Éthique économique Ethics Economics

Market Failure, Justice, and Preferences

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In this brief discussion, I will address two main issues. The first concerns our understanding of the nature of market failure as an evaluative concept. I suggest that we have reason to avoid defining market failure solely in relation to the technical notion of Pareto optimality. The second issue concerns the authority of individual preferences in market contexts and the circumstances in which it might be appropriate to override preferences in order to address various kinds of (broadly defined) market failure. I draw some distinctions between different kinds of preferences that help us understand the ways in which individual preferences can assume authority. Against this background, we can better understand why the responsiveness of markets to preferences can be a virtue. However, I also identify ways in which individual preferences can lack authority and how, consequently, overriding preferences that might otherwise drive market activity can be justified.

MARKET FAILURE AND THE PRIMACY OF JUSTICE

I assume that our interest in assessing the adequacy of actual economic institutional arrangements provides the most fundamental reason for articulating an account of market failure. Ultimately, we would like our theories to help guide us in deciding whether free markets are functioning well or poorly and whether the free market is the most suitable mechanism through which certain goods and services are produced and made available to persons. With this general observation in mind, let me begin by drawing a distinction between *narrow market failure* and *broad market failure*. We can treat market failure as a narrow technical notion in which the achievement of Pareto optimality is the only salient feature of our evaluative stance. On the narrow construal, market failure can be tracked against the background of an existing assignment of property rights that is implicitly assumed to be legitimate but which may, in fact, be quite unjust. Here questions about the existence or pervasiveness of market failure are just questions about the degree to which a market in conjunction with an existing property regime can yield Pareto optimal outcomes or whether interference with free market activity (e.g., through government regulations or restrictions) can improve the situation of some without worsening the condition of others. Broad market failure, by contrast, is defined in relation to a more comprehensive set of normative criteria. It occurs when a market fails to reliably or adequately generate social outcomes that are desirable from the point of view of an authoritative and overarching normative standard. Where we judge markets to have failed in this broad way, we assume that the normative criteria against which they are evaluated are the ones that, all things considered, are most important. Moreover we implicitly assume, in reaching such a verdict, that there is some form of non-market institutional arrangement (or perhaps a regulated market arrangement) through which the valued outcomes to which societal efforts are appropriately aimed at realizing can be more reliably or feasibly achieved.

There are many competing normative standards to which we might appeal in evaluating the functioning of markets in this broad way. For instance, we might ask whether (or the degree to which) an unregulated market can reliably satisfy any of the following familiar evaluative standards drawn from contemporary discussions of distributive justice: (a) securing basic capabilities for all persons (Sen/Nussbaum), (b) providing equal opportunity for welfare (Arneson), (c) maximizing aggregate human welfare (Mill), (d) distributing economic resources so as to provide the greatest benefit to the least advantaged (Rawls' difference principle) or (e) establishing and maintaining equality of resources (Dworkin). My point is not to defend any of these theories of justice but rather to make the simple observation that they provide possible criteria for evaluating whether markets are functioning well or poorly. Moreover, markets can display Pareto-optimality without satisfying any of these criteria. So broad market failure can be present even when narrow market failure is not. For example, a free market in primary school education could be technically economically efficient in the sense that the upshot of market exchanges is an outcome in which no one's situation can be improved without worsening the situation of at least one person. But an 'efficient' outcome need not be one in which equality of educational opportunity for children is actually secured. If we think that social and economic institutions should, all things considered, ensure that children enjoy equal educational opportunities then, on the broad account of market failure, we can conclude that the market has failed because permitting it to function does not reliably achieve the outcome we have most reason to care about.

