Chapter 6
How (Not) to Connect Ethics and Economics: Epistemological and Metaethical Problems for the Perfectly Competitive Market

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Abstract This paper addresses Joseph Heath's attempt to derive moral obligations from the conditions that are specified by the model of the perfectly competitive market. Through his market failures approach to business ethics he argues that firms should behave as if they are operating in a perfectly competitive market. However, I argue that this derivation of moral obligations runs counter to the metaethical principle that moral actions need to be voluntarily chosen from a set of alternatives. To the extent that Milton Friedman's derivation follows the same lines, my objection is also applicable to his approach to business ethics. I bring out the fact that the conditions required by the model of the perfectly competitive market cannot be realized in the actual world and argue that this causes problems for any moral obligations that might follow. My objection is illustrated by an intuitive example of someone set to an impossible task. I also bring in a way that Heath could work around this objection, but I argue that this would imply the collapse of his approach into another kind of theory that he wishes to distinguish himself from. More deeply, I show that my metaethical objection has epistemological consequences that undermine the very basis of the model of the perfectly competitive market. I conclude by stating that we need a different conception of competition, pointing to the facts that such a perspective would need to take into account, and suggesting that the concept of rivalry is up to the job.

6.1 Introduction

In recent years, Joseph Heath has provided a novel moral defence of markets with his market failures approach to business ethics (Heath 2014, vii-viii; 173; 199n14). His approach holds that firms have a moral obligation not to "seek to profit from

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market failure" on the basis of the economic model of the perfectly competitive market (Heath 2014, 89). This basis uniquely distinguishes Heath's approach from other stockholder theories that attempt to derive moral obligations by also involving general morality.[1]

I share Heath's goal of providing a moral defence of the free market, but I do not think that the model of the perfectly competitive market is suited to this end. My primary aim here is to show that his attempt to derive moral obligations from the model of the perfectly competitive market contradicts the metaethical principle that moral actions need to be voluntarily chosen.

Although I think that this metaethical problem originates in the deeper epistemological foundations of the model of the perfectly competitive market, the brunt of my criticism is directed towards the metaethical component of Heath's justification of the market failures approach. Without first trying to make strong claims about these deeper foundations, I will show that the issues that I will tackle are important for any usage of the model of the perfectly competitive market in an ethical context. For example, I will also show how Milton Friedman's business ethics is vulnerable to the same line of criticism. My analysis of Heath's justification of the market failures approach will thus centre on the way in which moral obligations are derived from the model of the perfectly competitive market.

First, I will start out by explaining the way in which Heath tries to derive moral obligations from the model of the perfectly competitive market. This will include the way in which he relates the role of the government to the privileges and operation of firms and the role that he assigns to the model of the perfectly competitive market. I will also touch upon the way in which Friedman's business ethics tries to perform the same kind of derivation of moral obligations (as interpreted by Heath).

Second, I will provide a metaethical objection to Heath's (and by extension, Friedman's) attempt at deriving moral obligations from the model of the perfectly competitive market. I bring out the fact that the conditions required by said model cannot be realized in the real world and argue that this causes problems for any moral obligations that might follow. This objection is illustrated by an intuitive example of someone set to an impossible task. I also bring in a way that Heath could work around this objection, but I argue that this would mean the collapse of his approach into another kind of theory that he wishes to distinguish himself from. I conclude this section by pointing out why it is in principle impossible to provide such a workaround, as my metaethical objection shows a deeper fault within the epistemological basis of the model of the perfectly competitive market.

Lastly, I conclude that we need a different conception of competition for correctly theorizing about competition from a moral and epistemological point of view and point to a conception of competition that seems to be a good alternative.

[1] For a comparison between Heath's foundational approach and those of Langtry and Goodpaster, see Heath (2014, 90).

6.2 Heath's Market Failures Approach

Heath starts arguing for his market failures approach by observing that firms are legal constructs which have certain privileges regular citizens do not have (such as limited liability). This means that firms exist only by virtue of the fact that the government grants them these privileges. Consequently, Heath says, the government may "impose certain obligations [upon firms], in return for the privileges granted" (Heath 2014, 29). In principle, these obligations can range from ethical obligations that ask the firms to adhere to a certain set of rules to government-enforced regulations that are backed up by legal sanctions.

