist—market affirming, perhaps, but certainly reformist in outlook. As Stanislaw Wellisz (1965, p. 347) put it, "The Pigovian tradition, accepted by modern welfare economists, claims that whenever private and social costs diverge, steps should be taken to equalize the two."[4]

When read against the background of Pigou's little-known essay on "State Action and Laisser-Faire" (1935), however, one gets a very different picture of what Pigou intended in this work[5]—one rather at odds with both the subsequent Pigovian tradition and the characterization of Pigou's approach by critics such as Ronald Coase.[6] In the pages that follow, we shall attempt both to juxtapose Pigou's position on the economic role of government as reflected in his 1935 essay with that in *The Economics of Welfare* and to attempt to shed a bit of light on how the Pigovian (as distinct from Pigou's) theory of market failure came to diverge so significantly from this. As we shall see, the answer has a great deal to do with Pigou's distinction between theory and practice, and the attribution of "practice" to Pigou's "theory" by those who later built upon

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[3] The first edition of *The Economics of Welfare* was published in 1920.

[4] In addition to Wellisz (1965), see also Meade (1952), Bator (1958), Mishan (1971), Coase (1960), Buchanan and Stubblebine (1962), and Baumol (1972).

[5] While one may argue that Pigou's position in 1935 may have been different than that elaborated in a book written in 1920 and revised in 1932, the revisions undertaken in editions published after 1935 do not contradict the basics of the earlier analysis. Moreover, his *Theory of Public Finance* (1928) evidences a similar perspective to that of his 1935 essay.

[6] See Baumol (1972) Coase (1960) and the discussion of Coase and Pigou in Aslanbeigui and Medema (1998).

his work in *The Economics of Welfare* in the process of constructing the neoclassical theory of market failure.

I. Market Failure in Theory

We need to begin with a brief account of the theory of market failure set out by Pigou in his *Economics of Welfare*. Here, Pigou endeavors to examine, in part, "how far the free play of self-interest, acting under the existing legal system, tends to distribute the country's resources in the way most favourable to the production of a large national dividend, and how far it is feasible for State action to improve upon 'natural' tendencies" (1932, p. xii). As the maximization of the national dividend comes through the equality of the values of marginal private net product and marginal social net product, he is led to analyze the extent to which market forces generate these coincidences. When the private and social net products diverge, a potential role for government corrective action arises, as "certain specific acts of interference with normal economic processes may be expected, not to diminish, but to increase the dividend" (p. 172).

The first of these situations of divergence between private and social net products pointed to by Pigou are those where agents with the potential to invest in socially-beneficial capital improvements fail to do so in optimal amounts because there is some positive probability that they will not be able to recoup the necessary share of associated benefits (pp. 174-83). This type of situation can arise in tenancy relationships, as well as when private firms are given concessions to operate "public utilities" where there exists the possibility that the plant may, at the expiration of the concession contract, pass into the hands of government without compensation. Pigou points out that the resultant under-investment problem can be mitigated through laws that mandate compensation for capital improvements made, whether between government and concessionaire or between landlord and tenant.

Of the various instances of divergence between private and social net product, perhaps the most important, in terms of long-run impact on the literature, are situations in which "one person A, in the course of rendering some service, for which payment is made, to a second person B, incidentally also render services or disservices to other persons (not producers of like services), of such a sort that payment cannot be exacted from the benefited parties or compensation enforced on behalf of the injured parties" (p. 183). Pigou distinguishes here between situations of positive externality, where "marginal private net product falls short of social net product, because incidental services are performed to third parties from whom it is technically difficult to exact payment" (pp. 183-84), and negative externalities, where, "owing to the technical difficulty of enforcing compensation for incidental disservices, marginal private net product is greater than marginal social net product" (p. 185). In the former case we have, e.g., lighthouses, parks, roads and tramways, afforestation, street lighting, pollution abatement, and scientific research, while in the latter category he includes the effects of such things as congestion and destruction of amenity from new factories and from new buildings erected in crowded city centers, the damage to roads from automobiles, the production and sale of alcohol, and the effects on children from factory labor of women.

