*Erasmus Journal for Philosophy and Economics,*
*Volume 8, Issue 1,*
*Spring 2015, pp. 116-122.*
*http://ejpe.org/pdf/8-1-br-4.pdf*

# Review of Joseph Heath's *Morality, competition, and the firm: the market failures approach to business ethics*. Oxford: Oxford University Press, 2014, 424 pp.

CARSON YOUNG
*Wharton School of Business, University of Pennsylvania*

Anyone who has taught or taken a business ethics course will be familiar with the tired debate between shareholder theory and stakeholder theory. Shareholder (or stockholder) theory is almost always represented by a Milton Friedman opinion piece from a 1970 issue of *The New York Times Magazine* that traditionally plays a role in the business ethics classroom comparable to that of the 'heel' in a professional wrestling match. It announces in its title the view it purports to defend: "The social responsibility of business is to increase its profits" (Friedman 1970). (Friedman's piece actually contains a variety of arguments that are difficult to reconcile with each other, which makes his ultimate views on the social responsibility of business both more nuanced and harder to pin down than the title suggests.) Swooping in to rescue business from Friedmanite moral laxity is usually an article expounding stakeholder theory by its founding father, R. Edward Freeman, who claims that the firm's managers should advance the interests of *all* of a firm's stakeholders, not merely those of shareholders, as an ultimate goal.

Shareholder theory and stakeholder theory have both generated enormous literatures. When reading through the three decades' worth of contributions to this literature, one gets the sense that there is little left to say. The shareholder-stakeholder debate has grown stale, but it never reached a particularly satisfying resolution. The big questions that originally set off the debate remain open: What are the ethical responsibilities of the corporate manager? What factors must the corporate manager take into account, and how, in order to run the corporation ethically?

Over the past decade, University of Toronto philosopher Joseph Heath has written a series of papers that put forward a new way of thinking about these central questions of business ethics. Heath's work features extensive use of economic theory. This is relatively common in

**AUTHOR'S NOTE:** I thank Wayne Norman for his guidance in writing this review. I also thank Eric Orts and Nicolas Cornell for their helpful comments.

business ethics. Indeed, as I have mentioned, one of the articles that gave rise to business ethics as an academic discipline was written by none other than Milton Friedman. But usually, economic approaches to business ethics are used to argue for extremely minimalist views about the ethical obligations that apply to corporate managers. What separates Heath's work from much of the previous business ethics literature is his extensive use of economic theory to justify a much more demanding set of ethical norms for business. *Morality, competition, and the firm* is a collection of essays on his novel alternative to stakeholder and shareholder theories, which he dubs the 'market failures' approach to business ethics. (Six of the chapters in the book develop and defend core elements of this approach, and the remaining eight chapters address related subjects relevant to the evaluation of markets, firms, and market agents.)

Heath's book is essential reading for scholars and students interested in new ways of thinking about the foundations of business ethics. But the themes in the book are also likely to be relevant to scholars working at the intersection between ethics, political philosophy, political economy, and economics more broadly. There is tension, to put it mildly, between mainstream views in political philosophy and mainstream views in economics. What is distinctive about Heath's work is that it links mainstream egalitarian views about justice in political philosophy to certain aspects of mainstream thinking about economics. Indeed, one of the most important chapters in the book, "Efficiency as the implicit morality of the market" (which I will briefly discuss later), gives an explicit and detailed account of how norms of economic efficiency are compatible with a commitment to a strict egalitarian theory of justice.

Before continuing, it is worth mentioning a few of the book's minor flaws, all of which stem from the fact that it is a collection of essays rather than a unified monograph. First, some of the chapters overlap with each other enough that they feel repetitive. Second, nine of the book's fourteen chapters were previously published elsewhere, so those already familiar with Heath's work may find it somewhat redundant. Third, the book's main themes might be easier to follow if the connections between the chapters were more explicit. That said, this third quibble is largely mitigated by the book's excellent introduction, in which Heath gives an intellectual history of his project as well as a survey of the field of business ethics as he sees it. Heath is a master at distilling the main literature on a topic into a gripping intellectual narrative in order to set up his own substantive arguments, and the introduction provides a fine example of Heath's expository savvy.

