Joseph Heath

Loving the market or supporting business

While there is a widespread consensus that capitalism represents the only viable way of organizing a modern economy, popular reaction to the recent spate of corporate governance scandals has reminded us that people still have profoundly different reasons for endorsing capitalism. In particular, the scandals have thrown into sharp relief the differences between those who support capitalism because they are promarket, and those who support it because they are probusiness.

Those who are pro-market are enthusiastic about capitalism because they understand the virtues of the price system. They know that a properly structured competitive market is the most effective institutional arrangement for ensuring that resources and labour flow to their most productive employment.

The key to their endorsement, however, lies not in the magic word "market," but rather in the qualifications that precede it. The pro-market camp believes that the virtues of private enterprise lie not in the system of private property *per se*, but rather in the competition that a properly structured market induces among enterprises. It is this competition that drives innovation, forces productivity gains and, most importantly, generates lower prices for consumers.

Those who are pro-business, on the other hand, are less concerned about the structure of the market, and are more impressed by the incentives that ownership creates. Thus they tend to think that the virtues of private enterprise lie in the business culture that it promotes within organizations, or in the entrepreneurship that it motivates.

These two stances can lead to very different conclusions when it comes to concrete policy questions. With respect to environmental regulation, for example, those who are pro-market are willing in principle to accept such regulations. Firms are entitled to make a profit, but not when doing so involves imposing uncompensated costs upon third parties. Government regulations aimed at internalizing such externalities are legitimate, because these regulations are simply one way of ensuring that the market is "properly structured."

Those who are pro-business, on the other hand, will tend to follow Milton Friedman in rejecting environmental regulation altogether, on the grounds that it constitutes an illegitimate imposition of "social responsibilities" upon business. (One could see these two perspectives played out last year in the low-level debate that took place in the *National Post* over the Kyoto Accord, between Andrew Coyne, who is generally pro-market, and Terence Corcoran, who is simply pro-business.)

When it comes to questions of corporate governance, those who are pro-business tend naturally to align themselves with the interests of management, and to resist calls for tighter government regulation. While fraud is obviously a bad thing, the pro-business camp considers the spotlight that has been cast upon executive compensation packages, with their stock options and golden parachutes, to be entirely inappropriate. These compensation arrangements are all the product of fully voluntary contracts, entered into by enlightened, self-interested adults. As such, they enjoy an enormous presumption of legitimacy. Executives are entitled to charge for their services whatever price the market will bear. As are baseball and hockey players.

Supporters of the market, on the other hand, look at the issue of corporate governance and see a serious case of market failure. When it comes to disciplining management, shareholders essentially face a collective action problem. It is well known that, in the public sector, well-organized special interest groups are often able to secure unreasonable gains at the expense of taxpayers. The problem occurs because each member of the interest group stands to gain a lot from any such transfer, while the cost to any one taxpayer will be slight.

Yet a moment's reflection reveals that the exact same dynamic arises between managers and shareholders within corporations, especially when ownership is diffuse. An outlandish executive compensation deal generates enormous gains for management, while the cost to any one shareholder may be quite low. Often the cost will not be high enough to provide any incentive to offer organized resistance. Thus managers may be able to exploit shareholders with impunity, in the same way that special interest groups are able to exploit taxpayers.

For those who are pro-market, the fact that a particular outcome is the result of voluntary contracts carries no particular authority, if these contracts are the outcome of a structurally flawed market. Furthermore, regulatory interventions aimed at correcting these flaws will be regarded in a positive light. After all, shareholders currently exercise far less control over managers than taxpayers do over government officials.

Joseph Heath, whose column appears monthly, teaches philosophy at the University of Toronto.
joseph.heath@utoronto.ca