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Is the "Point" of the Market Pareto or Kaldor-Hicks Efficiency?

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A COMMENTARY ON Jeffrey Moriarty (2019), "On the Origin, Content, and Relevance of the Market Failures Approach," ***J Bus Ethics***: (first online 17 January 2019) 1–12,
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ABSTRACT

Moriarty argues that the Market Failures Approach (MFA) to business ethics is inapplicable to "real world" problems, because it treats "market failure" as a failure to achieve Pareto efficiency. Depending upon how it is applied, Pareto efficiency is either trivially easy to satisfy or else so demanding that no real-world market could ever satisfy it. In this Commentary, I argue that Moriarty overstates these difficulties. The regulatory structure governing markets is best understood as an attempt to maximize the number of Pareto-improving exchanges that occur. There is no reason to think business self-regulation cannot be guided by the same normative-conceptual framework.

IN HIS RECENT article, "On the Origin, Content, and Relevance of the Market Failures Approach," Jeffrey Moriarty (2019: 1) claims that this view of business ethics – defended by myself and others – has "little relevance to the real world of business." Since the primary motivation

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for the development of the MFA was to make business ethics less of a wish list of things that we would like corporations to do and more of a philosophically informed reconstruction of the norms that are already implicit in the marketplace, this constitutes a surprising, and if correct, serious challenge. Moriarty's contribution is distinguished by the fact that it contains a charitable and substantially accurate understanding of my views.[2] Nevertheless, I think that he exaggerates the difficulties confronted by the MFA. After all, the state routinely engages in regulatory interventions aimed at correcting market failures. How hard is it to believe that businesses could adopt the same conceptual framework to guide their efforts at self-regulation?

The most important question raised by Moriarty's article is whether the "implicit morality of the market" involves a commitment to Pareto-efficiency or Kaldor-Hicks (KH) efficiency. Despite a superficial similarity, the two norms are of course quite different, with the latter being roughly equivalent to utilitarianism, and the former making the much less controversial claim, that transformations of the social state that make at least one person better off, and no one worse off, are to be preferred. Now I claim that markets institutionalize a commitment to Pareto efficiency, for two reasons: first, because the building-blocks of a market are individual exchanges, and each individual exchange is Pareto-improving for the transacting parties; and second, because of the first fundamental theorem of welfare economics, which shows that, in principle, it is possible for competitive markets to fully exhaust the set of Pareto improvements achievable through exchange.

Consider then one of the specific rules that structures the marketplace, such as the prohibition on price-fixing. It does not matter for Moriarty's argument whether the rule is conceived of as a law or a norm, and so I will focus on the case of legal regulation of markets through competition law. Moriarty's claim is that such a law cannot be seen as institutionalizing a commitment to the Pareto principle. Why? Because one cannot make the case for it from either the bottom-up "micro" perspective or the top-down "macro" perspective. In the former case, it is because the transaction between the monopolist and

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[2] Specifically, he recognizes that the view is not consequentialist. This is in contrast to Cohen and Peterson (2017) and Steinberg (2017), who all misinterpret the view as consequentialist.

client is mutually advantageous for the parties, and therefore does not violate Pareto. In the latter case, it is because the second-best theorem blocks us from inferring that the removal of one market imperfection will bring the outcome closer to Pareto-optimality, so long as there remain other imperfections. And so, Moriarty claims, a law aimed at reducing the market power of firms cannot be justified through appeal to the Pareto principle.

One might conclude, on this basis, that the "implicit morality of the market" is not Pareto efficiency, but rather KH efficiency. It is not difficult to summon additional prima facie evidence for this conclusion, in the fact that courts often use a KH conception of efficiency in considering competition law cases. Similarly, regulation is often justified through cost-benefit analysis (CBA), and CBA uses the KH standard. This all suggests that the "point" of markets – and thus, of both regulation and business self-regulation – must be to increase aggregate social welfare. Parenthetically, one might note that if this is the argument, then Moriarty's concerns over "inapplicability" are a bit overwrought. The worst-case scenario is that the MFA would have to treat KH, rather that Pareto efficiency as the "point" of the market. No one doubts that the KH standard is applicable to the "real world"—that's precisely what CBA does. Moriarty (2019: 11) dislikes this solution because "it turns the MFA into a rather mundane form of consequentialism about business ethics," a concern that I share. Nevertheless, it would not be a death-knell for the MFA if it wound up being a species of rule-utilitarianism.

