
Moving Beyond Market Failure: When the Failure is Government's

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A COMMENT ON Joseph Heath (2006), "Business Ethics Without Stakeholders," *Bus Ethics Q* 16(4): 533–557.

ABSTRACT

Joseph Heath lumps in rent-seeking with cartelization, taking advantage of information asymmetries, seeking a monopoly position, and so on, as all instances of behaviour that can lead to market failures in his market failures approach to business ethics. The problem is that rent and rent-seeking, when they fail to deliver socially desirable outcomes, are instances of government failure. I try to argue that this is so, offer an amendment to Heath's approach, and then explain why accurately describing the failure matters.

IN TWO SEPARATE papers, Joseph Heath (2004, 2006) has defended what he calls a Market Failures Approach to business ethics. More recently, Wayne Norman (2011) has redescribed a similar approach as the Self-Regulation Approach. Both approaches would result in a unification of normative justifications for business practices with the normative justifications of regulation. If accepted, these approaches would either supplant or supplement the variety of tools currently in use by business ethicists, including the stakeholder and shareholder

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approaches, as well as other approaches including corporate social responsibility.² In Heath's case, a manager ought to seek to go beyond compliance by avoiding behaviour in contexts that may lead to market failure. In this brief review, I want to highlight and make explicit a problem with Heath's approach and explain its significance for his approach. The problem is that Heath includes rent and rent-seeking in his list of business practices that can lead to market failure. Rent and rent-seeking, when they fail to deliver socially desirable outcomes, are instances of *government* failure. (Norman appears to recognize this fact by mentioning government failures,³ but he does not explain its inclusion nor why it matters.) Below I will give a brief sketch of the Market Failures Approach before trying to work out the problem of misidentifying rent and rent-seeking as a market failure and offer reasons for why this conceptual mistake matters for more than merely finger-pointing reasons.

Heath's Approach

Many of us approve of market institutions for instrumentalist or consequentialist reasons. The good is located in improvements in our well-being, and markets are to be approved of when they efficiently allocate goods and services in welfare-improving ways. This Heath describes as the "general justification of the market," a justification common within the disciplines of economics and political science, and in the policy world. Typically, markets self-organize into firms, and those firms have an organizational structure that includes roles like the manager of a firm. Those roles come bundled with certain duties and

² In describing his project, Wayne Norman (2011: 46) writes that "our modest proposal will be to allow the tools of regulation to 'break through' the compliance line, so as to speak. That is, to encourage the use of regulatory justificatory tools in the design and justification of business practices that go beyond the minimal standards defined by government regulation. In short, we shall be encouraging the more widespread use of the language of 'self-regulation' within debates that are now couched mainly in languages like 'corporate social responsibility,' 'corporate citizenship,' 'sustainability,' 'stakeholder theory,' and such."

³ In summarizing Heath's approach, for example, he prefaces what Heath says with "[...] it is a distinction between firms that succeed fairly in market competition and firms that succeed by exploiting loopholes created by market failures and government failures" (Norman 2011: 51). And, again, "[...] we find it *prima facie* unethical for firms to try to gain competitive advantage by ignoring legitimate norms, whether they are grounded in market failure, government failure, considerations of justice, public decency, or what have you" (Norman 2011: 55).

obligations, especially the fiduciary duty to maximize value for shareholders. We ought, however, to view these more particular rules and duties as derivative rules, of instrumental significance only. The profit-orientation of firms promotes the effective functioning of the price system, which in turn promotes the efficiency of the market as a whole. The rules and roles are constructs serving the end of improved general well-being through market efficiency. As Heath (2004: 541) puts it:

The more promising defense of profit is the Paretian one, which points to the efficiency properties of the market economy as a way of justifying the profit orientation of firms. According to this view, the point of the market economy is not to respect individual property rights, but rather to ensure the smooth operation of the price system. The profit orientation is valued, not because individuals have a right to pursue certain interests, but rather because it generates the competition necessary to push prices toward the levels at which markets clear. When markets clear, it means that all resources will have been put to their best use, by flowing to the individuals who derive the most relative satisfaction from their consumption.

