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Business Ethics

The Market Failures Approach and an Attempt to Strengthen it

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Abstract

The following paper is concerned with the *Market Failures Approach* to business ethics introduced by Joseph Heath. In order to show that business and ethics are not incompatible, Heath derives an obligation of managers to maximize profits and an additional moral responsibility not to exploit market failures. By introducing the problems of unilateral respect and the second-best theorem I show that the approach faces difficulties under real-world circumstances. Consulting the understandings of Richard Lipsey and Norman Wayne I attempt to strengten the approach by showing that departures from the second-best allocation are only permissable if they increase welfare and that market failures are not, as Heath assumed, intrinsically harmful. Thereby showing that a weaker version of the account is still applicable to reality.

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1. Introduction

In the following paper, I am going to be concerned with Joseph Heath's "*Market Failures Approach to Business Ethics"*, showing that to arrive at the most efficient allocation of resources we have to accept that managers have an obligation to maximize profits. Additionally, it will be derived that there is an ethical responsibility for managers not to exploit market failures. Further, I am going to deal with a few problems the approach faces when applied to real-world circumstances. The first one being the problem of unilateral respect and the second being the *Theorem of Second Best* claiming that we can only use Heath's approach in a contextual affair when evaluating economies.

To strengthen the claim that the *Theorem of Second Best* does not deprive the *Market Failures Approach* of all normative force, I am going to consult a theory of Richard Lipsey, which entails that the second-best allocation might be even harder to achieve than the first-best and that departures from our strategy to increase efficiency are only allowed if one has well-reasoned arguments for it. Further, we will be concerned with the nature of market failures, which do not always have to be harmful, thereby making an amendment to Heath's approach.

Finally, I am going to conclude that Heath's approach brings some desirable advantages with it but can only be made applicable to real-world circumstances when amended with the approaches of the other authors I am consulting.

2. The Market Failures Approach

2.1 The Obligation to Maximize Profits

In order to first of all agree that business and ethics, which is considered to restrict egoistic behaviour, are not incompatible, we have to acknowledge that profit-maximization is more of an obligation of managers rather than an instance of their self-interest. The confusion that profit-maximization and self-interest denote the same phenomena mainly stems from two sources. The first is the assumption that individuals acting in the market system tend to maximize their own utility. When aggregating many suppliers maximizing utility into "the firm", this leads to a blurring of the two distinct notions. The second source is that the competitive market system lacks appreciation. Assuming that it is the best known form to coordinate economic activity, the obligation of managers can be justified indirectly in virtue of the role they play in this system (Heath 2004: 3-6).

Now how can we derive an obligation of managers to maximize profits from the role they play in the market system? The market's goal is to achieve the most efficient allocation of resources. If we allow profit-maximization for the sake of competition this will lead to competing firms driving prices to a level on which they are market clearing. If the market is cleared, then there will be no demands that remain unfulfilled and no supply produced for which there is no need. Such a situation is not only minimizing the amount of waste but also leads to the most efficient allocation we aimed at. As soon as we do not end up in this allocation it is assumed that somewhere in the system there must be a market failure. To avoid market failures, we can only allow profit maximizing strategies leading to an efficient allocation (Heath 2004: 7-11, 15).

2.2 The Moral Responsibility of Managers

In doing that, we have to add a moral responsibility for managers not to exploit market failures, additionally to the social obligation to maximize profits. While legal regulation aims to prevent market failures, it is practically limitated, e.g. because in many cases the administrative costs of legal regulation are too high which can lead to the regulation bringing more harm than good. The advantage of moral prohibition is that it does not cost anything and still transfers an ethical responsibility towards managers and constrains their profit-maximizing strategies (Heath 2004: 15f.).

But what does acting ethically mean for the behavior of managers? It means that they should behave as though there was perfect competition, independent of whether perfect competition exists. They have no right to exploit market failures and should thereby act as if there were not any market failure to exploit in the first place because market failure would not exist under perfect competition. Meaning that they should minimize negative externalities, avoid constructing entry barriers and should not seek tariffs or other protectionist measures, to mention only a few (Heath 2004: 19).

2.3 The Problem of Unilateral Respect

Looking at these kinds of constraints there is one problem arising naturally. If a firm would respect the constraints unilaterally it would most likely lead to the elimination of that firm because it would have a great disadvantage compared to the other firms not respecting the constraints. However, the unethical behaviour of others does not invalidate the obligation for everyone. How can this problem be solved? For example, trust experiments among the firms could lead to cooperation over time. Another possibility would be to build up an incentive structure for the desired behaviour. If market failures get exploited by firms, this would increase the temptation for the state to intervene. If the firms have to pay enough just for the intervention of the state than they could be worse off afterwards than they had been before. Thereby giving them strong reasons not to exploit it at all (Heath 2004: 19-22).

