Does market failure justify redistribution?

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One can expect economists and philosophers to have very different reactions to this question. Economists are preoccupied with market failure as inefficiency, that is, the failure of markets to produce Pareto optimal outcomes, but they typically are not sensitive to the distributive impact of market failure. Political philosophers, on the other hand, tend to have a well-defined position on questions of distributive justice that arise as a result of market activity, yet they still often treat "the market" as a black box and therefore lack a clear conception of, among others things, market failure. This complementary focus of the two disciplines suggests that they have a lot to learn from each other.

In this short piece, I will tap into these interdisciplinary synergies and attempt to defend an affirmative answer to the question raised in the title. The structure of the text reflects the argumentative steps that are necessary to assess whether market failure justifies redistribution:

1) *The conceptual part:* In a first step, the notions of both market failure and redistribution need to be clearly defined. Given the potential of misunderstandings across disciplinary boundaries, this turns out to be a less obvious exercise than it may seem.
2) *The descriptive / empirical part:* In order to assess the distributive impact of market failure, one needs to be aware of the distributive impact of market success. The distributive consequences of functioning markets serve as the counterfactual to which instances of market failure have to be compared. The deviation in terms of the distributive outcome might then warrant redistribution or not.
3) *The normative part:* Unsurprisingly for a debate between economists and philosophers, the normative part of the argument will be the most controversial one. It can be subdivided into three elements: a) We need to define the criteria on the basis of which we evaluate the market as an institutional mechanism. b) We need to decide on how to arbitrate between these criteria in cases of conflict. c) We need to investigate whether the instruments of redistribution that are available to us are both effective, i.e. result in a greater satisfaction of our evaluation criteria of the market, and feasible. I will not address c) here.

Let me emphasise that the following considerations do not amount to a general account of when and to what extent market failure justifies redistribution. That would be ambitious for such a short text. Instead, my goal is, first, to lay out the conceptual groundwork that is necessary to develop such an account and, second, to analyse *one* paradigm case where I believe this conclusion to be warranted.

1. WHAT MARKET FAILURE? WHAT REDISTRIBUTION?

Several other contributions to this collection emphasise the distinction between market failure as a technical notion of welfare economics on the one hand, and the broader idea of the market producing undesirable results on the other.[1] For the present context, two aspects of this distinction are particularly relevant.

First, the technical notion is based on a unidimensional evaluation of the market in terms of the maximisation of social welfare.[2] The existence of externalities, information asymmetries, incompletely defined property rights, and so on, mean that the market will not produce Pareto optimal results, and that the market fails in this sense. Even if this approach offers certain insights for the idealised world of perfect competition, it is hard to justify it as a yardstick for *real* markets. As Geoffrey Brennan puts it, it is difficult to see how it could be legitimate to "partition normative concerns" in this way.
Therefore, this paper employs the term market failure in a different, broader sense. I adopt a consequentialist perspective in line with Amartya Sen's observation that "[i]t is hard to argue that the value of the market can be divorced from the value of its results and achievements." (Sen 1985, 7) According to this broader conceptualisation, there is market failure whenever it falls short in achieving the social objectives we set for the institutions governing our economic interactions.

However, and this is the second aspect, such a consequentialist approach has to produce a plausible definition of what counts as desirable and undesirable results of the market as a social institution. Section 3 will speak to this issue. Note that even if the market "fails" on whatever set of criteria we agree on, this is not yet a sufficient condition to turn our back on the market. If no preferable institutional arrangement is feasible, we may well have to tolerate a certain level of market failure. The robustness of the feasibility constraints in question is a matter of degree. For example, a conflict with hard-wired motivational constraints of economic agents is a more significant limitation than a conflict with the current configuration of political majorities.
The term "redistribution" equally calls for some clarifying remarks. I want to distinguish three kinds of redistribution. The first, classic case of redistribution refers to a reallocation of income or wealth through taxation, transfer payments, and government spending. I call this the *ex post* approach to the redistribution of income.

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[1] See the contributions of Daniel Hausman and Colin Macleod.
[2] See Francis Bator's classic article "The anatomy of market failure" (1958).

The second kind of redistribution operates on the initial holdings of agents rather than on their holdings after market interaction. Here, instead of redistributing income after market interaction has already taken place, the government might for example invest in education to narrow the skills gap among individuals, thereby increasing the bargaining power of the relatively low skilled. This latter approach to reducing income inequalities is an example for what I will call *ex ante* redistribution.