Pigou allows that the divergences between private and social products that arise between contracting parties—as in the case of the principal-agent problems that result from tenancy situations—may be amenable to resolution by negotiation, but he contends that such is not possible in situations of third-party effects. However, he says, it is possible for the state to step in "to remove the divergence in any field by 'extraordinary encouragements' or 'extraordinary restraints'," the "most obvious" forms of which are “bounties and taxes” (p. 192).[7] And in certain cases, “when the interrelations of the various private persons affected are highly complex,” regulations—such as zoning ordinances—may be in order. Pigou is clearly of the mind that large numbers externality problems are inevitable and that they invalidate the claims made by certain earlier commentators regarding the workings of the system of natural liberty:

> It is as idle to expect a well-planned town to result from the independent activities of isolated speculators as it would be to expect a satisfactory picture to result if each separate square inch were painted by an independent artist. No “invisible hand” can be relied on to produce a good arrangement of the whole from a combination of separate treatments of the parts. It is, therefore, necessary that an authority of wider reach should intervene and should tackle the collective problems of beauty, of air and of light, as those other problems of gas and water have been tackled (p. 195).

Pigou goes on to discuss a wealth of additional situations where private and social interests may diverge, both in input and in output markets. Most prominent among these, and the most controversial at the time of his writing, are situations of increasing and decreasing returns—the former generating a sub-optimal quantity of output and the later a supra-optimal quantity. Here, following Marshall, Pigou advocates corrective subsidies and taxes, respectively, to ensure the attainment of optimality (pp. 213-28).[8] The emerging recognition that there was something between perfect competition and monopoly—namely, monopolistic competition—introduces, according to Pigou, a further source of market failure:

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[7] Marshall had argued likewise, advocating taxes on those who build houses in highly populated areas to finance the construction of playgrounds.

[8] Pigou’s work in this vein was, of course, part of a running controversy over the treatment of the problems of increasing and decreasing returns, a number of the most important essays from which are reprinted in Stigler and Boulding (1952).

advertising. Because, in his view, advertising often serves merely to attempt to transfer business from one seller to another and thus generates a net social product lower than the private one, Pigou recommends that such advertisements either be taxed or be prohibited outright (pp. 196-200).

The next few decades saw the fleshing out of Pigou's analysis, as those working in the burgeoning field of welfare economics were able to demonstrate—and with increasing analytical rigor—the conditions 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.[9] While Pigou had demonstrated the existence of market failure where private and social interests diverge, his attempts to demonstrate that phenomena such as positive or negative third-party effects *cause* market failure relied on logical argument, and his assertions that government could remove these divergences with appropriate policy measures were statements of possibility or potential, rather than demonstrations on a par with analysis of market failures themselves.

But the groundwork had been laid, and it was not long before the economist's burgeoning mathematical toolkit was employed to hammer down all of the related details, to demonstrate both that externalities did indeed cause departures from the social optimum and that appropriately-set taxes, subsidies, and regulations could cause the actions of private agents to harmonize with the social interest. It was this that became the orthodox approach to the analysis of market failures, as Wellisz (1965, p. 345) makes clear in his 1965 commentary:

> Much of modern welfare economics is indeed concerned with the problem of market failure, and the analysis of market failure appears to imply the desirability of administrative intervention. Until recently everybody agreed that where there are externalities, market

[9] See Mishan (1971) for a survey.

> allocation is bound to be non-optimal; the only point of controversy concerned the frequency and the severity of the external effects and the urgency of administrative action.[10]

This perspective also came to dominate both the professional literature and the textbook treatments of public goods and externalities in the last half of the twentieth century.

The received view was ostensibly built on the foundation laid by Pigou in *The Economics of Welfare*. And, while there is no doubt that Pigou's work inspired much of the literature that followed, a good case can be made that this literature represents a significant departure from Pigou's perspective—especially when considered against the backdrop of Pigou's essay, "State Action and Laisser Faire."

III. Market Failure in Practice

A. Market, State, and the Fallacy of "Either-Or"

The subject of Pigou's 1935 essay, which is the published text of a lecture given in Cambridge, is "the attitude of economists towards state action" (1935d, p. 107).[11] Pigou comes right out of the gate by arguing not *against* laissez-faire, but that forming a sharp distinction between "State Action" and "Laisser-faire" is "unreal and misleading" (p. 109):

> No defender of so-called laisser-faire desires that the State should do absolutely nothing in matters relevant to economic life. The most ardent believer in the economic harmonies, that are supposed to flow from the unimpeded pursuit by individuals of their private interests, argues that these harmonies will not emerge unless robbery at arms is restrained by law, fraud repressed, and contracts which have been formally accepted enforced (p. 109).