The first of the book's three sections contains the 'greatest hits' of Heath's previous work on business ethics. These are the articles in which Heath developed the fundamental ideas of the market failures approach. "A market failures approach to business ethics", originally published in 2004, was Heath's first foray into the field. Stakeholder and shareholder theorists had been arguing for decades about whether a corporate manager's obligations extend beyond maximizing profit. Heath's insight was that adherents to both of these approaches, with few exceptions, attempted to defend views on the ethical status of profit maximization without considering how the profit motive's role in the broader economic system is (or can be) justified in the first place.

> It is in seeking to justify the profit motive that we discover that the appropriate form of managerial responsibility is not to maximize profits using any available strategy, but rather to take advantage of certain specific opportunities for profit (p. 26).

This starting point led Heath to argue for a more subtle version of Milton Friedman's defense of profit maximization. Heath gives his own reconstruction of Friedman's argument, claiming that in order to be consistent with the underlying economic logic on which he relies, Friedman cannot defend all forms of profit seeking, since

> managers have no right to take advantage of market imperfections in order to increase corporate profits. The set of permissible profit-maximizing strategies is limited to those strategies that would be permissible under conditions of perfect competition (p. 34).

This line of argument is further developed in two chapters that were both originally published as journal articles in 2006. In "Business ethics without stakeholders" Heath writes,

> [P]rofit is not intrinsically good. The profit-seeking orientation of the private firm is valued only because of the role that it plays in sustaining the price system, and thus the contribution that it makes to the efficiency properties of the market economy as a whole. Ideally, the only way that a firm could make a profit would be by employing one of the preferred [non-market-failure-exacerbating] strategies. However, for strictly practical reasons, it is often

> impossible to create a system of laws that prohibits the non-preferred ones. Thus according to the market failures perspective […] the ethical firm does not seek to profit from market failure (p. 89).

Heath makes a similar argument with somewhat different points of emphasis in "An adversarial ethic for business: or, when Sun-Tzu met the stakeholder", which stresses the importance of accounting for the adversarial structure of the market when developing a theory of business ethics.

In addition to the above three chapters that primarily focus on ethical obligations in an extra-firm context, the book's first section also has two chapters on corporate governance. "Stakeholder theory, corporate governance, and public management" (co-authored with Wayne Norman) discusses the governance problems that arise when firm management has a strong duty to serve different stakeholder groups beyond shareholders. "Business ethics and the 'End of History' in corporate law" includes a sympathetic discussion of Henry Hansmann and Reinier Kraakman's defense of shareholder primacy, which Hansmann and Kraakman argue is best understood as a special case of *owner* primacy, and as such would apply equally to worker-owned co-ops, or to tenant-owned condominiums (Hansmann and Kraakman 2003). The chapter concludes with an argument that Hansmann and Kraakman's endorsement of shareholder primacy is too strong, given their premises. Heath claims, "if there is a conflict between the interests of various constituency groups, management should assign priority to the interests of shareholders", but that when "the conflict is one between the interests of shareholders and the principle that managers should refrain from taking advantage of market power in dealing with other constituencies, then the principle trumps the interests" (p. 141).

In the background of all of these articles is Heath's commitment to the idea "that the market is essentially a staged competition, designed to promote Pareto efficiency" (p. 5). This will strike most readers as an implausibly minimalist normative principle. What is so great about Pareto efficiency? In perhaps the most important non-previously published chapter in the book, "Efficiency as the implicit morality of the market", Heath explains why, even if one were starting from a G. A. Cohen-style strict egalitarian theory of justice, there are good reasons to conclude that "the guiding idea in business ethics should be the principle of Pareto efficiency" (p. 173). Heath's explanation for this is technical and much too complex to explain adequately here, but the basic idea should be familiar to anyone who has read Rawls. The reason Rawls adopts the Difference Principle rather than strict egalitarianism is that, because of incentive problems, a principle that allows for certain economic inequalities will be better for the least well-off than a stricter egalitarian principle (Rawls 1971). Likewise, Heath thinks that given the incentive and information problems that plague egalitarian and prioritarian principles, we should adopt the Pareto principle for evaluating market behavior.

