The History and Reality of the Market Failures Approach to Business Ethics

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This paper surveys and critiques the current market failures approach (MFA) to business ethics, beginning with the concept of market inefficiencies as introduced by Coasian transaction costs and progressing to the concept of market failures as discussed in Arrowvian information costs. The second section outlines contemporary constructions of MFA. At the macroscopic level, MFA is justified with Pareto efficiency, generating its characteristic efficiency imperatives and their derivative implications of metavoluntarism. The third section outlines the use of agency theory and professionalism norms within microeconomics to evidence MFA's attractiveness. The final section advances a critique of MFA based on the general theory of second best, finding MFA irrelevant, because its fundamental premises do not obtain in a dynamic capitalist economy, and unreasonable in its expectations of individual human behavior.

From Inefficiency to Failure: Ronald Coase and Kenneth Arrow

The New Institutional Economics movement of the 1930s, beginning with Ronald Coase, sought to explain the existence of firms within a specialized market economy. Coase viewed firms as consciously planned bubbles of entrepreneurial direction in a sea of decentralized market relations, which self-regulated to Pareto optimality through the invisible hand of the price mechanism.[1] Firms earn profit by more efficiently coordinating economic activity, superseding the market price mechanism. Firms' primary comparative advantages include reducing costs of obtaining information about relevant prices, and reducing costs of negotiating and concluding spot contracts.[2] For example, entrepreneurs direct a firm's resources to economize on market transaction costs through long-term contracts, which eliminate repeat negotiation costs and allow employers to delay specifying the precise terms of the contract.[3] Thus, firms exist where organizing costs are less than transaction costs, while markets exist where organizing costs exceed transaction costs. Known as the 'make-or-buy' decision, a firm expands until marginal organizing costs equal either market transaction costs

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[1] Ronald H. Coase, "The Nature of the Firm," *Economica* 4, no. 16(1937): 388.

[2] *Id.*, 390-391.

[3] *Id.*, 391-392.

or a competitor firm's organizing costs. The economy's market-firm structure is thus characterized by substitution at the margins of the relative costs of coordination. Furthermore, the Coasian supersession of the price mechanism is not due to market failure; for example, markets can evidently create long-term contracts as well. Rather, Coase is acknowledging that entrepreneurs and organizations can be more efficient than markets, particularly around contracting.

For Kenneth Arrow, firms exist where markets exhibit avoidable inefficiencies and where the price system fundamentally fails to secure the benefits of collective action. Consistent with Coase, Arrow contends that the authority derived from employment contracts holds price relations and adversarial contracting in partial abeyance within firms.[4] However, where Coase identifies market inefficiencies, Arrow explains that that incomplete information signifies the market's failure to process the intrinsic uncertainty of reality. Market failures manifest in contracting problems of hidden actions and information (i.e., moral hazard, adverse selection), exemplified by the inability of the information structure of the price system to price and allocate risk-bearing.[5] Firms use long-term employment contracts to exploit the aggregate decision-making faculties of many individuals, who sift through the random noise of an uncertain world, code information necessary for decision-making, and thus retransmit a significantly reduced volume of information to the firm's top decision-makers.[6] Coded retransmission constitutes firms' ability to handle uncertainty where the market fails to, earning profit by generating increasing returns to the uses of information.[7]

The contemporary market failures approach develops from a general concept of market failures, additionally evoking the functionalist Arrowvian account of the role of firms in a market society. Economic rationality and liberal morality define 'better' social organization as Pareto efficient, such that no other system makes everyone 'better' off according pluralistic individual values. Thus, social systems organize collective action for collective improvement, regulating competition for resources, securing gains from specialization, and allocating the benefits of joint production.[8] The price system achieves enormous efficiency gains through supply and demand, requiring only minimal knowledgeability of participants, creating a sense of freedom, and promising to correct for aggregate effects of individual action.[9]

However, the market system rewards selfishness, overlooks distributive justice, and struggles to process immaterial 'commodities' essential to efficient markets—specifically, trust, loyalty, and truthfulness. Pareto optimality is indeterminate regarding distributive justice; any points along