The suggestion that the assessment of market outcomes should be oriented to evaluative standards besides Pareto optimality raises questions about what the pertinent evaluative standards are and about how the relationship between different, perhaps conflicting standards should be interpreted. I cannot delve deeply into these crucial issues here but I want to observe how discourse about market failure might be affected by acceptance of Rawls's famous claim that "justice is the first virtue of institutions".[1] If, following Rawls, we accept the normative primacy of justice then it would seem to follow that our interest in market failure should itself be animated by a concern for justice. Yet discussions of market failure, especially amongst economists, rarely emphasize the importance of justice per se to the evaluation of the functioning of markets. Instead they tend to interpret market failure solely in terms of a failure to achieve Pareto optimality. Allowing that justice is the most fundamental evaluative criterion against which the functioning of markets should be gauged does not mean, of course, that the detection of technical economic inefficiencies is normatively insignificant or practically unimportant. We often have good reason to be concerned with Pareto sub-optimal outcomes generated by free markets. But we should be reluctant to embrace the common assumption that efficiency is the sole or dominant evaluative standard for assessing the adequacy of real world market arrangements. Indeed, if

[1] John Rawls, *A Theory of Justice*, Harvard University Press, 1971: p. 3.

the Rawlsian view concerning the primacy of justice is sound, we should only care about the failure of markets to achieve Pareto optimal outcomes to the degree that justice assigns importance to the achievement of Pareto optimality. Moreover, the discovery that a market is technically efficient does not provide sufficient reason for viewing it as suitable or defensible institution for provision and distribution of certain goods. In some instances, we may have justice-based reasons to prefer non-market arrangements or highly regulated markets to free market arrangements market that are, in the technical sense, efficient. Narrow market failure is not a conceptually defective notion but it offers, at best, an incomplete specification of the evaluative criteria that are relevant to the goal of assessing the adequacy of actual market arrangements. I have suggested that considerations of justice, not technical efficiency, are credibly seen as the primary criteria for assessing whether markets are functioning well or failing. If this is right then technical inefficiency need not be the only or even the most important variety of market failure.

MARKETS AND THE AUTHORITY OF PREFERENCES

One general attraction of markets is the dynamic responsiveness they can display to diverse individual preferences. Markets respond to consumer demand and (at least under favourable conditions) this means people with different interests and appetites can get what they want. The satisfaction of well-formed and reasonable preferences contributes to human wellbeing and is thus presumptively desirable from the point of view of justice. However, individual preferences are not always well formed and the de facto preferences that individuals display in real market settings do not always reliably track wellbeing. This brings us to the second general issue I identified in the introduction concerning how we should interpret the authority of individual preferences in the context of addressing market failure. Three related preliminary points are worth noting. First, the authority of individual preferences is partly a function of the circumstances under which they are formed. Preferences that reflect ignorance, cognitive impairment (whether temporary, such as intoxication, or permanent, such as mental disability) or which are formed under duress or other distorting conditions cannot be expected to track wellbeing reliably. In the context of assessing market arrangements, we should not assume that markets can be relied upon to furnish what might be called the 'circumstances of authenticity'. The circumstances of authenticity are the social, informational, and deliberative conditions that are conducive to the formation of individual preferences such that the preferences each person forms track his or her wellbeing reasonably well. One way in which markets can fail, in the broad but not necessarily in the narrow sense, is by not adequately supplying persons with the circumstances of authenticity. Indeed, certain types of market activity, such as aggressive and manipulative advertising that preys upon vulnerable aspects of human psychology can be corrosive to the circumstances of authenticity.

Second, in interpreting the authority of individual preferences, we need to distinguish between different facets and types of preferences. There is a difference between 'valuational preferences' - i.e., preferences that reflect the ends, goals, or broad projects to which a person assigns deep normative significance – and 'implementation preferences' – i.e., preferences persons have concerning the strategies and means they wish to employ in pursuit of 'valuational preferences'. I suggest that, at least against the background of decent deliberative circumstances, we have reason to assign greater authority to valuational preferences than to implementation preferences.[2] There is ample evidence from experimental psychology that people are poor at various reasoning tasks and susceptible to irrationality.[3] As a consequence, persons sometimes adopt implementation preferences that fail to reliably track their valuational preferences. If, as often seems to be the case, markets respond to dubious implementation preferences, then markets will fail to satisfy valuational preferences. Since respecting (well-formed) valuational preferences typically has greater normative significance than satisfying implementation preferences, it can be legitimate to override implementation preferences in the name of promoting valuational preferences.

