
A capability framework for financial market regulation

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3.1 INTRODUCTION

In the aftermath of the global financial crisis, questions about when, why, and how to regulate financial markets have received renewed attention. Answers to such regulatory questions rely—implicitly or explicitly—on a *normative theory of market regulation*: a theory that justifies certain reasons as valid reasons for the state to interfere with the freedom of individuals to act on markets (in the following, “regulation” will be used as shorthand for “state regulation of markets”). This chapter is concerned with one specific approach, that is, the so-called capability approach to justice, which has been developed by Amartya Sen, Martha Nussbaum, and others. It asks whether this approach can provide a better basis for such a normative theory of regulation than the currently prevailing mainstream economic theories.

How the capability approach relates to markets and their regulation seems to be an open question, in the sense that the approach does not take an a priori positive or negative stance towards markets. As an introductory handbook on the capability approach notes:

the human development and capability approach is neither pro-state nor pro-market, nor does it favour any particular economic system of material provisioning. The essence of the approach is that the success of social and economic processes should be assessed according to whether they expand valuable freedoms. That these processes are state or market-led does not matter, provided that two conditions are met: people’s agency and well-being ... should be both promoted and respected.

(Johnson 2009, 179)

This passage admirably expresses the *independence* of the normative criterion (assess outcomes according to how they score on capabilities) on the one hand and the institutional arrangement (markets or alternatives) that are to bring

about these outcomes on the other hand. Competing normative theories (say, utilitarianism, or Rawls's theory) are equally independent: normative theories endorse specific institutional arrangements only contingently, to the extent that they happen to lead to the desired outcomes. This chapter can be seen as an exercise in thinking about how, given the initial distance, the capability approach bridges this gap to institutional conclusions and assesses the desirability of markets and their regulation. It will especially concentrate on how this compares to standard economic or utilitarian ways of bridging the same gap.

The chapter starts with a brief overview of the state of the art on regulation. It argues that the currently dominant approach is to distinguish economic from social regulation, where the first refers to efficiency considerations and the second to considerations of distributive justice and paternalism. No unified idea is available to ground these different types of regulation (Section 3.2). Moreover, a discussion of the justice literature will lead us to conclude that the utilitarian theory that underlies the economic justifications for regulation cannot provide a basis for thinking about social regulation (Section 3.3). To solve this problem, I argue that the capability approach has the potential to provide a unified theory of regulation. It shows how considerations of allocative efficiency, distributive justice, and paternalism all are related to a concern for the development of the agency of market participants and of citizens more generally (Section 3.4). To cash out this potential, the chapter proposes a capability framework for market regulation (Section 3.5). Finally, it discusses how using a capability approach would impact on our view of financial market regulation (Section 3.6).

3.2 THE STANDARD VIEW OF MARKET REGULATION

Standard handbooks of regulation show a remarkable convergence in their set-up. They generally divide justifications for regulation into three categories: one economic and two social justifications for regulation (Sunstein 1990, Barr 2004, Ogus 2004, Morgan and Yeung 2007, Stiglitz 2009, Baldwin, Cave, and Lodge 2012). In this section I will present these categories. This is meant to evoke an uncontroversial picture that is hopefully familiar to most of those who think about normative justifications for regulation.

1. Economic justification: efficiency. The economic justifications for regulation are often lumped together under the heading of "market failures" (Bator 1958, Cowen 1988, Den Hertog 1999). The guiding idea is that perfectly competitive markets are characterized by *allocative efficiency*. The more specific criterion of efficiency that is used in this context is that of Pareto-optimality.

This criterion holds that a state is efficient when no one can be made better off without making others worse off. The starting point of the economic analysis (as expressed in the First Fundamental Theorem of Welfare Economics) is that: on a perfect market all voluntary transactions are exhausted—no one is able to improve his or her position through further trades without making others worse off. However, in reality various market failures upset this efficiency property of perfect markets. Market failures include cases where markets do not provide for certain goods because of free rider problems (public goods), cases where market production involves negative spillovers to third parties (externalities), cases where imbalances in information between parties make transactions voluntary in name only (information asymmetries), and cases where parties gain large market shares and are able to dictate prices and reap economic rents (monopolistic or imperfect competition). In all these cases, there is at least a *prima facie* case to think that government regulation can enhance efficiency. Governments are required to regulate so as to restore Pareto-optimality, or at least bring the economy as close as possible to the Pareto-frontier. Allocative efficiency therefore is the guiding normative value for all forms of intervention in this category. Since an efficient economy does better at satisfying consumer preferences, the term “efficiency” should here be understood as a placeholder for the ultimate value: welfare, understood in terms of the satisfaction of preferences.