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[4] Kenneth Arrow, *The Limits of Organization* (New York: W. W. Norton & Company, 1974), 25.
[5] *Id.,* 34-37.
[6] *Id.,* 53-54.
[7] The difference between Coasian market inefficiencies and Arrowvian market failures is restated by Herbert Simon, who argues that firms internalize parts of the market system, subsuming market inefficiencies, and encompass non-market exchanges, addressing market failures (Herbert A. Simon, "Organizations and Markets," *Journal of Economic Perspectives* 4, no. 2(1991): 25).
[8] Arrow, *The Limits of Organization,* 16, 53.
[9] *Id.,* 27.

the efficiency frontier are equally optimal. Moreover, the incommensurability and incomplete communicability of individual values means that the choice amongst societal allocations is ultimately determined purely by power relations.[10] The limited ability of markets to govern distribution is thus due not only to market imperfections (i.e., externalities), but also to a fundamental incompatibility with private morality and indeterminacy regarding justice. Accordingly, Arrow argues that collective action and resource allocation require nonmarket governance where the price system fails. 'Invisible institutions' of ethical and moral principles, which support trust and reciprocity, are therefore essential to societies that wish to harness the productivity of the price system.

Falling in Love with Economics: The Market Failures Approach to Business Ethics

Consistent with Arrow, MFA invokes an efficiency principle that derives its morality from maximizing common interest. The morality of efficiency relies on the First Fundamental Theorem (FFT) of welfare economics, that a perfectly competitive market economy exhibits Pareto optimality. The invisible hand guides competitive prices to clear markets, maximizing aggregate utility and minimizing overall resource waste.[11] Locating the competitive market within a larger social scheme of social welfare,[12] markets are morally justified by their efficiency contributions to social prosperity.[13] Thus, FFT grounds the market's macrosocial role in achieving economic efficiency. In Coasian terms, firms complement markets with cooperatively organized production that supersedes the price mechanism, contributing to Paretian welfare.[14] Recall Arrow's recognition that in privileging efficiency, markets cannot accommodate values of fairness or justice;[15] rather, markets approach public morality in a roundabout way. FFT guarantees that firms pursuing profit indirectly achieve a societally optimal use of resources: individual willingness to pay operationalizes societal need and profit approximates a firm's efficiency in using resources to satisfy needs.[16]

The Second Fundamental Theorem of welfare economics, that tax-and-transfer schemes can secure optimal allocations, justifies limiting the scope of markets to concerns of efficiency.[17] Under a division of moral labor, markets promote efficiency and the welfare state promotes equality through structural changes and re-distribution.[18] Thus, individuals are permitted to

[10] *Id.*, 25.
[11] Joseph Heath, *Morality, Competition, and the Firm: the Market Failures Approach to Business Ethics* (Oxford, U.K.: Cambridge University Press, 2014), 29, 34.
[12] Singer, *The Form of the Firm*, 222, 238.
[13] Christopher McMahon, *Public Capitalism: The Political Authority of Corporate Executives* (Philadelphia, PA: University of Pennsylvania Press, 2013), 117.
[14] Abraham Singer, *The Form of the Firm: A Normative Political Theory of the Corporation* (Oxford, U.K.: Cambridge University Press, 2018), 182. 225.
[15] Heath, *Morality, Competition, and the Firm,* 186.
[16] *Id.*, 31, 41; Singer, *The Form of the Firm*, 224.
[17] Singer, *The Form of the Firm,* 235.
[18] *Id.*

suspend private moral principles of mutual aid, non-maleficence, and respect for autonomy[19] to seek profit in a competitive environment because markets' efficiency contribution to the goals of society confer an overarching morality.[20] The macrosocial role of markets justify suspending private morality within markets' institutional context,[21] and furthermore requires violations of private moral requirements.[22] While self-interested behavior sabotages close-knit cooperation, benevolence hampers competitive efficiency.[23] Large-scale cooperation amongst anonymous actors requires ample self-interest[24] for profit motives to, through competitive prices, produce societally-desirable Pareto-efficiency.[25]

Self-interest is one 'Pareto condition' needed for perfect competition, clear markets, and Pareto efficiency.[26] Furthermore, the morally meaningful macrosocial role of markets creates moral obligations to bring about Pareto conditions.[27] These 'efficiency imperatives,' instantiations of the spirit of perfect competition in duties toward Pareto conditions, define MFA's ethics.[28] Efficiency imperatives include principles prohibiting the pursuit and exploitation of monopoly power,[29] externalization,[30] deception,[31] and opportunism,[32] which inhibit perfect competition. Economic agents are expected to restrict their behavior for the sake of perfectly competitive market efficiency.[33] Individuals, firms, managers, and employees should not exploit market failures for profit,[34] because this undermines the moral foundation of perfect competition that premises the morality of the price mechanism.

