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Market Failure or Government Failure? A Response to Jaworski

Joseph Heath[1]

A RESPONSE TO Peter M. Jaworski (2013), "Moving Beyond Market Failure: When the Failure is Government's," ***Bus Ethics J Rev*** 1(1): 1–6.

ABSTRACT

Peter Jaworski objects to my "market failures" approach to business ethics on the grounds that in some cases I have mislabeled as "market failure" what are in fact instances of "government failure." While acknowledging that my overall approach might better be referred to as "Paretian," I resist Jaworski's specific criticism. I argue that the term government failure should not be used to describe market transactions that are made less efficient through government intervention, but should be reserved for cases in which the market mechanism has been suspended and the transaction is occurring, inefficiently, through the organizational power of the state.

I WOULD LIKE to thank Peter Jaworski for his thoughtful and thought-provoking discussion of my work. His analysis provides a useful occasion for me to clarify several concepts that are central to what I have called a "market failures" approach to business ethics. Strictly speaking, it would be more accurate to have called it a "Paretian" approach, since my major claim is that the point of marketplace competition is to promote Pareto-efficiency, and in cases where the explicit rules governing the competition are insufficient to secure the

[1] University of Toronto. Email: joseph.heath@utoronto.ca

class of favoured outcomes, economic actors should respect the spirit of these rules and refrain from pursing strategies that run contrary to the point of the competition.

Now of course any action that affects a sufficiently large number of people is unlikely to be literally Pareto-improving. Thus the Pareto-efficiency criterion is not intended to serve as a direct guide to ethical decision-making (and thus I am not promoting some sort of welfarist consequentialism). Instead, I have argued that the ideal of Pareto efficiency, combined with a set of empirical claims about the conditions under which marketplace competition generates true scarcity prices (Heath 2008: 150), can be used to generate a more specific set of principles to guide the moral reflections of economic actors. (In order to generate moral rules able to directly govern behaviour, these principles would need to be further refined, to reflect the specific circumstances of the market under consideration—with particular attention to second-best problems.)

In my early work on the subject, I put forward a list of these intermediate-level principles, as examples of what I had in mind (Heath 2004). Some of these principles would have come as no surprise to anyone, because they were just the Arrow conditions for perfect competition translated into a deontic mood (prohibiting the exploitation of externalities, information asymmetries, and market power). But some of them, as Jaworski correctly notes, were a bit different. In particular, I suggested that firms should "not seek tariffs or other protectionist measures" (2004: 84). This is, as Jaworski points out, a restriction on how firms interact with *government*; it is not, strictly speaking, a form of marketplace behaviour. That particular principle was unmotivated, in the context of the paper, because I had not said anything about how firms should interact with the state.

This is a point that has been developed by Pierre-Yves Néron (2010: 344), Dominic Martin (2012), and Wayne Norman (2011), all in ways that I find quite congenial. Jaworski, however, takes it in a slightly different direction, which I find less helpful. His central argument is that, to the extent that the firm succeeds in securing a protectionist measure, this is an example of "government failure," not "market failure," and so my view should not really be called a "market failures" approach to business ethics. While evincing some tolerance for the "Paretian" approach, he considers it an unhelpful confusion to describe it as a "market failures" approach.

The way that he presents this claim, however, is marred by a somewhat distracting discussion of "rent" and of "rent-seeking," which seems to me based on a straightforward misunderstanding of these concepts. In particular, he makes the peculiar claim that the existence of economic rent is always due to government, and so insists that we *identify* "rent and rent-seeking" with "government failure" (Jaworski 2013: 5). This is simply not the case. In order to see why, one need only read some of the excellent articles cited in Jaworski's own bibliography.

Although there is a bit of ambiguity in the term, the standard definition says that economic rent is the "excess earnings of a factor over the amount necessary to keep it in its current occupation." Many philosophers are familiar with the concept because of the debate that erupted over Robert Nozick's famous "Wilt Chamberlain" argument, in *Anarchy, State and Utopia* (1974). Nozick, as a libertarian, argued that if Chamberlain were able to impose a small surcharge on tickets, for fans wanting to see him play, then he would be entitled to keep the money, because it was the outcome of a series of voluntary transactions. David Gauthier (1986: 273), as a Paretian, pointed out that most of the money took the form of economic rent, and so could be taxed away without any loss of efficiency. To see how much of Chamberlain's salary was rent, one need only contemplate by how much it would need to be lowered, before Chamberlain decided to quit playing basketball and take up some other profession. The difference between the two sums is the portion of his salary that constitutes the rent.

The example is helpful, because it illustrates two important features of rent. The first is that it is, first and foremost, the result of natural scarcity. Wilt Chamberlain was a monopolist in the market for Wilt Chamberlain services, which is why he would have been able to charge the premium. Second, rent often arises in purely private transactions, without any sort of government intervention. (This is why Robert Tollison, in the article that Jaworski cites, starts out by distinguishing natural from artificial rent. He goes on to say that "The applicability of rent-seeking theory does not depend on a government-propped up monopoly right. The domain of rent-seeking also includes institutional processes in the private sector" (1982: 587).)