Finally, we should also distinguish between the 'preferences within a market' and 'preferences *for* a market'. Once we have determined that markets are appropriate institutions for allocating goods etc. in a given area, we generally have strong reasons to respect the authority of well-formed preferences that persons display in the market. However, preferences *for* a market – i.e., preferences that a market be permitted to operate in a certain area – generally carry little presumptive normative force. Indeed, considerations of justice often permit or even require the frustration of some preferences for markets.

THREE JUSTIFICATIONS FOR OVERRIDING MARKET PREFERENCES

By way of quickly drawing the different strands of the foregoing discussion together, I will sketch three plausible justifications for overriding individual preferences.[4] Each of these justifications can be seen as a way of addressing a kind of broad market failure. In each case, allowing markets to function and respond to the de facto individual preferences that are expressed in market contexts can generate outcomes that are arguably objectionable from the point of view of justice. We can see how intervention into the functioning of markets has a justification that is not essentially tied to the achievement of Pareto optimality. In this way, each justification is tied to the broader and more generally normatively significant conception of market failure.

First, consider a *Socratic justification* for supplementing and perhaps limiting the way markets function. Socrates famously claimed that the 'unexamined life is not worth living'. His observation reminds us of the importance of being able to reflect upon and, if necessary, revise our preferences, especially our valuational preferences. Markets may fail to provide

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[2] This does not mean that valuational preferences cannot be mistaken but it is typically more difficult and controversial to identify defective valuational preferences than it is to diagnose problematic implementation preferences.
[3] See Daniel Kahneman, Paul Slovic, and Amos Tversky (Editors) *Judgment under Uncertainty: Heuristics and Biases*, Cambridge University Press, 1982.
[4] The labels I attach to these justifications – Socratic, Homeric and Solomonic – are for thematic and mnemonic purposes only. In using them I am not making exegetical claims about the precise interpretation of classical texts.

conditions that are most conducive to successful Socratic reflection. For instance, they may fail to provide a diverse and vibrant aesthetic and intellectual culture of the sort that can nourish potentially valuable options and ideas. The existence of a rich culture can enhance the circumstances of authenticity but such a culture may be inadequately provided by the market. This type of failure will often not be narrow market failure because the sense in which the public culture might be deficient often cannot be coherently gauged in terms of what economic goods private consumers are willing to pay for. The difficulty is not a classic public goods problem in which culture, perhaps due to free rider problems, is undersupplied.[5] Instead a market-supplied culture can be poor in the sense that it does not make available potentially valuable but underappreciated deliberative resources/opportunities. For instance, various types of valuable aesthetic and intellectual resources may be unavailable not because they lack value (especially with respect to supplementing the context in which deliberation about value takes place) but simply because they are currently unpopular. In these conditions, government might be justified in overriding market preferences (e.g., via programs of taxation and subsidization) in order to secure some cultural resources that are plausibly linked to improving the circumstances of authenticity. We need not assume that markets, by responding to current preferences, adequately supply the conditions that best facilitate Socratic examination of our lives and valuational preferences.

