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Does Heath Have a Good Answer to Steinberg?

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A COMMENTARY ON Etye Steinberg (2017), "The Inapplicability of the Market-Failures Approach in a Non-Ideal World," ***Bus Ethics J Rev*** 5(5): 28–34, http://doi.org/10.12747/bejr2017.05.05

ABSTRACT

Etye Steinberg has recently raised a problem for Joseph Heath's Market Failures Approach. In this paper we consider a response by Heath. We argue that Heath's response not only leaves the original problem intact, but also raises a second one, analogous to stakeholder theory's so-called "identification problem."

ACCORDING TO JOSEPH Heath's "market failures approach" (MFA) to business ethics, the moral responsibilities of corporations flow from the ultimate justification for markets themselves, the production of Pareto-efficient allocations of goods under conditions of perfect competition. Profit-seeking strategies that violate conditions of perfect competition are unethical because they thwart Pareto efficiency, thereby undermining the moral goal that justifies corporations' pursuit of profit in the first place. Thus, on Heath's view, corporations are subject to a set of ethical rules ("MFA-rules") that forbid such strategies. Specifically, these rules (Heath 2014: 37) include:

1. Minimize negative externalities.

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2. Compete only through price and quality.
3. Reduce information asymmetries between firm and customers.
4. Do not exploit diffusion of ownership.
5. Avoid erecting barriers to entry.
6. Do not use cross-subsidization to eliminate competitors.
7. Do not oppose regulation aimed at correcting market imperfections.
8. Do not seek tariffs or other protectionist measures.
9. Treat price levels as exogenously determined.
10. Do not engage in opportunistic behavior toward customers or other firms.

Etye Steinberg (2017) has recently argued that under the non-ideal conditions that inevitably prevail in real world markets, the strategies forbidden by these rules do not in fact tend to reduce efficiency. Thus, even if Pareto-efficiency is the "implicit morality of the market" (Heath 2014: 173), the MFA-rules do not follow. In this Commentary we consider a proposed solution to this problem that Heath (2014) offers. Heath's (2017: 40–41) proposal is to shift focus from the general efficiency of the economy to "the particular efficiency gains that the firm is able to realize among its shareholders, its employees, and its customers." Using this "bottom-up" reasoning, Heath (2017: 40–41) claims, all the MFA-rules "could be justified in some form." We will argue that Heath's bottom-up approach not only fails to get around the problem Steinberg raises but is vulnerable to a further objection concerning the demarcation of the "bottom level."

Steinberg's Challenge

Steinberg's challenge to the MFA relies on Lipsey and Lancaster's (1956) "theory of second best." The theory holds that in any market that is less than perfectly competitive, there is no correspondence between how closely the market approximates the conditions of perfect competition and how close it comes to achieving maximal efficiency. The second best market in terms of competitiveness will not generally turn out to be the second best in terms of efficiency. Indeed, in any imperfectly competitive market, eliminating some competitive imperfections, short of eliminating them all, will often reduce efficiency.

A simple example illustrates how this can happen. Consider a monopolist who emits pollution. Assuming the pollution is unregulated, its negative effects on society will be external to the cost of the firm's goods, driving the firm to overproduce. At the same time, its market power as a monopolist will drive the firm to underproduce, counterbalancing the effect of the negative externality. Eliminating the negative externality would result in unmitigated overproduction, while introducing competition would result in unmitigated underproduction. From the standpoint of efficiency, therefore, the aggregate effect of these two market failures might be more optimal than the effect of either one by itself.

Steinberg argues that the second best theorem undermines Heath's justification for the MFA-rules. The MFA-rules proscribe profit-seeking strategies that would reduce efficiency in a perfectly competitive market. But in the real world there is no such thing as a perfectly competitive market. Even if some market failures can be eliminated, others will always remain. Thus, in the real world, the strategies forbidden by the MFA-rules will not, in fact, have any general tendency to reduce efficiency.

To appreciate how big a problem this is for the MFA, it is useful to understand what problems the MFA itself was introduced to solve. Heath presents the theory as a way to supply deficiencies in the two long-dominant approaches to business ethics—the shareholder and stakeholder theories. Shareholder theorists like Milton Friedman (1970) maintain that the only responsibility of managers is to maximize profits for shareholders. Heath finds this view appealing insofar as it is guided by a commitment to the principles of capitalism, but, like many, objects to its moral thinness. The stakeholder theory has the opposite problem, Heath thinks. According to stakeholder theorists like Edward Freeman (1998), managers have a responsibility to balance the interests of all "stakeholders," including not only shareholders but also customers, employees, suppliers, and local communities. While this theory is morally robust, Heath (2014: 91) argues, it effectively calls on corporations to operate like public institutions, and thus is "implicitly, if not explicitly, anticapitalist." The main selling point of the MFA is that it promises both to deliver a robust set of moral constraints on corporate behavior (the MFA-rules) and to derive these constraints from an ideal internal to capitalism

(Pareto efficiency). In light of the second best theorem, however, it appears that the MFA fails to do either. Pareto efficiency turns out to provide no clear basis for deriving the MFA-rules, nor, it seems, any other substantive set of ethical constraints.