So one cannot simply equate "rent" and "government failure." However, nothing that Jaworski says depends upon the claim that *all* rents are caused by government; the argument works just as well if only some of them are. Thus the real question is simply whether "government failure" needs to be introduced as an important concept in a Paretian approach to business ethics. Here I am inclined to resist Jaworski's suggestion, not because I don't think that government failure is an important phenomenon, but because the use of the term in this context constitutes an unhelpful blurring of an important conceptual distinction.

There is, it should be noted, considerable disagreement in the literature over the proper extension of the term "government failure." Whereas "market failure" picks out a fairly well-understood phenomenon, the term "government failure" is used in a variety of different ways. My inclination is to approach the term from within the general framework of transaction-cost analysis. Within this tradition, it is common to distinguish between market transactions and administered transactions. The latter are characterized by what Ronald Coase (1937: 389) referred to as the "supersession of the price mechanism" and the substitution of an organizational hierarchy for the decentralized mechanism of the market as a way of securing cooperation. Hierarchies, however, come in two flavours. First, there is the internal administrative hierarchy of the corporation, and second, there is the state. Transaction cost theory claims that, *grosso modo*, the organization of economic activity through hierarchical organizations will be preferred when it is more efficient (i.e., transaction-cost minimizing) than through the market.

This is equivalent to the view that the organization of economic activity through administrative hierarchies is everywhere explained by the existence of market failure. (And thus, as I have elsewhere observed (Heath 2001: 144), the transaction-cost theory of the firm is essentially a "market failures" theory of the firm.) Correlatively, it means that the organization of economic activity through markets is everywhere explained by "administrative failure." All of this is to say that neither the concept of market failure nor that of administrative failure does much work, taken alone, what matters is simply the relative cost profile of these different modes of economic organization.

This analysis lends support to Charles Wolf's (1979) view that the primary distinction should be between “market” and “nonmarket” failure. From this perspective, “government failure” would be a subspecies of nonmarket (or administrative) failure, and would designate cases where the organization of an economic transaction through the state (canonically, the provision of a public good financed through taxation) fails *egregiously*, which is to say, is so inefficient that it would be better to organize the transaction using some other institutional modality.

This is the core case that Wolf had in mind when using the term. There is another sense of the term, however, that has become common in public choice circles, that I think is less useful. This involves describing as “government failure” cases in which government intervention in the market results in *the market* becoming less efficient. In such cases, the state does not substitute its own organizational capacities for that of the market, it merely alters the boundary conditions of economic activity so that market transactions generate outcomes that are less socially desirable. The core transactions, however, remain market transactions.

Now in this case, I am inclined to say that it is still a market failure. It is a policy-induced market failure, but it is nevertheless still a market failure, because a market transaction is failing to deliver an efficient outcome. The desire to label it a government failure springs, I think, from a desire to blame the government for the market failure (or as Jaworski puts it, to identify “the right culprit”). This seems to me just a recipe for confusion. The term “market failure” is used to designate a failure *of the market*, it is not necessarily a failure *caused by* market actors. It can be caused by bad weather just as easily as it can be caused by bad policy. To insist that each different type of market failure be given a different name, depending on its ultimate cause, just to avoid impugning the reputation of “the market” seems to me unnecessarily thin-skinned. The case for capitalism is sufficiently robust, in my view, that it can withstand widespread use of the words “market” and “failure” in the same sentence.

Jaworski does mention one other issue, beyond his desire to “point the finger” of blame at government. His concern is that if people spend too much time talking about “market failure,” it may lead to calls for more government, because “market failures are typically used as justification for regulation or other interventions by government" (Jaworski 2013: 5). Although I think this is true, I also have difficulty imagining a more dramatic way of missing the point of the "market failures" approach to business ethics. Ethics, as Steen Thomsen (2001) has argued, should be regarded as a governance mechanism, part of the toolkit of institutional strategies we have available for the organization of economic activity. As Norman (2011) has observed, if corporations exercised greater moral restraint in their exploitation of market imperfections, then the identification of a market failure, even an egregious one, would not lead automatically to a call for government intervention. It is only because so many corporations are so intransigent in this regard that society has no recourse but to employ legal rules to discourage anti-social corporate behaviour.

At the very end of his article, Jaworski raises a final point concerning the obligations of firms in cases where legal interventions are not efficiency-promoting. Here my inclination would be to say that, under such conditions, the beyond-compliance obligations of firms run contrary to the intention of the law. However, I am not inclined to accept Jaworski's suggestion that this might justify non-compliance, for the familiar reason that laws may be unjust and yet still be legitimate, and private actors are not free to pick and choose which laws they will obey. There is a certain threshold at which a right of civil disobedience may be triggered, but it will typically be higher than a mere failure to promote efficiency. Furthermore, it is already difficult enough getting corporations to comply with laws that are both just and legitimate, so I am not convinced that "overcompliance" is a particularly pressing concern. This argument, however, trades on a number of much larger commitments in political philosophy, which I have neither time nor leisure to elaborate on here.

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