

The Economics of Market Failure

That the absence of excludability, competition, or transparency is bad for the functioning Invisible Hand is not news to economists. The analysis of failure of transparency now makes up an entire subfield of economics: "imperfect information." Non-rivalry has been the basis of the theory of government programs and public goods, as well as of natural monopolies: the solution has been to try to find a regulatory regime that will mimic the decisions that market ought to make, or to accept that the "second-best" public provision of the good by the government is the best that can be done. Analysis of the impact of the lack of excludability is the core of the economic analysis of research and development. It has led to the conclusion that the best course is to try to work around non-excludability by mimicking what a well-functioning market system would have done by using the law to expand "property" or through tax-and-subsidy schemes to promote actions with broad benefits.

But the focus of analysis has always been on overcoming "frictions": how can we make this situation where the requirements of *laissez faire* fail to hold into a situation in which the Invisible Hand works tolerably well? And as long as the Invisible Hand works well throughout most of the economy this is a tolerable strategy: a finite number of government programs and legal doctrines to mimic what the Invisible Hand would do if it could function properly in a few distinct areas of the economy (like the natural monopoly implicit in the turn-of-the-twentieth-century railroad, or government subsidization of basic research). Such a strategy can achieve reasonable performance, as long as the industries and commodities that do not fit the Invisible Hand paradigm are an easily-identified, relatively-small subset of the economy.