Second, now consider a *Homeric justification* for overriding individual preferences. Homer's Ulysses, it will be recalled, had himself tied to the mast so as to avoid yielding to the temptation of the dangerous, but alluring, calls of the Sirens. Ulysses presents a classic case of a person whose implementation preferences (e.g., to heed the Sirens' calls) are not in sync with his valuational preferences. Where such a divergence can be detected, an appropriate remedy is to put in place obstacles to the satisfaction of defective implementation preferences. Research from behavioural economics reveals various ways in which the strategies that agents employ in pursuit of their valuational preferences are ineffective or irrational. Thus anchoring effects, endowment effects, and effort aversion are ubiquitous and generate various kinds of dubious implementation preferences.[6] Markets that are responsive to defective implementation preferences will generate obviously undesirable outcomes. So in some contexts, we can assist individuals in realizing their valuational preferences by impeding or frustrating their implementation preferences. The Homeric justification provides a rationale for various familiar types of state regulation of markets. Government can tie us to the mast in various ways thereby frustrating our implementation preferences but allowing us to better achieve valuational preferences. For instance, if, as seems to be the case, individuals tend to make poor choices about retirement planning, governments can pressure people to save at a greater rate than they are unreflectively inclined to do.[7]

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[5] On this point see Ronald Dworkin 'Can A Liberal State Support the Arts' in *A Matter of Principle*, Harvard University Press, 1985.

[6] See Dan Ariely, *Predictably Irrational: The Hidden Forces That Shape Our Decisions*, Harper Collins 2008.

[7] See Richard H. Thayer and Cass Sunstein *Nudge: Improving Decisions about Health, Wealth and Happiness*, Yale University Press 2008. One gentle device favoured by Thayer and Sunstein to encourage more retirement savings is to have employee savings programs in which employees must contribute unless they opt out. This is in contrast to the arrangements in which employees must 'opt

Finally, consider a *Solomonic justification* for limiting preferences for markets. In resolving a custody dispute between two women, King Solomon proposed cutting baby in half and dividing the child between the women. One woman preferred this solution to the possibility of getting nothing, while the other woman preferred losing the baby altogether but letting it survive. Solomon recognized that the real mother was the one who preferred to save the child's life even at the expense of losing access to her baby. Ultimately, of course, Solomon wisely overrode the *expressed* preferences of both women and awarded the child to the real mother. Justice was served by frustrating the expressed preferences of persons. The story of Solomon's choice does not involve overriding preferences expressed in a market setting but we can easily extrapolate and apply the general lesson about how justice can trump preference satisfaction to market examples. Consider, for instance, the preferences that individuals can have for the creation of certain types of markets.[8] On many credible conceptions of justice, there are powerful reasons to frustrate or block preferences individuals have *for* markets (even where the creation or existence of such markets is technically efficient) because the existence of a market generates or contributes to unfair disadvantage. An important example of this is the preference that some people have for a market in private health insurance. Individuals who have good overall health prospects may find it advantageous to secure private health insurance. Such individuals can pool their risks with other low risk consumers and thereby achieve good health insurance coverage at a lower rate than they could obtain if they were forced to share health costs with persons whose overall health prospects are poor (e.g., those with serious 'pre-existing' medical problems). But permitting markets in private health insurance can impede the access of persons with poor health prospects to adequate health insurance. If, as seem plausible, health insurance should be available to all on a fair and equal basis, then there is a strong justice-based rationale for frustrating the preferences some individuals have for access to a market in private health insurance.

CONCLUSION

There are two principal points I hope to have motivated in the foregoing remarks. First, the narrow, technical conception of market failure is of limited normative significance. What we should care about in assessing the functioning of economic arrangements is the degree to which they contribute to the realization of objectives that have overall normative significance, especially justice. Although narrow market failure is often important, it tracks only a subset of the evaluative considerations that are relevant to overall assessments of the adequacy of market institutional arrangements. Second, although the responsiveness of markets to preferences is often a good thing, we should not assume that sensitivity to the de facto market preferences of persons is always desirable. Preferences vary in the normative

in' to join a savings program. Changing the default to participation provides employees with a gentle 'nudge' in the direction of the saving plan that most likely serves their interests.

[8] These preferences can be rational in the sense that they may accurately track the actual interests of the people who have them.

authority they command and there are, consequently, various reasons to regulate, control and otherwise to interfere with even technically efficient markets.