Corporate law is as a mechanism for restricting profit-maximization to strategies consistent with Pareto conditions; however, legal mechanisms are blunt and costly.[35] Accordingly, MFA attempts to circumvent information costs through business internalized efficiency imperatives. Business ethics thus supersedes legal mechanisms for regulating Pareto-violating profit-

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[19] McMahon, *Public Capitalism*, 118-126.
[20] *Id.*, 117; Christopher McMahon, "Morality and the Invisible Hand," *Philosophy & Public Affairs* 10, no. 3(1981): 255; Heath, *Morality, Competition, and the Firm*, 29; Singer, *The Form of the Firm*, 222.
[21] Heath, *Morality, Competition, and the Firm*, 28..
[22] McMahon, "Morality and the Invisible Hand," 111, 127; Heath, *Morality, Competition, and the Firm*, 25.
[23] Singer, *The Form of the Firm*, 123.
[24] *Id.*; Heath, *Morality, Competition, and the Firm*, 186.
[25] Heath, *Morality, Competition, and the Firm*, 29, 41.
[26] *Id.*, 30, 34.
[27] McMahon, "Morality and the Invisible Hand," 255.
[28] Singer, *The Form of the Firm*, 233, 237; Moriarty, "On the Origin, Content, and Relevance," 3.
[29] Moriarty, "On the Origin, Content, and Relevance," 2.
[30] Heath, *Morality, Competition, and the Firm*, 199.
[31] *Id.*, 33; McMahon, "Morality and the Invisible Hand," 257.
[32] Heath, *Morality, Competition, and the Firm*, 199.
[33] McMahon, *Public Capitalism*, 117.
[34] Singer, *The Form of the Firm*, 218, 228.
[35] *Id.*, 226-228; Heath, *Morality, Competition, and the Firm*, 31, 34.

maximization strategies,[36] internalizing enforcement of Pareto conditions where external enforcement is unreasonably costly and even impossible. However, internalization creates collective action problems. All actors have self-interested incentives to defect, since anyone abiding by the high standards of Pareto competition would quickly be eliminated.[37] Moreover, this martyrdom would undermine actors' moral-economic purpose of driving prices down through competition. MFA attempts to respond by permitting individual noncompliance[38] so long as actors work toward the conditions for viable collective compliance with efficiency imperatives.[39] This 'metavolutarism' could include building cooperation through long-term reciprocity, non-legal agreements, and industry self-regulation.[40] Ultimately, MFA narrates a moral cascade from FFT to high-level consequentialist principles, encoded into intermediate deontological conditions,[41] internalized in granular-level ethical imperatives.

Case Study: MFA on Agency Theory and Professionalism Norms

At the managerial level, MFA has been applied to solve the principal-agent problem and justify the shareholder theory of managerial responsibility, by arguing that profit-maximization is not managerial self-interest, but rather a professional obligation constrained by principal interests and efficiency imperatives.[42] Agency when advancing the principal interests intrinsically necessitates trust,[43] creating moral obligations to further shareholder interests[44] that are founded on the maximization of social welfare from competitive firms.[45] If managers fail to maximize profits, firms will be uncompetitive, markets will be inefficient, and social utility will not be maximized.[46] However, this straightforward promise breaks down in modern economies where ownership and control are separate. Rational actors using private property to pursue self-interest no longer guarantees maximal efficiency,[47] creating a principal-agent confound for the invisible hand mechanism of individual initiative in industrial enterprise.[48]

The ownership-control separation that creates the principle-agent problem can be traced back to Frank Knight, who discussed the division of entrepreneurship into stockholder risk-bearing