Next, Heath asks the fundamental question why governments should grant these privileges in the first place. His answer to this question is fairly complex, but it boils down to the idea that "society wants to encourage competition between suppliers" because it "secures the operation of the price mechanism" without which "you simply cannot organize a complex economy" (Heath 2014, 29; 30). Under the correct conditions, the price mechanism makes sure that the prices of goods are "cleared" – which means that there will be no unsold goods nor unsatisfied customers. According to Heath, we should look to the model of the perfectly competitive market to provide us with these conditions:

> *The central conclusion [of the first fundamental theory of welfare economics] is that the outcome of a perfectly competitive market economy will be Pareto-optimal—which means that it will not be possible to improve any one person's condition without worsening someone else's.* (Heath 2014, 29–30)

In a perfectly competitive market, there is a "race to the bottom" between suppliers of goods. Each supplier is able to achieve profit by lowering their prices under those of their competitors, making up for the lower price because they attain a larger number of sales. This means that competitors keep undercutting each other to the point at which all prices in the market are cleared and all profits have disappeared.[2] In the end, competition allows for "a more efficient allocation of [society's] resources and labor time" than economic systems in which competition is absent (Heath 2014, 30–31).[3]

In the next step, Heath connects this institutional argument back to the privileges that the government can grant to firms. This means that the conditions under which firms are to be granted their privileges are those dictated by the model of the perfectly competitive market. This provides the basis for both government regulation of firms and moral obligations for firms. Heath argues that firms need to be regulated by the government in such a way as to create the conditions that will make sure that the prices of the goods they produce will be cleared. Since profits are price signals that show whether there are still customer needs to be satisfied or resources to be put

[2] The technical name for these profits in the model of the perfectly competitive market is pure profits.

[3] Heath illustrates this contrast by discussing the way in which the absence of the price mechanism caused problems for the former Soviet Union Heath (2014, 30).

to a better use in another place, firms gain a moral obligation "to do what is necessary in order for the firm to maximize profits in this way" (Heath 2014, 31).

However, the conditions demanded by the model of the perfectly competitive market to achieve a Pareto-optimal outcome are not always met. In such a case, market outcomes are not Pareto-optimal and are called market 'failures' as they haven't lived up to the standard of the perfectly competitive market.[4] The next question that arises is: Should the state start regulating firms in order to make sure that market failures are prevented from happening?

Although Heath holds that there is a basis for the government to regulate firms through the legal mechanism because their privileges are granted by the government, he argues that these regulations are unfeasible. He says that the legal apparatus is "a somewhat blunt instrument" and that in too many cases "the state simply lacks the information needed to implement the necessary measures" that are needed to make sure that market failures do not occur (Heath 2014, 36–38). Even in cases where the government has enough information to regulate for situations in which the market fails, he argues that the administrative costs that are incurred in such a situation are so high that they turn government regulations into an unfeasible task. It is at this point in the argument that firms become subject to moral constraints that are not backed up by legalized force:

> *Imagine for a moment a deontically perfect world, in which everyone could be counted on to comply with all moral requirements. How should an ethical corporation behave in such a world? The answer is quite simple. The firm should behave as though market conditions were perfectly competitive, even though they may not in fact be.* (Heath 2014, 37)

In this respect, Heath agrees with Milton Friedman's metaethical approach to business ethics (Friedman 1962). In his interpretation of Friedman's business ethics, moral obligations of firms are also grounded in the model of the perfectly competitive market; firms are thus morally obligated not to exploit market failures (Heath 2014, 31–35). However, Heath is very critical of Friedman's approach and criticizes it on two grounds. His first criticism is directed at Friedman's derivation of normative ethics from his metaethical basis. According to Heath, Friedman "arbitrarily limits the set of obligations [for firms] to those that support only some of the many Pareto conditions [demanded by the model of the perfectly competitive market]" (Heath 2014, 35). In this respect, Heath wishes to be more consistent in the derivation of moral obligations from the model of the perfectly competitive market. He illustrates this through a very compelling argument that will at the same time provide us with a concrete example of the moral obligations that both authors have in mind:

> *…Friedman argues that pollution reduction is one of the illegitimate responsibilities pressed upon managers in the name of "social responsibility." But pollution is a negative externality—a cost associated with some economic activity that is transferred to a third party without compensation. These externalities exist because the set of markets is incomplete. We cannot exercise property rights over the air that we breathe, for example. As a*

[4] For a compelling critique of the very idea that markets can fail, see Simpson (2005).

