
The Inapplicability of the Market-Failures Approach in a Non-Ideal World

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A COMMENTARY ON Joseph Heath (2014), *Morality, Competition, and the Firm: The Market Failures Approach to Business Ethics* (Oxford: Oxford University Press), <http://doi.org/10.1093/acprof:osobl/9780199990481.001.0001>

ABSTRACT

Joseph Heath (2014) argues that the contribution of competitive markets to Pareto-efficiency generates moral constraints that apply to business managers. Heath argues that ethical behavior on the part of management consists in avoiding profit-seeking strategies which, under conditions of perfect competition, would decrease Pareto-efficiency. I argue that because (1) such conditions do not obtain; and (2) the most efficient result – under imperfect conditions – is not achieved by satisfying the largest possible set of the remaining conditions; it is (3) impossible to draw any substantive ethical guidelines from Heath’s approach.

IN *MORALITY, COMPETITION, and the Firm*, Joseph Heath (2014) presents the most recent formulation of his Market-Failures approach (MFA).² According to Heath, the ethical constraints that apply to man-

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² See Heath (2006) for an earlier formulation. For other formulations of this view, see Brown (2013) and Norman (2011).

agers should be derived from the value, or ‘point’ of having a competitive market in the first place, i.e., its contribution to efficiency. Specifically, the very point of instituting competitive markets as a primary way of distributing resources and benefits in society is that competitive markets, under conditions of perfect competition, lead to a Pareto-efficient allocation, in which no individual’s welfare can be increased without decreasing that of another. It is in virtue of their contribution (under conditions of perfect competition) to such efficiency that competitive markets are valuable.

Heath claims that this efficiency-based justification of the market places ethical constraints on managers. Firms behave unethically when they undermine the efficiency of the market. In so behaving, such firms undermine the value of having them compete in the market in the first place. Thus, Heath claims that managers should avoid profit-seeking strategies that would, under conditions of perfect competition, decrease efficiency.

The conditions of perfect competition, under which competitive markets lead to Pareto-efficient outcomes, comprise a set of idealizations (e.g., full symmetry of information between all consumers and all suppliers about the entire market, suppliers and consumers taking prices as given, absence of externalities). However, these idealizations do not obtain in the real world. Therefore, firms have ample opportunity to profit from strategies which exploit these market imperfections: selling at above-market-clearing levels, externalizing costs, etc. Consequently, actual markets fail (often egregiously) to produce Pareto-efficient outcomes. Thus, profiting from strategies that exploit the absence of the conditions of perfect competition undermines the market’s efficiency, and is therefore unethical, according to the MFA. While Heath (2006: 89) initially put this point by saying that “the ethical firm does not seek to profit from market failures,” his view has since gravitated away from the narrow focus on market failures towards a stronger emphasis on Pareto-efficiency (2014: 5–12, 199–203).³ In light of this, we may revise Heath’s original statement to the claim that the ethical firm does not seek to profit from behavior that (ultimately) leads to a decrease in the market’s efficiency.

³ For discussion of why the narrower focus on market failure fails to capture the essential insight of Heath’s view see Norman (2011) and Von-Kriegstein (2016).

Imperfect Markets and the Second Best

In the real world, the conditions of perfect competition do not obtain. This means that real-world markets are unlikely to produce Pareto-optimal allocations. It may be natural to assume that to achieve outcomes approaching Pareto-efficiency as much as possible, we need markets that approach the conditions of perfect competition as much as possible. But, importantly, this would be a mistake. Whenever any one of the conditions for perfect competition is violated, it is not true that satisfying all the remaining conditions necessarily produces the most efficient result possible under the circumstances. In fact, satisfying the remaining set of conditions is guaranteed to be worse than at least one situation in which one further condition is violated—the different violations may “cancel each other out,” so to speak, and lead to a more efficient outcome than if only one condition had been violated.⁴

To illustrate, consider the case of sweatshops. Use of sweatshops is a profit-seeking strategy that exploits imperfect conditions (e.g., there are barriers to entry and exit on the part of labor, firms can set market prices on labor). Given the prevalence of sweatshops in developing markets, if we correct for one of these conditions (e.g., make it harder for firms to set market prices on labor), then this may lead to a sharp decline in efficiency: sweatshops will close, and employees will lose their jobs and income, which – despite the horrid conditions these provided – were perhaps better than the alternative of having no job and no income whatsoever. Approximating the conditions of perfect competition may lead to a decline in efficiency. Alternatively, violating a further condition (e.g., allowing only a small number of firms to exist) may increase overall efficiency: these may be able to hire more employees, whose income will increase.

While in earlier work Heath explicitly attempts to draw substantive ethical constraints from the MFA, he now restricts the view, stating that the MFA provides an “articulation of the ‘point’ of marketplace competition [instead of explicit guidelines for managers], which can in turn be used as a basis for distinguishing permissible from impermissible forms of competitive behavior” (2014: 198-9). Never-

⁴ See Lipsey and Lancaster (1956). Heath discusses this extensively (2014:175-9), but mainly regarding the comparison of mechanisms for distribution and allocation of resources in society.

theless, if realizing all remaining conditions for perfect competition does not produce the most efficient outcome possible, then – I argue – this has disconcerting implications for Heath’s view.