When other justifications for regulation are presented, these are usually labeled “social,” to mark the contrast with these economic grounds for regulation. Unlike the economic theory of market failure (which is more or less standardized), there is nothing approaching consensus on the main features of social justifications for regulation. Authors endorsing social justifications are usually dissatisfied with the narrow confines of the economic focus on efficiency. They normally do not reject economic justifications, but want to supplement them with social justifications. How this is worked out, however, depends on the specifics of each author’s theory. One finds a bewildering variety of proposals, with much less standardization than is usual in economics (Stewart 1982, Sunstein 1990, Trebilcock 1993, Bozeman 2002, Soule 2003, Prosser 2006, Feintuck 2010). Nonetheless, two broad types of social justifications can be singled out as particularly prominent, which are added to efficiency grounds in the standard views of regulation in the handbooks mentioned at the start of this section:

2. *Social justification (1): distributive justice.* Here, the general idea is that efficiency can never replace considerations of equity. Indeed, *if* one deems equity reasons valid reasons for regulation at all (which, it is stressed by the handbooks, is politically contested), then one cannot incorporate them into economic ones but needs to add them separately. Analytically, the distinction is based on the equity/efficiency split. The market can be considered as a game

in which players have different starting positions, depending on their endowments, both external ones (monetarily valuable assets) and internal ones (marketable talents). Some theories of justice (of a broadly libertarian flavor) would hold that any initial allocation of endowments that happens to arise is just. Absent “force and fraud,” individuals are entitled to their endowments and have to play the market game with the endowments they can get a hold on. Transactions starting from this baseline are just. Most other theories of justice disagree and want to place constraints on these endowments. A general intuition is that redistribution is necessary to enhance the bargaining power of vulnerable parties and may thus be necessary to make their transactions voluntary in a more than formal sense. This can be cashed out in different ways. For example, one familiar type of egalitarian theory, luck egalitarianism, holds that inequalities in endowments between individuals that have arisen out of unchosen circumstances can be a reason for compensation by government. This is only one example: different theories of justice diverge widely in the amount and specific justificatory rationales for redistribution.

3. *Social justification (2): paternalism.* A third reason for regulating is *paternalism*. Traditionally, this category was treated with suspicion by economists and (liberal) philosophers alike. Government regulations interfering with the choices of individuals, for the sake of their own well-being, both violate individual freedom and disrespect revealed preferences. The individual who is allowed entry into the market is supposed to have the status of an autonomous agent who can choose what is best for him or her. Nonetheless, with the advent of behavioral economics, which has shown how irrational human decision-making can often be, it has become more accepted to think that some forms of intervention (especially milder ones, leaving choices open while nudging behavior in the “right” direction) may be necessary to prevent gross deviations from the welfare-maximizing choices people would make if they were fully rational. Protecting weaker parties on the market can thus also be understood as a matter of protecting people from falling prey to their own cognitive biases, such as when they would be prepared to contract higher wages to work in a physically hazardous working place out of over-optimism (“this won’t happen to me”). This is the rationale behind a lot of health and safety regulation as well as consumer regulation. Note that for this diagnosis of paternalism the deficiencies in the formation of one party’s preferences are coupled with the inequality between parties. It is the threat of the other party, having market power because of its superior information position, abusing the weaker party, which makes paternalist intervention by a third party (i.e. governments) necessary.

Obviously, there can be interaction effects between the different types of justification in practice. The most familiar one probably is that redistribution in the name of justice may have negative effects on efficiency; there may be an

efficiency price to more equality (today's final allocation is tomorrow's initial allocation—in reality there is a constant sequence of market games). This does not invalidate the general observation, however, that the three main categories for regulating markets are distinct and provide diverging reasons for interfering with market processes. This state-of-the-art makes one wonder whether a unified perspective is possible. This seems desirable, not only for reasons of theoretical elegance, but also precisely because of the cases where the different justifications lead to conflicting prescriptions. Some idea of how they hang together is needed for deciding how to deal with these conflicts.