The book's remaining chapters cover topics somewhat outside the book's central themes, but they are worth reading for those with relevant interests. In "The benefits of cooperation", Heath argues that there are five main mechanisms through which cooperation yields benefits: economies of scale, gains from trade, risk pooling, self-binding, and information transmission. Clearly distinguishing these mechanisms, Heath claims, is vital for understanding the normative foundations of the welfare state. "Contractualism: micro and macro" argues that there is a tension between versions of contractualist ("social contract") theories of justice that take small group interactions as an analytical point of departure (such as David Gauthier's, see Gauthier 1986) and those that focus instead on society as a whole (such as John Rawls's, see Rawls 1971). Microcontractualist theories are unable to provide principles that ensure justice at the society-wide level, while macrocontractualist theories lack the resources to generate principles that ensure justice in small-scale, particular interactions. Heath proposes a contractualist framework that he claims can resolve this puzzle. "The history of the invisible hand" examines the evolution of the invisible hand argument from Adam Smith to Friedrich Hayek. As its title suggests, "The uses and abuses of agency theory" argues against some prominent conceptions and applications of agency theory and suggests how agency theory should be understood and employed. In "Business ethics and moral motivation", Heath criticizes certain folk theories of moral motivation that have been popular among business ethicists and suggests criminological literature as a promising resource for insights into the causes of unethical behavior in organizations. "Business ethics after virtue" urges business ethicists to "put virtue theory behind us once and for all" (p. 323). Finally, in "Reasonable restrictions on underwriting", Heath looks at insurance markets, which he argues are different in significant ways from other markets. He shows how these differences can lead to otherwise counterintuitive conclusions. For example, he defends the position that (with some caveats) it is morally permissible for private insurers to charge individuals different insurance premiums based on statistical predictions about how expensive those individuals will be to insure.

As Heath recognizes, the market failures approach to business ethics remains very much a work in progress. So before concluding, I will mention one deficiency that adherents to the view need to address. In the book's first chapter, Heath writes that "[t]he firm should behave as though market conditions were perfectly competitive, even though they may not in fact be" (p. 37). This principle entails a variety of restrictions on how firms may pursue profit. For example, ethical firms must "[m]inimize negative externalities" and "[t]reat price levels as exogenously determined" (p. 37). Heath recognizes that we cannot hold firms to these ethical standards in our non-ideal world, since any firm that abided by them would be unable to survive in a competitive marketplace. However, as Heath acknowledges, we cannot even claim that firms should abide by these constraints as best they can given the competitive pressures they face because of the 'second-best theorem' (Lipsey and Lancaster 1956). The second-best theorem implies that if there is a distortion in the market, the most efficient possible outcome may require introducing other market distortions. Therefore, one cannot straightforwardly apply principles derived under ideal assumptions to a non-ideal context in which those assumptions do not hold. Heath writes in the book's introduction that he "would someday like to address more thoroughly […] the non-ideal aspect of the theory" (p. 20). I hope he does, because as long as its non-ideal aspect remains unresolved, the market failures approach risks being strictly academic. A good approach to business ethics should be able to give concrete, practical guidance to a firm manager who wants to do business ethically.

One could quibble about *Morality, competition, and the firm* being a collection of articles more so than a coherent, unified book. But it contains such a wealth of challenging and thought-provoking ideas about the ethics of business and economics that I believe those interested in these fields will find it worthy of their attention.

## REFERENCES

Friedman, Milton. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine*, September 13.

Gauthier, David. 1986. *Morals by agreement*. Oxford: Oxford University Press.
Hansmann, Henry, and Reinier Kraakman. 2003. The end of history for corporate law. In *Convergence and persistence in corporate governance*, eds. Jeffrey Gordon, and Mark J. Roe. Cambridge: Cambridge University Press, 33-68.
Lipsey, Richard, and Kelvin Lancaster. 1956. The general theory of the second best. *The Review of Economic Studies,* 24 (1): 11-32.
Rawls, John. 1971. *A theory of justice*. Cambridge (MA): Harvard University Press.

**Carson Young** is a PhD student in the Ethics and Legal Studies department at the Wharton School of the University of Pennsylvania.
Contact e-mail: <carsony@wharton.upenn.edu>