> *result, while we can charge people for dumping noxious substances on land that we own, we cannot do the same when they dump it in the air. For this reason, one of the Pareto conditions effectively requires that there be no externalities. Any corporation that pollutes is essentially profiting from a market imperfection. This means that there is no difference, from the moral point of view, between deception and pollution—both represent impermissible profit-maximization strategies. Friedman's decision to prohibit deception, while giving the wink to environmental degradation, is arbitrary and unmotivated.* (Heath 2014, 35)

This brings us to Heath's second criticism of Friedman's approach, which is directed at the way in which Friedman thinks that we can approach the ideal of the perfectly competitive market. Let us take a closer look at what kind of ideal is presented. The abstraction of the perfectly competitive market is claimed to be an ideal model such as that of a frictionless plane or a mathematically perfect circle. Any attempt to approach such a type of ideal is a simple corollary of the ideal in question. For example, if one draws a circle on a whiteboard by means of a pair of compasses, then one approaches an ideal circle quite linearly and directly. Friedman phrases this idea as follows:

> *No one has ever seen a Euclidian line—which has zero width and depth— yet we all find it useful to regard many a Euclidian volume—such as a surveyor's string—as a Euclidian line. Similarly, there is no such thing as "pure" competition. Every producer has some effect, however tiny, on the price of the product he produces. The important issue for understanding and for policy is whether this effect is significant or can properly be neglected, as the surveyor can neglect the thickness of what he calls a "line."* (Friedman 1962, 120)

It is not this type of ideal abstraction that Heath finds problematic, but its function as a gauge for the approximation of the ideal itself. He notes that "we may be tempted to conclude that if perfect competition generates perfect efficiency, then near-perfect competition should generate as close as possible to perfect efficiency" (Heath 2014, 39). It is this line of reasoning that is blocked by the second-best theorem (Lipsey and Lancaster 1956):

> *This theorem shows that in a situation in which one of the Pareto conditions is violated, respect for all of the other Pareto conditions will generate an outcome that is less efficient than some other outcome that could be obtained by violating one or more of the remaining conditions. In other words, while perfect competition generates a perfectly efficient outcome, a situation that is as close as possible to perfect competition will not generate an outcome that is as close as possible to perfect efficiency.* (Heath 2014, 39)

According to Heath, the implication of this theorem is that Friedman is blocked from making "the big sweeping generalizations that were the stock-in-trade of economists of Friedman's generation" (Heath 2014, 40). If one wishes to approximate the ideal presented by the model of the perfectly competitive market, then one cannot use Friedman's top-down reasoning to achieve this end.

In order to derive actual moral obligations for firms, Heath wishes to use a more bottom-up approach.[5] He notes that every individual trade that takes place still causes a Pareto improvement and that this makes the Pareto-optimum of the

[5] For the reason why the second-best theorem can't be used to derive moral obligations, see Heath (2014, 40).

perfectly competitive market model irrelevant for everyday life. Instead of appealing to the Pareto-optimum, one would need to "appeal to the particular efficiency gains that the firm is able to realize among its shareholders, its employees, and its customers" (Heath 2014, 40). On the one hand, this means that the model of the perfectly competitive market is still the source and foundation of the moral obligations that firms have to adhere to. On the other hand, the way in which we could determine what the moral obligations are of firms in day-to-day situations is turned into a much more contextual enterprise that needs to take into account the particular efficiency gains of the situation in question. Heath notes that:

> *…actually making the case [for specific moral obligations] requires a more detailed analysis, one that examines the specific conditions of the market in question. These remarks are clearly unsatisfactory. The more general research program, however, is one that I believe has considerable promise.* (Heath 2014, 41)

6.3 A Metaethical Objection to Deriving Moral Obligations from the Model of the Perfectly Competitive Market

Although Heath tries to separate the way in which we can determine day-to-day moral obligations from the conditions specified by the model of the perfectly competitive market by means of his bottom-up approach, the justification of these obligations can still be found in said model. It is at this point in the argument that my objection comes in.

The model of the perfectly competitive market is an ideal whose conditions can never be fully met. Firms can thus never completely follow the requirements set out by Heath's ethic. This is something Heath recognizes and tries to work around. For example, he says that firms need to "minimize negative externalities" because "without some pollution there would be no economy" (Heath 2014, 36: 37). These market failures unavoidably occur because the set of property rights is not complete (as not everything in the world is owned or "can be owned," such as most parts of the sky and the sea) and because all actors on the market do not have access to all necessary information (Heath 2014, 35). As we can readily see, a minimalization of pollution is not a complete elimination of negative externalities. Although we wouldn't be able to reach such an elimination in reality, such an elimination of negative externalities is demanded of us by the model of the perfectly competitive market. This means that firms are put in an impossible situation. On the one hand, they are supposed to (in the end) eliminate their negative externalities, but on the other hand, it is impossible to avoid such market failures in practice.