3.3 JUSTICE AND THE EQUITY/EFFICIENCY SPLIT

To approach a unifying perspective, I first want to steer the conversation to the field of justice as the field on which to search for such a perspective. This may seem counterintuitive (given the association of the norms of justice with one of the three specific justifications for regulation, as described above). Let me explain why this is nonetheless warranted, through a small excursion into intellectual history.

The search for justifying grounds for regulation has traditionally been a preoccupation of both political philosophy and economics. The two disciplines have handled the matter very differently. From a political philosophical perspective, the split between the state (public domain) and markets (private domain) forms the basis of the theory of liberalism. A liberal understanding of society as consisting of these two domains has informed political thinking since the political revolutions of the eighteenth and nineteenth centuries and the advent of capitalist markets. In this liberal understanding, private freedom to act on markets has an a priori justified status, and interventions with market freedom require justification. From an economic perspective, the market sphere was often conceptualized as a self-standing sphere which, if left to its own devices (i.e. the automatic processes of adjustment steered by the price mechanisms mediating supply and demand), would bring maximal welfare to all citizens. This welfare-maximizing property of markets was and remains its justifying basis from an economic perspective (see also Sen 1985). Underlying this perspective often is a utilitarian view in which individual preferences form the justified basis for market decisions. Respecting these preferences is the economist's way of respecting individuals themselves.

This raises the question of how these liberal freedom-based considerations and economic welfare-based considerations relate to each other. The economic view of respecting market-based preferences in practice often supported liberalism's a priori defense of individual freedom, even if it was based on a very different—namely utilitarian—philosophical theory. But the two may

also come apart on certain occasions, and regulation, I think, is one of them. The highly sophisticated philosophical literature that has arisen since the 1970s on the question of social *justice* is, in my view, the best place to discuss this issue, because liberal, utilitarian, and other normative theories can be understood as specific conceptions of justice, as so many different and competing interpretations of what justice requires. This quest for the right conception of justice, in turn, has been interpreted as underlying the quest for the legitimate limits of state action: the state should restrict itself to establish justice, whatever that requires. For the purposes of this chapter, therefore, we may work within this justice literature and treat economic and philosophical answers to the regulation question as competing answers to the same question: how markets need to be regulated as a part for the larger quest of realizing a just society.

The importance of this move is that the general philosophical literature on justice throws doubt on the use of the equity/efficiency split that underlies the distinction between economic and social justifications for regulation mentioned in the previous section (we leave out the separate role of paternalism for the moment, but will come back to it later). It forces one to think about how a unified measure of efficiency/justice can be constructed.

The justice literature thinks about justice in distribution in terms of two parameters: a *metric* that specifies the object of distribution, and a *distributive rule* that specifies how the objects are to be distributed to individuals (E. Anderson 2010). Both parameters are a necessary input to answer the first question of (philosophically informed) policy-making: according to justice in distribution, which state of affairs ought to be reached? Answering this question requires having a theory of justice (both a metric and a distributive rule). It gives us the target we want to reach. The second question is, assuming that means are scarce, how to reach this distribution as efficiently as possible? The salient point is that when we represent things in this way, then we do not face an efficiency/equity trade-off in the sense described above. We have a fixed end-point, which is a matter of justice, followed by an efficiency question, which relates to how to reach this end-point. Efficiency is thus about how to realize in practice what justice requires in theory with as few means as possible.