Heath's Bottom-Up Strategy

Steinberg is not the first to have noticed this problem. In fact, Heath (2014: 38–41) himself acknowledges it in one of his earliest papers on the topic, where he also proposes a solution to it. According to Heath, the problem Steinberg raises can be avoided by shifting from a "top-down" to a "bottom-up" approach. Whereas the "top-down" approach attempts to derive the ethical responsibilities of corporations by appeal to efficiency of the whole economy, the bottom-up approach appeals only to the Pareto improvements that firms can generate among customers, employees, and shareholders. Heath (2014: 41) admits to leaving the details of the bottom-up approach unsatisfactorily developed, but he confidently predicts that it will serve to secure all the MFA-rules "in some form."

Even the most charitable attempt to reconstruct Heath's proposal, however, runs into some problems. One difficulty concerns the boundaries of the "bottom" level. The bottom level seems to be a subset of the economy, consisting of a firm's customers, employees, and shareholders, within which it is a firm's responsibility to promote efficiency. Thus, whatever principle defines the boundaries of the bottom level must not only serve to distinguish these groups clearly from other groups in the economy, but also explain why firms are morally accountable only to these groups. But it is hard to see what this principle could be.

This worry parallels an objection that Heath himself (among others) raises against the stakeholder theory. On a broad interpretation of "stakeholder," anybody counts as one who is affected by the decisions of a corporation. But this would seem to extend managers''responsibilities too far, since it would mean, in effect, that managers are accountable to all of society and thus "should be motivated by general considerations of social justice" (Heath 2014: 84). Alternatively, "stakeholder" might be understood more narrowly to mean anyone "vital to the success and survival of the firm" (Freeman 1998: 129). But the line demarcating those who are vital to the success and survival of the firm from those who are not is hardly clear, and even if it were, Heath (2014: 82) claims, it would not track any morally significant distinction. The bottom-up approach seems to face a similar challenge with respect to bottom-level groups. Some line must be drawn between the bottom-level groups and the rest of the economy, or else the bottom-up approach risks collapsing into the top-down approach. But the line cannot be arbitrary from a moral standpoint, since it delineates for each firm its moral sphere.

There are hints that Heath thinks the distinguishing feature of bottom-level groups is that they engage in voluntary exchanges with the firm. This criterion does arguably capture something morally relevant, but it would lead to a much broader extension of the bottom level than Heath wants. After all, it is not just customers, employees, and shareholders who enter into voluntary exchanges with firms, but also suppliers and local governments. Moreover, if the voluntary exchange criterion is adequate for demarcating the bottom level, it would seem to be equally adequate for identifying stakeholders. Shifting from the top-down to the bottom-up approach thus seems to put the MFA back on all fours with stakeholder theory in an important respect.

An even more serious worry for the bottom-up approach, however, is that it does not seem to escape the problem posed by the second best theorem. Heath seems to assume that Lipsey and Lancaster's theorem pertains only to the economy as a whole and not to any of its proper subsets. This would explain why he thinks the MFA rules could increase efficiency among a firm's customers, employees, and shareholders, even as he admits that these rules will not promote efficiency for the economy as a whole. However, nothing in Lipsey and Lancaster's formal statement of the theorem confines its implications to the economy as a whole. The scope of the function from which efficiency is derived in the theorem can be interpreted as the entire population or just the shareholders, employees, and customers of a particular corporation (Lipsey and Lancaster 1956: 26). The theory thus seems to suggest that what is true for the whole economy will be just as true for the bottom level: eliminating some competitive imperfections without eliminating them all is no more likely to increase than decrease efficiency at this level.

To illustrate, consider again the example of the polluting monopolist. If we take consumer surplus to indicate the well-being of the monopolist's customers and producer surplus to indicate the well-being of the monopolist's shareholders and employees, then we can take total surplus to indicate the efficiency of the monopolist's bottom level. Forcing the monopolist to pay the costs of its pollution would remove one market failure, but it would drive up prices and drive down production. Forcing the monopolist, instead, to compete with other firms would eliminate the other market failure, but would lead to increased pollution. Now, either consumers care more about reducing prices or reducing pollution. In the first case, forcing the monopolist to reduce pollution would lower total surplus. In the second case, forcing the monopolist to compete with other firms would lower total surplus. Thus, either way, eliminating one market failure without eliminating both is as likely to decrease as to increase efficiency at the bottom level.

Conclusion

We have argued that Heath's bottom-up proposal fails to solve the problem that Steinberg raises and, furthermore, brings with it a new a problem of its own, analogous to the so-called "identification" problem for stakeholder theory. If sound, this assessment lends strength to Steinberg's criticism of the market failures view and puts added pressure on Heath to address it.

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