Heath tries to work around this problem by saying that companies should therefore only try to minimize negative externalities, but a basis for such a proviso cannot be found in the model of the perfectly competitive market.[6] Its Pareto-optimal conditions demand the end of these negative externalities, among other things.[7] The same holds true for Friedman's business ethics, as it tries to ground obligations in the model of the perfectly competitive market along similar lines. As long as the model of the perfectly competitive market is held to be the sole foundation for the ethical obligations of firms (and no "general morality" or any other purposes are brought in), these ethical obligations are ultimately void.

In this regard, the model of the perfectly competitive market would demand all firms to become the idealized entities that the model theorizes. As economists readily recognize, these idealizations were never meant to become a possible reality. However, by setting the model of the perfectly competitive market as the foundation of ethical obligations, these impossibilities are still, in the end, demanded of firms.

If the government would grant firms their unique privileges under the market failures approach, then they would be put in a morally impossible position. Because firms aren't the idealized entities of the world of perfect competition, the state would be asking them to strive for an impossible ideal. Such a demand goes contrary to the very nature of morality, because it would not allow firms to ultimately choose between moral and immoral actions. This negates the very fact that makes morality possible, which is our volition (Binswanger 1981, 8). To be moral, an action needs to be voluntarily chosen from a set of alternatives. Because the world can never be fully consistent with the model of the perfectly competitive market, firms are, in the end, not allowed such an alternative. This means that as an ethic, the market failures approach cannot get off the ground because it fundamentally derives moral obligations from an impossible standard.

Let me try to illustrate this objection with an example that was mentioned previously. Consider a person who aims to draw a mathematically perfect circle with a pair of compasses on a whiteboard. Such a person will most definitely fail in this task, because the circle that he ends up drawing will always differ from a mathematically perfect circle. This might have several causes. For example, his compasses might have shifted a little bit, or his marker might not have excreted an even amount of ink while being dragged across the whiteboard. In the end, one can always argue that the atoms that make up the circle are vibrating a bit because of heat energy. This means that in reality, one is always unable to draw a mathematically perfect circle. The implication of this fact is that it is impossible to derive moral obligations from the task of drawing a mathematically perfect circle. Someone tasked with such a goal would never be able to achieve it, as it cannot be successfully achieved. Consequently, such a task is outside the realm of morality. The attempt to derive

[6] Heath says that society needs to accept this minimal pollution in exchange for the goods that are produced, but no argument is given that would explain how this consideration would be connected to the grounding of moral obligations in the model of the perfectly competitive market Heath (2014, 36). As it stands, it seems that this proviso runs counter to Heath's idea that moral obligations are solely derived from the model of the perfectly competitive market and do not involve general morality.

[7] For more examples, see Heath (2014, 37).

moral obligations from the model of the perfectly competitive market proceeds analogously, as it asks people to commit to an abstraction that is impossible to realize in reality.[8]

When discussing possible excusing conditions for immoral behaviour by firms, Heath seems to be aware of the kind of objection that I am posing here:

> *…it cannot be argued that these demands [of the market failures approach] are too onerous in principle, since the demands simply articulate the way that capitalist economies are supposed to function in the first place.* (Heath 2014, 38)

Heath holds that firms are supposed to function according to the model of the perfectly competitive market because that is what the government should demand of firms. However, this does not take into regard the point that the demands set upon firms by said model are in principle *impossible*.[9]

It seems that the only way that Heath could work around this objection is by bringing in other moral principles or purposes that would allow him to mitigate the moral impossibilities that are caused by the model of the perfectly competitive market. The downside to such a defence seems to be that if he would attempt it, then his approach would collapse into the kind of stockholder theory that (partly) derives moral obligations from general morality. This is problematic for Heath's approach because he sees it as an important innovation of his approach that it does not need to appeal to general morality (Heath 2014, 90).

In order to concretize this possible workaround, let us relate it to the example of the person that tries to draw a mathematically perfect circle. We now ask him to draw a mathematically perfect circle that is good enough. But the question that then arises is: *Good enough with respect to what?* Any attempt to limit the precision of a mathematically perfect circle needs to be justified by some kind of outside consideration. For example, one might say that the circle needs to be good enough for people to see that it is a circle instead of an oval. In such a case, one has brought in a purpose that comes from outside the model of the mathematically perfect circle.[10]

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[8] Note that the difference between the task of trying to draw a mathematically perfect circle and Heath's market failures approach is just the way in which one determines practical action. As discussed in Heath's critique of Friedman's approach, Heath argues that his ideal cannot be achieved linearly (whereas the approximation of a mathematically perfect circle can be achieved linearly). This is beside the point of my example, however, as it serves to illustrate the nature of the abstraction that is being used instead of the nature of the way it can be approximated. For an analysis of why the type of abstraction that the model of the perfectly competitive market utilizes is faulty, see Reisman (1998, 425–437).