[36] *Id.*, 35-36; Singer, *The Form of the Firm*, 227-228

[37] Heath, *Morality, Competition, and the Firm*, 37; Singer, *The Form of the Firm*, 251-252.
[38] Heath, *Morality, Competition, and the Firm*, 202; Singer, *The Form of the Firm*, 251-252.
[39] Heath, *Morality, Competition, and the Firm*, 37-38.
[40] *Id.*, 38.
[41] *Id.*, 199.
[42] *Id.*, 25.
[43] *Id.*, 25.
[44] *Id.*
[45] Mansell *Capitalism, Corporations, and the Social Contract*, 133.
[46] Samuel F. Mansell, *Capitalism, Corporations, and the Social Contract: A Critique of Stakeholder Theory* (Cambridge, U.K.: Cambridge University Press, 2013), 133.
[47] *Id.*, 128.
[48] Mansell *Capitalism, Corporations, and the Social Contract*, 128-129.

and managerial decision-making.[49] In order to restore the Pareto promise underlying the moral justification of markets, accountability mechanisms must bridge the ownership-control gap.[50] As the shareholder-manager relationship is tighter than the stakeholder-manager relationship,[51] MFA promotes self-monitoring and self-enforcement to solve the principle-agent problem, internalizing monitoring-enforcement costs using efficiency imperatives. Managerial professional norms are derived through MFA, starting with the goal of Pareto conditions and working backward to the implications for a firm in a market economy.[52]

The academic concept of professional norms dates back to institutional economists' 'professionalism project' of the early 20th century.[53] Norms of business conduct including integrity, honesty, trustworthiness, disinterestedness, transparency, competence, and duties of care and loyalty create a trustworthy basis for impersonal, transactional relationships in an institutional context that explicitly sanctions violations of private morality.[54] Professional norms are consistent with empirical findings that people exhibit cooperation, loyalty, and opportunistic restraint even without external incentives.[55] Accordingly, game theory consistently overemphasizes monitoring-enforcement costs while underinvesting in trust, loyalty, and professionalism,[56] rationalizing, motivating, and fulfilling the rational-actor prophecy.[57]

Rather, a team-oriented organizational culture of shared reciprocity and coordination values is a distinct competitive advantage of firms.[58] Simon conjectures that organizational identification is a powerful mechanism for motivating employees to further organizational goals.[59] Pride in work and organizational loyalty supersede supervision and piecework reward in addressing free-riding problems.[60] Normative principles allow firm relationships to supersede external incentive structures and adversarial bargaining.[61] Thus, a professional ethos addresses the principal-agent problem, allowing firms to maximize profits and contribute to competitive markets that deliver efficiency to society.

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49 Frank Knight, *Risk, Uncertainty, and Profit,* (Boston: Houghton Mifflin Co., 1921) 289-290
50 Mansell, *Capitalism, Corporations, and the Social Contract,* 128.
51 *Id.*, 155.
52 Heath, *Morality, Competition, and the Firm,* 41, 344.
53 Douglas E. Stevens, *Social Norms and the Theory of the Firm: A Foundational Approach* (Cambridge, U.K.: Cambridge University Press, 2018), 51.
54 Stevens, *Social Norms and the Theory of the Firm*, 51.
55 Heath, *Morality, Competition, and the Firm*, 279.
56 *Id.*, 281.
57 *Id.*, 282-283.
58 *Id.*, 285, 343-344; Singer, *The Form of the Firm,* 118.
59 Simon, "Organizations and Markets," 34.
60 *Id.*
61 Singer, *The Form of the Firm*, 219.

Irrelevance and Idealism: Critique of the Market Failures Approach

The beauty of MFA is that its business ethics embody the logic of markets: if actors honor the spirit of the market, the invisible hand produces morality alongside efficiency, addressing macrosocial questions of social justice and microsocial question of ethical agency. However, MFA rests on the significant assumption of Pareto conditions. The General Theory of Second Best finds that, paradoxically, violating multiple Pareto conditions may produce more efficiency than violating one Pareto condition.[62] That is, under nonideal conditions, such as empirical economies, additional purposeful market failures may increase efficiency.[63] This non-linear relationship between competition and efficiency destroys the ability of MFA to make normative claims in real-world circumstances.[64] MFA is useless in our second-best reality. It can no longer promote efficiency imperatives; they are devoid of justification since they no longer create Pareto efficiency.[65] Re-defining ethics in terms of the moral justification of markets turns MFA's characteristic efficiency imperatives into mundane individual duties to promote societal welfare, obviating MFA.[66]