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[10] See also the references cited in note 4, above.

[11] Unless otherwise noted, all cites to Pigou are to 1935d.

This, of course, is completely consistent with Adam Smith's discussion in *The Wealth of Nations* (1776), and, as Pigou points out, it is also reflected in the perspective of Edwin Cannan—no friend of the Pigovian-Cambridge tradition, who notes that "The working of self-interest is generally beneficial, not because of some natural coincidence between the self-interest of each and the good of all, but because human institutions are arranged so as to compel self-interest to work in directions in which it will be beneficial."[12] Pigou contends that institutions such as family, property and contract law, prohibition of fraud, and the police are all obvious and almost universally unobjectionable components of the societal structure in the West and help to channel the operation of self-interest to the benefit of society (p. 110).

Recognition of this (oft-unrecognized) basic idea changes the entire character of one's thinking about market and state. The "real question," says Pigou, "is not whether the State should act or not, but on what principles, in what degree and over what departments of economic life its action should be carried on." Nor are the answers to this question by any means obvious: "The issue is not one of yes or no, but of more or less; of delimiting an uncertain frontier; of weighing, in different departments, conflicting advantages, the balance of which sometimes tips to one side, sometimes to the other" (p. 110).

B. Method

This might seem to leave rather little room for the sort of theoretical approach set out in *The Economics of Welfare*. And indeed, given the theoretical nature of Pigou's *Economics of Welfare*, it may come as a surprise—if one neglects Pigou's strong links to Marshall—to note that he considers economics "a tradesman among the sciences" (1935a, p. 2) and is of the mind that, while the elegant systems of equations set out by, e.g., Walras and Pareto

[12] Quoted in Pigou (1935d, pp. 109-110).

have a certain "aesthetic appeal," economics "does not lend itself to triumphs of pure reasoning" (1935a, p. 4). Because of this, economics finds its reason for being in "its promise of fruit rather than … its promise of light" (1935a, p. 5). This does not mean, however, that Pigou is willing to write off theorizing or suggest that economists should only study practical problems, as we can see in his strong defense of economic theorizing in the "empty boxes" debate.[13] Here, at least, economics can learn from the natural sciences, he says, in that "Remoter, more fundamental, so to speak more theoretical, investigations sometimes in the end yield the largest harvests" (1935a, p. 6).

The policy realm, though, does introduce a number of complications, the most fundamental of which is that one cannot determine which particular course of action is desirable absent some criterion for judging between them (1935b, p. 132). Many policies are wide-spread in their effects. "On which human beings," he asks, are the effects to be measured? Do we look at the effects on domestic society? On some subset of society? If the latter, which subset? On the whole world? The answers to questions of this nature, says Pigou, are "for the student of Ethics, not for economists" (1935b, p. 133).

Here, Pigou's perspective, while thoroughly Marshallian in orientation, also reinforces the position evidenced in Lionel Robbins's *Essay on the Nature and Significance of Economic Science* (1932), the parallels to which are even more fully elaborated in Pigou's contention that:

> in economics proper the word *ought* has no place. Its business is to study what *tends* to happen, to trace the connection between causes and effects, to analyse the interplay of conflicting forces. It is a positive science, not a normative science. It is concerned, like physiology, to discover what effects various drugs will produce, not, like medicine, to prescribe what drugs ought to be taken (p. 107).

[13] See, e.g., Clapham (1922) and Pigou (1922).

This, then, conflicts with the market failure *cum* government corrective action approach that was to develop within the Pigovian tradition. Moreover, while the theory was to move in an increasingly technical and homogenized direction over the next several decades, finds that the positive scientific process is facilitated by pluralism, noting that "Divergent methods," such as the historical and mathematical approaches, "are partners not rivals" in building economic understanding (1935a, p. 22).[14]

But even a positive approach has significant limitations, according to Pigou. In particular Pigou argues that it is very difficult to gauge the effects of many proposals beyond what he calls "vague judgments." The problem, he says, is that while economics is very successful at qualitative analysis, it has severe limitations on the quantitative analysis side. The result is that prediction amounts, at best, to "instructed guess-work," although he holds out hope that the progress of economics may lead to some advances on this front (p. 109).