2.4 The Problem of Second-Best

Now let us have a look of another major problem for the *Market Failures Approach*, which is *the Theorem of Second-Best*. The theorem says that as soon as one of the conditions for perfect competition is violated, we are obviously not anymore in the first-best allocation and we cannot necessarily conclude that fulfilling all other conditions will lead to the second best allocation, which has been proven mathematically. The second-best allocation could then only be achievable if even more conditions are violated. Therefore, the closest approximation to perfect competition without any market failures is less efficient than a more distant alternative. It is assumed, that the state of perfect competition is only an idealization and is not achievable because the conditions are not satisfiable under real-world circumstances. Now, if reducing market failures and their exploitation does not necessarily lead to a better allocation, what is the consequence for Heath's approach? It follows that under real-world circumstances we cannot derive any normative conclusions from the *Market Failures Approach* because the assumption, that we can achieve the best state by eliminating market failures, is falsified. However, there is some normative force left to it, because the approach aims to increase efficiency which is in itself a desirable end. Although we cannot use the approach to evaluate whole economies, we can use it in a more contextual affair while looking at distinct sectors of the economy (Heath 2004: 22-26).

3. An Attempted Solution to the Problem of Second-Best

The author himself now claims that *"these remarks are clearly unsatisfactory"* (Heath 2004: 26).Therefore, I introduce another perspective to strengthen the claim that the *Market Failures Approach* is not deprived of all normative force. According to Richard Lipsey, we cannot say in general whether adding or removing one violation of the conditions for perfect competition will lead to a more or less efficient allocation or if it is going to change anything at all. Thus, there are many possible combinations of constraints laid upon the system of free markets that can lead to the second-best allocation as soon as one of the conditions is violated. The second-best might therefore be even harder to achieve, because we cannot define the conditions needed for a fully industrialised economy to end up in that allocation. However, as we assumed in the beginning, the competitive market system is the best known method to allocate our resources. Thus, departures from it are undesirable as long as you do not have well-reasoned arguments that an additional violation of a condition leads in your specific case to a more efficient allocation and thus increases welfare (Lipsey 2007).

4. Questioning the Nature of Market Failures

Assuming, that the second-best theorem holds and that we can never actually achieve perfect competition and thereby the first-best allocation, we will have to change one of Heath's indirect assumptions, which is that all market failures are harmful. When a market failure already exists, adding another one can in some cases even improve the welfare. We would therefore conclude that not all market failures are intrinsically harmful. The imperative laid upon managers would now not be something like "do not exploit any market failures" but more like "do not do x because there are strong reasons why x should be illegal, although it is not". This imperative is derived from the assumption that the most effective way to make corporations behave more socially responsible is through state regulation. However, there can be many reasons why a certain behaviour does not get regulated although it should be. For example, the administrative costs for this reg- ulation being too high. With this amendment to the *Market Failures Approach* it would no longer be unethical to exploit any market failures, but only to exploit those that should be, but are not well regulated (Norman 2011). This view seems to be more fitting when considering real-world circumstances.

5. Conclusion

Now, let us have a short recapitulation of what I elaborated on. First, I examined the *Market Failures Approach* to business ethics deriving not only an obligation of managers to maximize profits. I concluded that to achieve the most efficient allocation we have to transfer an ethical responsibility to managers not to exploit market failures, thereby constraining their available strategies to maximize profits.

The paper tackled the problem of unilateral respect, suggesting trust experiments or an incentive structure built up by threats of state intervention as a solution.

Concerning the with the *Theorem of Second Best*, I showed that if the first-best allocation is not available, we have to violate even more optimum conditions to achieve the second-best allocation. Consequently, we can use Heath's approach only in a contextual affair and not to evaluate whole economies.

Using Lipsey's understanding of the theorem, we saw that it is permissible to depart from Heath's approach if one can argue that in a particular case a violation of one of the constraints will lead to increased welfare and efficiency.

Finally, I had a closer look at the nature of market failures, concluding that if we are not in a system of perfect competition, not all market failures are intrinsically harmful. Thus, it would be only unethical to exploit market failures that should be but are not well regulated.

In summary it can be said, that Heath's approach brings some desirable advantages with it, having the ability to give practical advice to the behaviour of managers. Although the approach faces some difficulties when applied to real-world circumstances, I have shown in my paper that by amending it with the approaches of other authors it can be made applicable.

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