Sometimes, however, the rules of the roles imply or suggest that a manager take some action that conflicts with the general justification of the market. So, for example, greater profits may, in some cases, be had through the formation of a cartel with competitors or seeking a monopoly position, through the exploitation of information asymmetries, by starting a false whisper campaign about the safety of a competitor's product or through deceptive and manipulative advertising, through the production of pollution or other negative externalities, or by an attempt to regulate the competition out of existence through tariffs or quotas. Heath calls these profit-seeking strategies of competition "non-preferred strategies." He contrasts these with "preferred strategies" which include lowering prices, improving quality, innovating in the industry, and so on. What unifies our objections to the use of non-preferred strategies, Heath suggests, is that they conflict with the general justification of the market in failing to generate social gains by creating distortions that lead the price mechanism to send the wrong signals. Heath then describes each of the non-preferred strategies as generating or being instances of market failure, and urges managers to go beyond merely complying with the law by committing themselves to avoiding strategies and behaviours that may lead to market failures.

Accurately Diagnosing the Failure

In offering a list of activities that managers should not engage in order to avoid “market failure,” Heath (2006: 64) offers “Do not seek tariffs or other protectionist measures.” This illustrates an important confusion. Tariffs and protectionist measures, and, we might say, the successful extraction of rents in general when they contribute to socially inefficient outcomes,⁴ cannot be described as a *market* failure. Instead, these are properly described as instances of *government* failure.⁵ A market failure is not just any failure on the part of any institution in allocating goods or services efficiently, but a failure of free markets to deliver a Pareto-optimal efficient allocation. (See Bator 1958 for the first seminal treatment of market failures.) A free market is a market that is free of interference from government.⁶ If the appropriate diagnosis of a failure in generating socially efficient outcomes involves a causal contribution by non-market institutions, we cannot properly describe the situation as a market failure. While the seeking of tariffs, quotas, and other rents is within management’s control, the existence of rents, and the choice to grant these special favours to certain firms is controlled not by market, but by government actors and institutions. In the absence of government, or in contexts where the government is credibly committed to avoid dispensing rents, management has no incentive to engage in rent-seeking behaviour. It follows that this non-preferred strategy in Heath’s approach is better understood as to be avoided not because it is an instance of or leads to market failures, but because it generates government failure. (See McKean 1965 for the first seminal contribution to our understanding of government failures.)

Why It Matters

A friendly amendment to Heath’s approach, then, would be to urge managers to avoid engaging in behaviours that generate market or government failures. Indeed, Norman’s self-regulation approach captures both considerations, and is immune from my conceptual criti-

⁴ For an early treatment of the literature on rent and rent-seeking, see Robert D. Tollison (1982); see also Gordon Tullock (1989).

⁵ For an analysis of the difference between rent- and profit-seeking behaviour, see James M. Buchanan (1980).

⁶ Property rights are typically treated as endogenous to markets, despite the fact that they are enforced by government institutions.

cism. The criticism, however, matters. It matters for several reasons, apart from merely pointing the finger at the right culprit. The most significant reason why it matters is because a misidentification of the problem can sometimes lead us to misidentify a possibly effective solution. Market failures are typically used as justifications for regulatory or other interventions on the part of governments. If we make the mistake of regarding tariffs, quotas and other rents as failures on the part of market institutions or actors, we may fail to see that a possible solution is not to call for reforms in markets, but rather to look for a solution in reforming governments.

Relatedly, if reforming the institution is not feasible, accurately identifying rent and rent-seeking as government failures will help us to turn our critical gaze on government actors and the role they play in generating socially non-optimal outcomes. Government actors are not passive players, but play a significant role in promoting or undermining social efficiency. While it may be true that it is wrong for managers to put pressure on government actors to enact policies that have the effect of undermining efficient outcomes, we recognize that it is also an obligation on the part of government actors not to succumb to this pressure. Accurately describing tariffs, quotas, and other rents that generate socially inefficient outcomes as instances of government failure helps us to better see that. Indeed, the accurate identification of certain non-preferred strategies as strategies that may generate government failures further promotes the goal of normative symmetry and unification. Just as market actors have obligations that go above and beyond mere compliance, so do government actors. With respect to the economy, they are both obligated to avoid strategies that undermine social efficiency.

Conclusion

Both Heath's and Norman's approaches to business ethics are, in my mind, significant improvements to business ethics. In closing, let me suggest a tantalizing prospect as yet unexplored in the burgeoning beyond-compliance literature. One sense of "beyond-compliance" is the sense in which we accept compliance as obligatory but view it as merely a floor above which we ought to go. A very different sense is where we treat compliance itself as open to potential criticism, "beyond-compliance" as an approach that transcends compliance. Both Heath's and Norman's approaches should make us question the im-

portance of compliance itself. If we are to view the roles of the market as instrumentally justified toward the normative goal of improving social efficiency, then what are managers to do when some regulation, law, or policy conflicts with this very goal? These approaches appear amenable to the suggestion that, in those cases, it would be right for managers to choose not to comply.

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