Why then do regulation theories posit an efficiency/equity trade-off and set allocative efficiency and distributive justice apart? My suggestion is that this comes naturally because of the set-up of our social institutions: we are accustomed to thinking about society as consisting of a private domain of free interactions (the market) and a public domain of collective action. Regulation theories reflect this division, by using a different criterion of justice for each realm. The market game is supposed to generate a maximal satisfaction of consumer preferences. Efficiency is then—often tacitly—related to a specific theory of justice, with its own metric and rule: utilitarianism. The metric is subjective well-being, the distributive rule is Pareto-optimality. Equity should characterize the initial allocation of resources (hence: whatever

is done by public institutions, outside of the market), while efficiency should characterize the market process played on the basis of that initial allocation. This requirement on the market process is most often characterized as allocative efficiency, and rarely recognized as a distributive theory in itself. Nonetheless, it is. As Julian Le Grand has aptly remarked (1990, 566):

Investigations of the trade-offs between various interpretations of equity and Pareto-optimality are not really concerned with the trade-off between equity and efficiency at all. Instead they are investigating what is, at least in part, actually a trade-off between two different kinds of equity: that whose properties are being explored and that embodied in the Pareto social welfare function.

However natural, the tendency to equate efficiency with the objective of welfare maximization (in its Pareto form or otherwise) should be resisted. Efficiency denotes not one social objective, but a relation between social objectives that are each part of one's theory of justice. An economy is efficient to the extent that it is able to reach as many of these objectives as possible, given available resources, and subject to a decision about how to make trade-offs between these objectives.¹

Given these insights, the position of the handbooks of regulation is not merely theoretically inelegant (in presenting a disparate set of justificatory grounds for regulation), but incomprehensible. The economic justifications are backed up by a utilitarian theory, but the social justifications cannot be grounded in utilitarianism.² For consider the *utilitarian view of the person*. According to standard utilitarianism, the person participating in market transactions is deemed to be a person who holds his or her preferences and endowments legitimately. This is the reason why regulatory interventions with these preferences (paternalism) or these endowments (distributive justice) on the market are deemed to be an interference with the free, spontaneous forces of supply and demand. This intervention is seen as lowering social welfare. The individual coming to the market is already constituted as a person, a participant whose holdings and preferences are to count as legitimate input for the game. Any doubts about this view must be dismissed since the utilitarian

¹ Trade-offs, then, are not between "efficiency" and "equity," but either between justice-related and other goals, or between several parts of one's scheme of justice. In the latter case multidimensionality in one's distributive scheme (e.g. separate capabilities) requires to somehow weigh these dimensions even if they are separately important for justice (hence, to some extent, incommensurable).

² I here use the label "utilitarian." Some would object since Pareto-optimality does not require interpersonal comparisons of utility and does not allow maximization across persons (and utilitarianism only exists where the rule is to maximize utility). Nonetheless, I use the label, given that the nature of the underlying metric of the Pareto-criterion remains utility, in terms of satisfaction of preferences. Note that in practice, a lot of regulation does aim at utility maximization: standard cost-benefit analysis makes use of the criterion of potential Pareto-improvements (Kaldor-Hicks compensation criterion).

believes in utilitarianism not just on the market but everywhere in social life. The utilitarian cannot admit that this is intuitively unattractive because preferences are not well formed or because some inequalities are not fair. For this would render his or her theory a problematic hybrid of non-utilitarian and utilitarian distributive rules (leaving open which metric the utilitarian would adopt for the social, non-market part). Given the entanglement of the “before,” “during,” and “after” the market processes in practice, the position will be indeterminate in its prescriptions.³

Hence, we face the choice between either rejecting social regulation and identifying justice with market efficiency, or finding a common normative basis for the traditional social and economic justifications for regulation (and the latter option requires showing how economic regulation can be understood on a non-utilitarian basis). It is here that the capability approach comes in.

3.4 THE CAPABILITY APPROACH AND THE MARKET

In this section, I first introduce the essentials of the capability approach and then show how the use of a capability approach is able to unify the trichotomy of justifications that has haunted us so far. This provides the philosophical basis on which, in Section 3.5, I will propose a concrete capability framework for market regulation.