C. Disharmony and Waste

What is the relation of all of this to Pigou's discussion of market failure? In attempting to discern the appropriate scope of State action, Pigou argues that the market system leads to two forms of "evils and wastes" (p. 113). The first of these arises from the incompetence of individual agents in pursuing their chosen ends—e.g., the supply of a good for which there is insufficient demand to sustain the production process and led, in Pigou's time, to calls for central planning. The second is the divergence between private and social interests—e.g., monopoly and externalities—and suggests the possibility of correction state action operating on the market.[15]

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[14] Again, this is the same position that we see Pigou (1922) taking in the empty boxes debate.

[15] A more extensive discussion of Pigou's conception of waste can be found in his essay on "Economy and Waste" (1935c).

As Pigou rightly points out, the first of these sources of waste arises from the failure of private agents to properly forecast the market for these products. The cases for State action (central planning) in this instance, then, comes down to one's willingness to assume that the State can do a better job of forecasting demands than can private enterprise—a proposition that Pigou finds rather dubious:

> It is easy for a public servant, looking back when he knows the course that demand has taken, to point out the mistakes of those who tried to forecast it. But it is a very different thing for that public servant to make a forecast. The fundamental assumption, on which the whole case for this sort of planning rests, is that public servants will prove specially skilled at this (pp. 114-15).

That Pigou finds this assumption "at least a doubtful one" (p. 115) is not surprising in light of his views on the problems of forecasting, noted above.

This issue takes on a somewhat different cast in the case of private and social disharmonies. Here, there is a degree of simultaneity that may well allow the agents of the State to discern a divergence between private and social interests—a divergence that the private agents likely would not be willing to mitigate of their own volition since doing so would run contrary to their self-interest. The problem here, as Pigou points out, is that institutions are not always structured in such a way as to channel private interests to the best interests of society as a whole (p. 115).

Pigou is quick to point out that this is not a uniquely Cambridge insight—that "the doctrine of the invisible hand evolving social benefit out of private selfishness has never been held by any economist," including Adam Smith—in any sort of rigid form. Rather, he says, "All are agreed that many times the hand falters in its aim" (p. 115). Pigou breaks down the resulting disharmonies into three general categories. The first is disharmonies in production, which includes instances where firms are able to garner for themselves substantial monopoly power, situations of negative and positive externalities, and excessive discounting of the future, which gives rise to problems such as underinvestment and premature depletion of natural resources.

The second major category of disharmony is in the distribution of income, which, he says, gives rise to social losses whenever there are substantial inequalities of income. Here, Pigou explicitly invokes the assumption of diminishing marginal utility of income and does so in an almost sarcastic way, noting that, "The ninth course of the plutocrat's dinner, despite the indirect benefit that it may confer on his doctor, yields much less satisfaction on the whole than the milk which the cost of it might have secured for a poor man's child" (p. 121). Pigou also finds this distributional disharmony in the wage bargain, absent employee unions. Finally, there is a third manifestation of disharmony in the various problems associated with industrial fluctuations, including in levels of production, consumer demands, and the expansion and contraction of credit (pp. 123-24).

What we have here are, in modern language, allocation failure, distribution failure, and stability failure, respectively—"failures" in the sense that, in each instance, the market fails to generate the best possible result for society.[16] When this happens—that is, when "private self-interest, acting freely, subject only to the ordinary forms of law, does not lead to the best results from a general social point of view"—there is, says Pigou, "a *prima facie* case for State action" (1935d, p. 124). Pigou makes the same argument in his *Economics of Welfare*, where he says that "[i]n any industry, where there is reason to believe that the free play of self-interest will cause an amount of resources to be invested different from the amount that is required in the best interest of the national dividend, there is a *prima facie* case for public intervention" (1932, p. 331).

[16] Our focus in the present paper is allocation failure, although certain aspects of the discussion generalize.

D. The "*Prima Facie* Case"

To this point, the story sounds remarkably like the post-war neoclassical theory of market failure, described above. But where does the *prima facie* case actually take Pigou? Specifically, what normative content is to be attributed to it? He speaks briefly about this topic in *Economics of Welfare*, noting that "The case … cannot be more than a *prima facie* one, until we have considered the qualifications, which governmental agencies maybe expected to possess for intervening advantageously." Here, he gets specifically to the theory-practice distinction, although not characterizing it as such, when he says that "It is not sufficient to contrast the imperfect adjustments of unfettered private enterprise with the best adjustment that economists in their studies can imagine. For we cannot expect that any public authority will attain, or will even wholeheartedly seek, that ideal" because of information problems faced by, and the pressures brought to bear on, governmental agents (1932, pp. 331-32). One can hear in this echoes of the classical economists' qualms regarding the ability of government to get things right.