The complete collapse of macrosocial objectives into microeconomic interactions demands that economic actors fully internalized and constantly expressed the ideals of a perfect market. Yet, the market's competitive institutional context is diametrically opposed to efficiency imperatives that strive toward collective welfare. The macro/micro-inconsistency of the firm-market dichotomy is visible in several domains. Managers are morally obligated to be cooperative within firms but competitive with other firms.[67] Firm culture must be antithetical to market culture; in order to address the principal-agent problem, professionalism norms must counteract market opportunism.[68] The internal inconsistency of MFA explains why extra-legal mechanisms suggested to secure inter-firm ethical compliance are intrinsically untenable. Non-legal agreements fall victim to the same regulatory costs from asymmetric information as corporate law, and while long-term reciprocity and industry self-regulation reduce free-riding opportunities by restricting the scope of the collective, they do not fundamentally eliminate incentives to defect from cooperation. Inter-firm ethical compliance fails because it is inherently inconsistent with the structure, goals, and practices of the market.

Furthermore, given the nonideal realities of a dynamic economy, the conscious negation of the market's invisible hand logic—that individuals need not concern themselves with high-level

[62] Heath, *Morality, Competition, and the Firm*, 39; Moriarty, "On the Origin, Content, and Relevance," 4-5.
[63] Moriarty, "On the Origin, Content, and Relevance," 5.
[64] Heath, *Morality, Competition, and the Firm*, 40; Singer, *The Form of the Firm*, 226.
[65] Moriarty, "On the Origin, Content, and Relevance," 11.
[66] *Id.*
[67] Singer, *The Form of the Firm*, 225.
[68] *Id.*, 252.

goals—is a futile sacrifice for Paretian efficiency. Theories of second- and third-best approaches try to apply MFA to formulate a response to the general theory of second best, deriving sets of imperatives from nonideal conditions.[69] However, these iterations are susceptible to infinite regress, and a time-slice reformation of ethical principles is broadly unhelpful in a dynamic economy with complex, simultaneous change. The stopgap response of MFA, which produces an imperative to fix each isolated condition that is causing deviation from Pareto-efficient output, is overwhelmed by the sheer complexity of emergent systems. In the Knightian sense of uncertainty, individual efforts to fix market failures cannot meaningfully contribute to societal welfare.

Conclusion: Business Ethics for Dynamic Capitalism

While MFA recognizes the existence of market failures, it is overly and unreasonably idealistic in believing that first-degree market failures can be fully absorbed by second-degree internalization.[70] MFA uses the promise of ideal theory under premises of nonideal theory. However, efficiency imperatives cannot morally hold in an imperfect market where competition does not maximize Paretian efficiency. It is a grand attempt to salvage Pareto conditions from the general theory of second best, but it is beleaguered by fundamental internal inconsistencies. Moving forward, MFA suggests that business ethics must answer the question of a macrosocial justification for an institution that privileges efficiency, and the question of its corresponding microeconomic imperatives at the individual level. The desire to create a macrosocial justification for markets seems to stem from the perceived mismatch between the competitive efficiency of markets and the welfarist norms of liberal democracy,[71] which are becoming increasingly outdated under neoliberalism. Though the *pars construens* is beyond the scope of this paper, entrepreneurship presents a rich case study for analyzing dynamic competition where the social benefits of creative destruction could form a moral foundation for business ethics. An inquiry into business ethics under dynamic capitalism must first consider the meta-ethics of markets: if there should be a moral justification, if it lies in macrosocial welfare, and if it is consistent with the nature and purpose of markets. While MFA provides a tempting story of Paretian redemption, it is realistically untenable as a contemporary theory of business ethics.

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[69] Heath, *Morality, Competition, and the Firm*, 173-175.
[70] Moriarty, "On the Origin, Content, and Relevance," 10.
[71] Singer, *The Form of the Firm*, 219.

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