The basis of the capability approach is the distinction between capabilities and functionings. Functionings are defined as “doings” or “beings”: to have good health, to be well educated, to write a book, to drink a coffee, are all examples of functionings. Capabilities refer to the ability to do these things or to be in these states. When a person has a capability, say to drink coffee, then the person can “convert” this capability into a functioning, by choosing to act in the way that is open to him or her. An essential element is thus that when individuals are provided (by society or by government) with a set of capabilities, they have the freedom to decide for themselves which ones to convert into functionings. The terminology of functionings and capabilities is extremely flexible, so much depends on the level of generality at which one defines these capabilities. In any case, each capability has an internal and an external aspect. The internal aspect refers to the developed abilities of the person to act in the way the capability indicates: the presence of the required capacities, dispositions, or skills in the person. The external aspect refers to the options open to the agent, for example the legally permitted access to higher

³ To be consistent, such a position needs a meta-criterion to decide trade-offs between utilitarian and non-utilitarian distributions.

education or the health care system. Both aspects can come in degrees, so it is a matter of further normative decisions when we are prepared to say that a person “has the capability to x ”: this depends on how many capacities and options are necessary to judge that this is the case.

The term “capability to function” indicates a metric of justice. Amartya Sen has argued that any view about justice provides an answer to the “equality of what” question (Sen 1979, 1992, 2009). In contrast to resourcist and utilitarian metrics (see below) the capability approach proposes to conceive of a just society as one in which citizens have “equality of capabilities,” or more precisely, an equal right to a set of basic capabilities. To develop this general starting point into a fully fledged theory of justice, however, two further decisions need to be made. First, a selection of a set of basic capabilities needs to be made. Martha Nussbaum has argued, based on her neo-Aristotelian criterion of human flourishing (later, human dignity), for a set of ten basic capabilities, such as the capability to life, bodily integrity, senses, imagination and thought, play, practical reason, affiliation, and others (Nussbaum 2000, 2006, 2011). Other criteria for the selection of basic capabilities have also been explored. Elsewhere, I have argued for using a criterion of free and autonomous agency as the basis for the capability approach to justice. The basic idea here is that of positive freedom: if individuals are to be truly free, they need to become persons who have sufficient capacities and options to choose and realize their own goals in life. This requires both non-interference from others with one’s options and positive contributions to enhance one’s capacities to make use of these options (Claassen 2017a).

Second, which distributive rule would fit the capability approach? In the justice literature, many distributive rules have been proposed: (luck) egalitarian, prioritarian, sufficientarian, or maximizing rules, all subject to countless variations. The capability metric itself does not dictate any distributive rule. Nonetheless, many authors have employed the capability approach in combination with a sufficientarian rule (Nussbaum 2006, Schuppert 2014, Axelsen and Nielsen 2014). Each capability should be provided up to a threshold level. Below this level, citizens are in need. Above this level, the political community has no role to play for its citizens (these are luxury levels of functioning). Elsewhere, I have argued for a qualified defense of this sufficientarian position (Claassen 2017b). The general idea of setting thresholds will prove to be important for a theory of regulation.

Properly worked out, a capability theory of justice would be a competitor to its two main rivals: resourcist and utilitarian metrics. The capability metric can best be thought of as intermediate between these two. On the one hand, resources provide the input for capabilities. The resource bundle at someone’s disposal is a major determinant of this person’s capability set. However, various social, personal, and environmental conversion factors

determine how many resources one needs to reach a certain capability level. Thus, a physically disabled person may need more resources to reach the same level of, say, mobility, than a physically healthy person. Capability theorists have argued that resources are mere means, while capabilities present goals in life; thus justice should be defined in terms of the latter. This is important given the fact that—due to differences between people in conversion factors—a purely resourcist approach that gives people equal bundles of resources may give some too much while giving others too little. On the other hand, after a person has converted certain capabilities into functionings, he or she experiences a certain feeling of well-being, happiness or satisfaction of his or her preferences, as attached to his or her functioning in a certain way (“listening to music makes me happy”). These utility levels (output), however, are also variably related to functionings. Those with a more pessimistic character will need more or higher-level capabilities or functionings to experience the same utility level as those with a more optimistic character. Here the capability theorist argues that people should be responsible for their own subjective well-being. This is especially important because otherwise some might claim that they need higher capability levels (hence more resources) than others in order to reach the same level of well-being (expensive tastes problem), while others might claim too little because they have become accustomed to be satisfied with very little (adaptive preferences problem). Thus, being positioned in between resources and utility, capability is the right metric for defining social justice.