In "State Action and Laisser-Faire," Pigou provides a more elaborate answer, albeit again not the answer one might expect based on the direction taken by modern Pigovian economics and ascribed to it, and to Pigou himself, by the critics. The *prima facie* case, Pigou says, "only takes us a little way":

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

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

First, the attitude of the citizens toward government action is of great import. Second, there is the issue of the "quality of the body" that would be making these decisions about the form and extent of state action. This includes:

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

While acknowledging that the governmental authorities of Smith's day were likely less than stellar in their abilities to manage economic affairs—thereby justifying Smith's dim view of governmental interference with the flow of resources—Pigou is of the mind that the 150 years since Smith have seen the rise of "governing authorities … enormously better equipped for successful action" (p. 126). Drawing on Marshall, Pigou attributes this at least in part to increased levels of education and the "surplus energy" that was made possible by increases in the technology of production, and he praises both the Civil Service for its "high capacity and unquestioned public spirit" and the politicians for their absence of personal corruption (p. 126).

Pigou was not so naïve, though, as to think that governing bodies had reached anything like perfection. In particular, Pigou saw politicians as "subject to great pressure from persons who can control votes," and the financial stakes that accompany many policy proposals make logrolling and lobbying "powerful forces" that "are certain to be called into play" (p. 126). The effect of this is that the efforts of the state are "most likely to be invoked successfully by the strong," rather than by the weak, who really need it (p. 126). It is practical concerns of this nature, rather than "any abstract plea for laisser-faire in matters of trade," that speak most loudly against government interference.

Even so, Pigou does point out, both in *Economics of Welfare* and in "State Action and Laissez-Faire, that these problems can potentially be gotten around. Specifically, he argues that quasi-governmental entities—he mentions Public Service Boards and Commissions—that are not directly subject to political control offer a means of avoiding some of these problems that wasn't present in times past. The members of general governmental bodies are elected for a host of reasons often unrelated to the regulation of industry. The specialized boards and commissions, in contrast, offer the opportunity to appoint members whose abilities are well-suited to the regulation of industry. Moreover, he says, these individuals could be appointed for longer terms of service than are standard for elected officials, which would help to insulate them from electoral pressures (1932, p. 333-35; 1935d, p. 127).

The overarching point, for Pigou, is that there is no definitive answer, *a priori*, to the effects of the problems of state intervention pointed to above. Rather. "For different kinds of action their importance is different: sometimes it is trifling, sometimes dominant" (1935d, p. 127). Thus, he says, whether one comes at this from the direction of laissez-faire or that of state action, one is led to a single conclusion:

> Inquiring how far the free play of private self-interest makes for social advantage, we find that it frequently fails to do this, but that there are many different forms and many different degrees in its failure. Inquiring how far Government is fitted to take action against these failures, we find that its fitness to do this varies, not only in different places and different times, but also as between interventions directed against different kinds of failure (p. 127).

The larger lesson that Pigou draws from this is that generalizations are of little or no help in dealing with the difficult issues of economic policy. In particular, he says, "The issue about which popular writers argue—the principle of laisser-faire *versus* the principle of State action—is not an issue at all. There is no principle involved on either side." Instead of appeal to so-called principle, Pigou argues, "Each particular case must be considered on its merits in all the detail of its concrete circumstance" (pp. 127-28).

It is interesting to compare Pigou's position here with that of Henry Sidgwick, who had a significant influence on both Marshall and Pigou. Sidgwick, like Pigou—although without the graphical tools—worked out the analytics of market failure and governmental response in a marginalist framework. In doing so, he determined that

> the general presumption derived from abstract economic reasoning is not in favor 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. ... [B]ut it would hardly be possible to work out a system of detailed practical rules on the basis of these principles, by the abstract deductive method here adopted; owing to the extent to which the construction of such a system ought to be influenced by the particular social and political conditions of the country and time for which it is framed. In passing, therefore, from abstract principles to their concrete applications ... it seems best to adopt a more empirical treatment (Sidgwick, 1901, pp. 417-418).