As section 3 will illustrate, it would be a serious omission to neglect a third kind of redistribution. We can redistribute income by "shaping" the legal framework of markets differently.[3] Choices of institutional design have an impact on how markets function, and thereby on the distributive results they produce. The objective here is to *shape* markets rather than correct their results. I call this the *process* approach to the redistribution of income.

Let me add a few comments on this latter approach. First, shaping markets is inevitable, there are simply different ways to go about it. This serves as a welcome reminder that there is no such thing as the "free market", but that all functioning markets are embedded in a substantial legal framework. Second, though both economists and philosophers are aware of the importance of the legal substructure of markets, they rarely investigate its impact on distribution. This may in part explain why the *process* approach to the redistribution of income does not play a more prominent role in social policy. Third, one might ask how *process* redistribution differs from the other two kinds of redistribution identified above. The analogy with a game is useful here. Whereas *ex ante* redistribution aims to create a level playing field among players and the purpose of *ex post* redistribution consists in compensation for unjust disadvantages, *process* redistribution changes the rules of the game themselves.

2. THE MARKET AND (IN)EQUALITY

In order to isolate the distributive impact of various kinds of market failure we need to identify a distributive benchmark that obtains when the market works. In other words, we need to contrast market failure with market success. When considering the impact of market interaction on the distribution of income, there are three exhaustive possibilities:

a) Market interaction tends to *increase* inequalities in income and wealth. I call this "the popular view."

[3] I borrow the term of "shaping markets" in this sense from Daniel Hausman.

b) The market is a constitutive element in defining equality, since it imposes on individuals the opportunity costs their choices create for others. In this sense, the market *promotes* equality.[4]

c) The market *preserves* whatever (in)equality is present in the initial distribution of income and wealth. This is the dominant view in welfare economics.[5]

Which of these three assessments is correct depends on what kind of "market" we are referring to.

1) If we are referring to the benchmark model of perfect competition, then the answer is given by the Second Fundamental Theorem of Welfare Economics: Under certain assumptions, every Pareto optimal allocation can be the equilibrium outcome of a competitive market, depending on the initial allocation of resources. The market *preserves* (in)equality as it were. Under this hypothetical scenario, any redistribution takes place *ex ante* by adjusting the initial holdings with which economic agents enter the market. However, as has already been pointed out, the hypothetical world of perfect competition is of limited use for assessing real markets.

2) If we are referring to real markets, the answer is more complex and dependent on a host of empirical questions. To give just one example, if the returns on capital are higher than the returns on labour and if capital ownership is concentrated in the hands of a minority, both of which hold in most industrialised economies today, then the popular view is more likely to be true.[6] If markets are believed to increase inequality in ways that are unjust, then redistribution can be used as a corrective measure.

What follows from these considerations for the analysis of market failure? The distributive impact of various kinds of market failure, just like the distributive impact of real markets themselves, is highly contextual. I cannot address the many empirical questions that this issue raises here, and will limit my discussion to two brief examples in the next section. There is no doubt that the presence of negative externalities like pollution or of asymmetries in information will modify the distribution of welfare between economic agents, but the actual magnitude of these effects will have to be gauged on a case by case basis. As I will argue in section 3, if a particular instance of market failure renders the distribution of income and wealth unjust or more unjust, then redistribution may well be justified.

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[4] This is for instance Ronald Dworkin's view in his conception of equality of resources (Dworkin 1981).

[5] For an insightful formulation of this idea, which also underscores how it differs from Dworkin's position, see Joseph Heath (2004, in particular pp. 326-27).

[6] For an account of the shifting balance between labour and capital in the second half of the 20th century, see Glyn (2006).

3. EVALUATING THE PERFORMANCE OF THE MARKET – THEORY AND PRACTICE

As already highlighted in section 1, the normative conclusions of a consequentialist evaluation of the market hinge on the definition and delineation of what counts as desirable and undesirable results of the market. It is safe to say that standard criteria include the market's capacity to produce wealth and promote the standard of living, its stability, and its ability to process decentralised information. Now, I do not see any reason why distributive concerns should be excluded from this list. The distributive results that a social institution like the market produces is *one* of the dimensions we use to evaluate it.