However, I think that we should not be so quick to cast aside the Pareto principle. This is an issue that concerns anyone who has some sympathy for the market, since the suggestion that a market economy only admits of a utilitarian justification represents a significant concession to its critics. It is noteworthy, in this context, that the standard argument made by welfare economists against price-fixing is not that it lowers aggregate social welfare, but that it generates *deadweight losses*.[3] How do they differ? A deadweight loss is an unrealized exchange—a transaction that "should" be occurring, because there is someone who is willing to sell and someone else who is willing to buy at a price that is lower than the prevailing market price, who are not

[3] For textbook treatment, see McEachern (2012: 261), who observes that it is called deadweight because "it is a loss to consumers but a gain to nobody."

able to transact, due to the market power of the monopolist, which keeps the price above that level. An unrealized exchange is a *Pareto* inefficiency.

Similarly, the imposition of a regulation to curtail production of a negative externality, such as pollution, seems as though it could only be justified on KH grounds, since it hurts the polluter, while benefiting those who had previously been harmed by the externality (Moriarty 2019: 6). Thus the purpose of doing a CBA is to make sure that the benefits are large enough that the winners could compensate the losers. This is, however, not entirely correct. As the Coase theorem shows, in the absence of transaction costs, the parties themselves can be expected to negotiate to a Pareto optimal outcome (Coase 1960). (If the externality is sufficiently harmful, those who are affected by it will pay the polluter to stop producing it.) What the existence of a KH-inefficient externality shows is that the parties were prevented from negotiating to the Pareto optimal outcome. So what the CBA reveals is actually another type of deadweight loss. When positive, it shows that the parties "should" have contracted to end the externality, but were prevented from doing so by some contingency of the world. Thus there remain unrealized gains from trade between them. The rationale for the regulation is therefore that it eliminates a Pareto inefficiency.

This is why, in my discussion, I put so much emphasis on deadweight losses. These represent not just a failure to maximize social welfare. As unrealized exchanges, they constitute Pareto inefficiencies. The regulatory structure that governs the market – most obviously, competition law – is intended to maximize the number of Pareto-improving exchanges that occur. This is why, I claim, the "point" of market institutions is Pareto efficiency, not KH. The central claim made by the MFA is that our thinking about what constitutes morally acceptable behavior by firms, and by business managers, should be guided by the same normative-conceptual framework that guides the regulatory and legal structure of markets. If state officials are able to make these judgments, then there is absolutely no reason to imagine that business managers – who are often in a much better information state – will be unable to make them.

So what is the significance of the second-best theorem? While I myself am the one who brought up the issue, it is important not to overstate its practical importance.[4] Empirically, the existence of offsetting market imperfections will be quite rare. If there is one tariff in place, imposing a second tariff will almost always make things worse, by adding another price distortion. What Lipsey and Lancaster (1956: 20) observed was that, if one were to impose a comprehensive system of proportional tariffs on every other imported good, then that would actually minimize the price distortion, and so in that sense make things better. This is, of course, a science fiction scenario, invoked in order to make a conceptual point. It shows that the connection between the elimination of a tariff and the elimination of a Pareto inefficiency is an empirical generalization, not a deductive consequence of the first fundamental theorem of welfare economics. Needless to say, the fact that some bad outcome *b* is not a necessary consequence of some action *a*, should not be allowed to paralyze moral decision making, much less serve as an excuse for doing *a*.[5]

Medical students, while being trained to diagnose illness, are often reminded that "common things are common," and that "when you hear hoofbeats, think horses, not zebras." This is because, having memorized the symptoms of various exotic diseases, they have a tendency to overdiagnose them, forgetting that almost every patient who presents with flu symptoms has the flu, most people with headaches just have headaches, and so on. By focusing so much on the second-best theorem, and thus on the possibility of offsetting market imperfections, Moriarty is basically getting distracted by a zebra. When firms produce pollution, it's almost always bad. When firms collude to fix prices, it's almost always bad. When firms withhold information from customers about the quality of their goods, it's almost always bad. The suggestion that a moral theory is "inapplicable" to the real

[4] See Heath (2014: 39). Note that Steinberg (2017) mischaracterizes the theorem throughout his article. He claims, falsely, that "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" (Steinberg 2017: 31). The theorem says nothing about the relative probability of this occurrence. Steinberg (2017: 32) also claims that "under imperfect conditions, we simply cannot tell which strategies are those that would best contribute to the overall efficiency of the market." Nothing in the second-best theorem implies this.

[5] By contrast, Moriarty (2019: 5, emphasis in the original) writes that, because compliance with certain norms does not "necessarily lead to efficient outcomes in an imperfect market," these norms are therefore "*not justified* in an imperfect market." I am curious what conception of moral justification Moriarty is presupposing that requires such a strong modal connection between actions and their consequences.

world, unless it can show that actions of this type are *necessarily* bad, is unreasonable. The set of deontic constraints proposed by the MFA are designed to handle the "horses" of marketplace immorality.

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