Indications for Efficiency (or Lack Thereof)

As we noted, when the conditions of perfect competition are not fully satisfied, the best outcome will not be produced by approximating these conditions as much as possible. This leads to the conclusion that for any profit-seeking strategy, the MFA is at a loss for evaluating its ethical status.

To explain this, let us first stipulate that an “ideal” profit-seeking strategy is any profit-seeking strategy that – under conditions of perfect competition – leads to Pareto improvement. Such a strategy would be condoned by the MFA, since it abides by those constraints and rules which can be deduced from the MFA (call these constraints and rules “MFA-rules”). Given Heath’s recent work, we may treat these MFA-rules as general guidelines for evaluating the contribution of different profit-maximizing strategies to the overall efficiency of the market (2014: 5–12).

Now, under conditions of perfect competition, we can easily discover whether a profit-seeking strategy is “ideal”: the fact that it conforms (or at least seems to conform) to the set of MFA-rules is a strong indication that this strategy is “ideal.” In a state of perfect competition, those profit-seeking strategies that adhere to MFA-rules will be those which result in the best Pareto-improvements. Indeed, MFA-rules are meant to ensure that firms act in ways that (eventually) lead to such improvements. That is why, under conditions of perfect competition, following MFA-rules is what firms are ethically obligated to do – it is what best contributes to the overall efficiency of the market.

However, when conditions of perfect competition do not hold, any strategy that would have been “ideal” under conditions of perfect competition is just as likely not to contribute to the overall efficiency of the market. This is so because under conditions of *imperfect* competition, satisfying all remaining conditions will not result in the most Pareto-optimal allocation possible, as discussed above regarding sweatshop.

The fact that some strategy abides by MFA-rules (i.e., that it would increase efficiency under conditions of perfect competition) simply cannot be taken as evidence for whether it results in Pareto improvements under conditions of imperfect competition. Such behavior, which does not undermine or violate any remaining condition of perfect competition, could end up leading to a non-optimal allocation. Under imperfect conditions, there is at least one profit-maximizing strategy which would be “ideal” under conditions of perfect competition, but would reduce efficiency under conditions of imperfect competition.

The same applies, *mutatis mutandis*, to profit-maximizing strategies which violate MFA-rules. Under imperfect conditions, a profit-seeking strategy that violates MFA-rules could lead to more effective outcomes than a strategy which abides by them (e.g., if sweatshops are prevalent, using them will increase market efficiency). So, not only could exploiting market failures lead to Pareto improvements; but also, exploiting market failures in a way that exacerbates them (or others) can lead to Pareto improvement. In fact, given the theory of the second best, it follows that under conditions of imperfect competition, there is going to be at least one additional violation of the conditions of perfect competition that will result in Pareto improvement.

We thus reach the conclusion that under imperfect conditions, we simply cannot tell which strategies are those that would best contribute to the overall efficiency of the market. If we cannot tell which strategies and which conditions would lead, in our real world, to the most efficient outcome, then the MFA cannot tell us which profit-seeking behavior is permissible and which is impermissible. Therefore, Heath’s Paretian approach fails to provide us with ethical guidelines for managers.

The Value of Competition and Deontic Constraints

In response, consider Heath’s (2014: 199) claim that the ‘point’ of having competitive markets (i.e., the contribution of perfectly competitive markets to Pareto efficiency) can “be used as a basis for distinguishing permissible from impermissible forms of competitive behavior.” Perhaps, then, we should understand Heath as providing us with deontic guidelines and constraints for managers, regardless of the

effect this will have on the market's efficiency. On such a view, the value of competitive markets is not regarded as some consequentialist aim which should guide the behavior of managers. Rather, the value of competitive markets should be understood as a starting point, which sets deontic constraints on managers. Managers should adhere to the MFA-rules, regardless of the consequences. If that is the case, then the objection presented here is not quite as detrimental to Heath's view.

But this response seems to undermine the motivation for the Paretian approach. Heath (2014: 19) wants to draw normative guidelines for managers from the internal value of competitive markets (as opposed to 'dropping' such normative guidelines on business managers as though from 'out of the blue'). Now, according to Heath, a competitive market is valuable only as a means to an end (namely, as a means to the best possible allocation of resources); not as end in itself. But then, why should managers be guided by anything other than this valued end? If Heath's Paretian approach sets deontic constraints in this way, then it seems to end up 'dropping' normative guidelines on managers from 'out of the blue' after all.

Thus, the problem raised in this paper arises from the very feature that makes Heath's approach so attractive. It is precisely because Heath wants to derive normative constraints on managers from the "point of having markets," which he conceives as producing Pareto-efficient outcomes, that he cannot afford to ignore whether the constraints he recommends do in fact contribute to such outcomes in the real world. As I have shown, there is no reason to think that they would.

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