Conflicts between the various evaluation criteria will be inevitable. The most productive way to organise the provision of goods and services may well not be the most stable or the most equitable one. Such trade-offs confront us with difficult choices, which makes it even more important to spell out in detail the different social objectives at stake.

Though this task is beyond the scope of this text, let me open one short parenthesis at this point regarding the alleged trade-off between equity and efficiency. In contrast to equity, efficiency is merely of instrumental value. It is valued as a means to a more fundamental social objective, most frequently as a means to the maximisation of social welfare.[7]

This concludes the conceptual groundwork that is necessary to answer the question of whether market failure justifies redistribution. The task consists in defining the different criteria we want to use to evaluate the market, identifying trade-offs between them, and taking a stance on how to resolve these trade-offs. Rather than tackling this substantial project, my goal for the remainder of the paper is to identify two examples for such a trade-off that arise in economic practice as a result of a market failure.

First, consider increasing returns to scale and the resulting market power of firms. Economic theory classifies this phenomenon as a market failure, since it leads to allocative inefficiencies. Taken together, consumers and producers are worse off than they would be under an arrangement where the firm does not have market power. The presence of increasing returns to scale confronts us with the following trade-off between a larger social product on the one hand, and a more equally distributed social product on the other: The more significant the economies of scale, the bigger the social product, but also the bigger the capacity of firms to charge a price premium on the back of their market power. Given the concentrated ownership of capital today[8], the profits generated thanks to this market power tend to be distributed in a way that increases inequality. On the other hand, reduced economies of scale in a more competitive industry would result in a smaller social product,

[7] For a lucid discussion of this issue, see LeGrand (1990).
[8] Cf. footnote 6.

but more of the consumer surplus would be passed on to consumers in the form of lower prices. This can be qualified as an egalitarian consequence of competition.[9]

The second potential example is the ownership of enterprise. The laws of most industrialised countries today favour listed companies owned by shareholders over other possible structures like producer-, employee-, or consumer-cooperatives. On efficiency grounds, shareholder structures do indeed appear to be preferable.[10] However, it is at least an open question whether the same is true from the perspective of distributive justice. If it turned out, for instance, that employee-owned firms result in a more equal distribution of income, we would be faced with another trade-off.

Note two things about these trade-offs: First, they are contingent on the current, unequal distribution of corporate profits. If share ownership were more equally distributed, the trade-offs would disappear. This already suggest one possible policy option, namely the promotion of more equal share ownership, i.e. a kind of *ex ante* redistribution. Second, suppose the distribution of share ownership is hard to influence, but that at the same time we consider that the market fails to produce results that satisfy out concern for distributive justice relative to other social objectives. Suppose, in other words, that our assessment of how the trade-off plays out in economic practice today concluded that too much equality is sacrificed for too little gain in social product. In this case, the two other kinds of redistributive measures introduced above would be available. We could either choose classic *ex post* redistribution by imposing a higher tax on the return on capital and transferring the proceeds directly or indirectly to those who do not own any capital. Alternatively, or in addition, we could adapt economic policy by, for example, tightening anti-trust laws in order to make certain industries more competitive and thereby promote equality through lower prices for consumers. Note that the three policy options discussed in this paragraph can complement each other.

4. CONCLUSION

The conventional understanding of market failure needs to be revised both in terms of the concept of the "market" and in terms of the notion of "failure." We should move from an analysis of the hypothetical world of perfect competition to real markets, and assess them in terms of their consequences generally rather than merely along the single dimension of the maximisation of social welfare.

From this perspective, reforms aimed at bettering the results of the market will often face trade-offs between the various social objectives that the market as a social institution serves.

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[9] For argument's sake, I assume here that a more equal distribution of income and wealth would also be a more just one. This does not automatically follow. Any call for distributive equality has to be backed up by an argument about why the equality in question should be considered just.
[10] See Henry Hansmann's insightful book *The Ownership of Enterprise* (1996).

The goal of a larger social product might conflict with concerns for stability or distributive justice.
When we do think the market fails to produce the desired results in terms of distribution relative to other objectives, redistribution will be justified. It can take three forms: *ex post* through tax and transfer policies, *ex ante* through the redistribution of initial holdings, and *process* through adjusting the mechanisms of the market that generate more or less equal distributions of income and wealth.

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