Let us now turn to the question of regulation. A capability theorist evaluates social states with respect to the question of whether the set of basic capabilities is realized up to the threshold level. In contrast to the economic approach described earlier, there is no distinction between pre-market allocations and market-based outcomes. The sufficientarian capability criterion is used to assess the normative rightness of both. The sufficiency threshold does institute a dichotomy, between below-threshold distributions and above-threshold distributions. If a person or group of persons is below a capability threshold, some form of government action is needed to bring them above that threshold. If a person or group is above the threshold, no action is needed. This means that these persons can act freely above the threshold. Since I identify the bundle of capabilities with a view to their contribution in rendering people free and autonomous agents, we can state this dichotomy as follows: below the threshold a person is not yet *constituted as an agent*, above the threshold he or she is. We may think of this by analogy to legal capacity, which is not granted to minors and persons with severe mental disabilities, but is granted to all others. Similarly, a capability theory of justice looks at the agency required to be able to live a free and autonomous life. Below the threshold individuals are still *developing* their capacity for agency, above the threshold they are *exercising* their agency in freely chosen activities which bring them enjoyment,

well-being, or anything else they wish for (Claassen 2016).⁴ The dichotomy of agency development/exercise is orthogonal to the state/market dichotomy. The capability theory does not have an a priori view of markets as good or bad institutions, but rather evaluates markets' contributions to capabilities enhancement from this dual agency perspective.

On the one hand, markets, like other institutions, may be *instruments* in the service of capability justice. Markets may be the most efficient institutions for the production of certain resources which are in turn necessary for giving people basic capabilities. Food markets may be the most efficient way to produce food for the population; hence they enable their basic capability for nutrition. If, and to the extent that, a particular market is thus a necessary condition for the realization of one or more basic capabilities, it is placed under scrutiny. What is at stake is the *constitution of agents in general* via their market-based roles (producers, consumers). To do so, markets need to function well, and this requires that the market failures familiar from economic theory be addressed. From a capability perspective, however, the reason to remedy market failures is not to maximize welfare, but to realize basic capabilities. Since the normative criterion is different, we can expect that this will lead to different diagnoses of these market failures than those available in mainstream economic theory. Markets need participants which can play the market game well, but what playing well means depends on the outcomes one envisages for the game (more on this in Section 3.5).

On the other hand, to the extent that a market is not necessary as an instrument of capability justice, it is a social domain which is *intrinsically* valuable, for the free exercise of one's agency. Here market activity is on a par with activity in other parts in the private sphere: with the activities in the home or in civil associations. No conditions are put on such activity, except for the negative one of not harming the basic capabilities of others (i.e. making them fall below the threshold). Note that although the capability theory does not put any positive requirements on actions above the threshold, it is crucial that there is an above-threshold domain of action. If not, the whole point of developing agency would become redundant. Government regulation here has a role which is not interfering with the market, but enabling the constitution of the market itself. The protection of the market as such an arena is emphasized by all those who defend economic liberties as basic liberties (Tomasi 2012). In capability terms, these liberties are capabilities which serve the *constitution of persons as market participants*, which is a specific social role (see p. 67). This requirement is analytically distinct from the previous one, and both are relevant for a capability theory. In reality both

⁴ For another influential view which evaluates markets from the angle of agency, see Satz 2010 and my review (Claassen 2012).

are considerations that have to be weighed where they come together on specific markets.

This section has shown how the capability approach to markets starts from a fundamental concern for the *constitution of agency* in individuals. Such a concern is able to integrate the elements of allocative efficiency, distributive justice, and paternalism, which are often mentioned as grounds for market regulation. Corrections on pre-market endowments and preferences are warranted to the extent that they are necessary to realize basic capabilities. Enhancing “market efficiency” (the market’s ability to satisfy consumer demand) is valuable, to the extent that it is, for the same reason. Overall, the difference with the utilitarian-economic theory of regulation is deeper than it may appear if we only look at the reasons usually quoted to prefer capability metrics to utility metrics, such as adaptive preferences or expensive tastes. The difference lies in how these approaches perceive the constitution of persons as agents. For utilitarians/economists, a person’s preferences and endowments are leading, since the person is deemed to be already fully constituted as an autonomous agent. For the capability theory, a person’s preferences and endowments can only determine his or her free actions to the extent that his or her agency is sufficiently developed, which may or may not be the case at the point where he or she is engaged in a market transaction. Corrections on preferences and endowments are warranted where this is not (yet) the case.