[9] As I will argue at the end of this section, the fact that firms can fundamentally never behave in line with the model of the perfectly competitive market is a failure of the descriptive power of the model. It seems to me not a surprise that firms cannot conform to an inaccurate description of their behaviour, but an inversion of the relationship between theory and reality.

[10] Bear in mind that the standard for perfection in this case has shifted because its purpose has shifted from a purely mathematical to a visual purpose. A regular circle drawn on a whiteboard with a pair of compasses is visually perfect, as it allows one to distinguish it from other kinds of shapes (such as ovals). Thus, the drawn circle perfectly fulfils its standard. As will be argued in the next paragraph, however, such an application is not possible when trying to realize the model of

The line of defence that is open to Heath is analogous to this example, as it would need to bring in moral principles or purposes that come from outside the model of the perfectly competitive market. But as was noted, such principles or purposes would then require their own justification and collapse the market failures approach into the kind of stockholder theory that Heath wishes to distinguish himself from.[11]

In a deeper sense, however, it is not possible to successfully execute such a defence.[12] Because market failures always inevitably occur (as Heath recognizes), human beings can fundamentally never behave as specified by the perfectly competitive market model. From an epistemological point of view, this means that the model of the perfectly competitive market does not accurately capture the nature of human volition with respect to the actual ways in which humans *can* and *do* act. This is where the analogy between the model of the perfectly competitive market and the model of the mathematically perfect circle comes apart. Because humans possess fundamentally different properties than mechanistic entities such as circles, they cannot be modelled with the same kind of mathematical idealizations.[13] The fact that market failures inevitably occur is an epistemological problem for the way in which the model tries to describe actual human behaviour, instead of an opening that can provide a basis for moral obligations. In this sense, my metaethical critique of the perfectly competitive market model hinges on a metaphysical fact (volition) that backfires on the very epistemological basis of the model once said fact is recognized.[14] The implication of this criticism is that we need a fundamentally different

the perfectly competitive market (which partly shows why the model is faulty). See Binswanger (1981) for an extended defence of this conception of perfection.

[11] As discussed in footnote 6, Heath seems to say that the inevitable market failures that 'slip through the cracks' of government regulations and moral obligations need to be accepted by society in exchange for the goods produced. But why should society accept this exchange? It seems that any attempt to answer this question would require a defence along the lines that I have suggested, as it would involve moral principles or purposes that come from outside the model of the perfectly competitive market.

[12] I thank Péter Róna for pressing me on this issue.

[13] Let us note again that one can draw a perfect circle, if one recognizes that the concept of perfection then becomes a function of visual aptness (i.e., being flawless when seen with the naked eye) instead of a function of mathematically infinite precision. However, one cannot shift the function of the adjective 'perfection' in the model of the perfectly competitive market, as said model is supposed to be a direct standard for actual markets Heath (2014, 39–40). The implication of this point is that the type of abstraction that the model of the perfectly competitive market engages in differs fundamentally from that of the mathematically perfect circle. For an analysis and critique of the type of abstraction that the model of the perfectly competitive market engages in, see Reisman (1998, 425–437).

[14] Note that that the model still has value as a game-theoretic scenario that is a logically sound way of describing the activity of abstract actors. However, this activity cannot be properly called 'competition' and claiming that it is only leads to the confusion that the model serves as a standard for what competition both is and should look like. This means that a renaming/rebranding of the model of the perfectly competitive market is necessary. I thank Brendan Hogan for gently pressing me on this issue.

way of looking at competition that can successfully describe how people *can* and *do* behave. Here, it is important to note that the model of the perfectly competitive market is not the only game in town.[15]

6.4 Conclusion

These considerations lead to the conclusion that the model of the perfectly competitive market is not a suitable source for moral obligations and, by extension, for a moral defence of markets. If we wish to preserve the metaethical principle that moral actions need to be voluntarily chosen from a set of alternatives (and, as a corollary, take into account volition), then we need an approach for looking at and modelling competition that does not abstract away from essential aspects of human nature. In order to judge and defend the operations of the market, we need epistemological and ethical theorizing that can correctly conceptualize human action and does not result in a type of idealized abstraction that cannot be realized in reality.[16]

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[15] These remarks are clearly unsatisfactory as a full critique of the model of the perfectly competitive market, but I hope to have shown the fundamental point at which the model is faulty as a result of the fact of volition. See Simpson (2010) for an alternative conception of competition (competition as rivalry) and a broader critique of the model of the perfectly competitive market that shows other facts and considerations that the model does not accurately take into account.

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