Sidgwick goes on to note that, while it is possible to deductively derive governmental remedies for externalities, "such interference is, no doubt, likely to be attended by economic drawbacks, which have to be carefully weighed against the evils which experience shews it to be capable of preventing" (Sidgwick, 1901, p. 424). Pigou's practical aspect, then, falls squarely within the Cambridge tradition.

IV. Conclusion: Marshallian, But Not Neoclassical

So, whence comes the nearly universal tendency to lump Pigou in with the neoclassical theory of market failure and the economists who promulgated it?[17] One need only scan the pages of *Economics of Welfare* to see the link. Here, Pigou takes Marshallian economics to the next level, applying the framework to a host of economic problems and deriving the implications that flow logically out of this. The book is an "economics" of welfare that pushes the analytics to the limits in a manner not unlike one would see some decades later in, e.g., a Samuelson or a Becker. Issues of practice are given almost no place at all in *Economics of Welfare*—a few pages in a work of many hundred. It is Sidgwick's (1901) "science" of economics, not his "art."

The contrast between *Economics of Welfare* and "State Action and Laisser Faire" could not be more stark. The former shows the *prima facie* case and from whence it arises; the latter shows how one navigates the waters from the *prima facie* case to reality. "State Action and Laisser Faire" is the application of *Economics of Welfare* and, one could argue, takes us places where economic theory cannot. The essay deals with issues of practice, to the complete exclusion of theory—to the extent, even, of taking a jab at those who wrap themselves in theory with no attention to practical matters. In this sense, the essay is almost the antithesis of *Economics of Welfare*. When Pigou argues that

> High-sounding generalisations on these matters are irrelevant fireworks. They may have a place in political perorations, but they have none in real life. Accumulation of evidence, the balancing of probabilities,

[17] As evidenced in the ubiquitous references to Pigovian externality theory in the literature, to say nothing of the conflation of Pigou and Pigovian within the Chicago tradition, most notably in Ronald Coase's "The Problem of Social Cost" (1960). On Coase's critique of Pigou, see Alsanbeigui and Medema (1998).

> judgment of men, by these alone practical problems in this region can be successfully attacked (p. 128),

he is working with Sidgwick's *art*, not his science.[18] The essay shows the import of the theory-practice distinction for Pigou himself, and this, in turn, calls into question the accuracy of the "Pigovian" label that has been placed on the neoclassical theory of market failures in the middle-third of the twentieth century.

It seems apparent that *The Economics of Welfare* was made to do something that it was neither intended to do nor capable of doing. That it became the foundation for the purely theoretical, non-practical, neoclassical theory of market failures, then, calls for some attempt at explanation. To say that no one read "State Action and Laisser Faire," and that everyone simply overlooked or glossed over the practical bits in *Economics of Welfare*, while perhaps accurate, does not suffice.[19] The analysis of market failure in *Economics of Welfare* meshed very nicely with the tools and approach evidenced in the neoclassical ascendancy of the 1940s, 50s, and 60s. While Pigou's notion of the national dividend was pushed aside early on in the development of neoclassical welfare economics,[20] his treatment of market failure—via the distinction between private and social net products, in particular—lent itself to the formalization that was at the heart of the neoclassical push to firm up a "scientific" theory describing the role for the state in economic activity. The quest for determinate, optimal solutions to questions of economic theory and policy in post-war neoclassical theorizing left little room for the practical matters that Pigou dealt with in his essay. As

[18] A case can be made that Pigou's "art" is the "science" and "art" of Chicago and Virginia critics of Pigou and of the neoclassical theory of market failure. However, we will not explore this connection in the present paper. See, instead, Medema (2007).

[19] "State Action and Laisser Faire" and the book in which it appeared, *Economics in Practice*, are all but unmentioned in the economics literature during the formative era of neoclassical economics, and not at all in any significant work of the period.

[20] See Aslanbeigui (1990) for a discussion of this point.

such, the answer to our question may to some extent lie in the increasing methodological narrowing that characterized economics during this period—a narrowing that moved economic analysis increasingly away from the pluralistic approach (and recognition of the virtues thereof) that Pigou found so useful (see above). That the demonstrated pervasiveness of market failure and the ability of government to move the market to or near to the social optimum may have comported with Pigou's priors is neither here nor there.

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