3.5 A CAPABILITY FRAMEWORK FOR MARKET REGULATION

This section will provide the outlines of a capability framework for market regulation. The first and biggest part is to identify whose capabilities are at stake when regulating markets. The second part is about setting thresholds and dealing with conflicts.

I propose to identify three types of capability interests that may be at stake when assessing a specific (set of) markets. I will call these participatory capabilities, consumptive capabilities, and third-party capabilities. *Participatory capabilities* are the capabilities of those acting as market participants. This category relates to the intrinsic valuation of markets mentioned in the previous section. The economic liberties mentioned above are, roughly, the capability to hold and use property and the capability to make contracts. Following the standard perspective on economic liberties, the aim of enhancing participatory capabilities is to allow maximal freedom to hold property and make contracts. *Consumptive capabilities* are the capabilities that agents have as consumers of goods which they have bought on the market. This is connected to the

instrumental perspective: people often value their participation in markets for the goods it brings them, and the general agency (basic capabilities) which they gain by having access to these goods. Markets are in the business of providing nutrition, mobility, education, health, and many other important basic capabilities. Markets can be assessed according to how they enable consumers to enhance their access: this requires strengthening their position on the market itself (as a participant) so that they can better enjoy the results of such participation. Finally, *third-party capabilities* refer to the capabilities of those who are affected by market exchanges even if they are not connected to them as producers or consumers. This category needs to be included because of the ability of markets to produce negative externalities. Neighbors suffering damages, future generations being harmed by present production, etc. all are third parties whose capability interests need to be included in an assessment of markets.

For all these capabilities, thresholds need to be set. There is very little that can be said about this task in general. The normative criterion for selecting capabilities is crucial in setting thresholds as well. If—as I would propose—the criterion is (some form of) free and autonomous agency, then for every capability one would have to ask: how much of this capability does a person need, in terms of the potential of this capability to contribute to the person's ability to act autonomously? For some capabilities the answer may require adequate biological information (for example, assessing the capability of nourishment requires information about human metabolism and caloric intake); for other capabilities social and cultural information is crucial (for example, the capability for mobility depends on available technologies and networks of transportation). In all cases a margin of judgment is unavoidable. Once capability thresholds are established, judgment is also required when different capabilities conflict, to weigh the respective importance of each capability appropriately. Although little can be said in general about setting thresholds and weighing conflicting capabilities, there is one marked difference that can be identified in general between the capability framework and alternative approaches with an aggregative structure (such as most forms of utilitarianism): given its sufficientarian structure, further increases in one capability above the threshold will be (sharply) discounted against subthreshold levels of other capabilities. This can have important practical implications that differ from standard economic theories of regulation.⁵

⁵ For example, in competition law, we argued that certain agreements between corporations, which raise prices for consumers (who remain, however, above the threshold for the relevant goods which are at stake) and would therefore be forbidden as market-distorting under an economic approach, may need to be allowed if they bring third parties above the threshold. See Claassen and Gerbrandy 2016.

Let us now see in more detail how this general framework affects market regulation. Here we can build upon work already being done. I will discuss two examples of areas of market regulation where the capability approach has been applied: those of property law and contract law.

1. Property law. Gregory Alexander defends the position that property should be understood as a coin that has two sides. On the one hand a property owner has the right to exclude others from (unconsented) uses of his or her property. Property rights protect a zone of individual discretion. On the other hand, a property owner has social obligations that restrict the use of his or her property. The idea that a property right would only be characterized by the exclusionary side of the coin is a myth. There have always been restrictions on property. Both the granting of the exclusionary right and the imposing of social duties emanate from the same source: the decision-making authority of the relevant political community (Alexander 2009a). The question is not whether communities have the right to impose restrictions, but how to determine which restrictions are legitimate. Alexander rejects the law-and-economics scholarship that uses utility (welfare) as the decisive criterion for determining the legitimacy of restrictions. Instead, he proposes that this role should be fulfilled by the concept of human flourishing: “[t]he very factor that makes the institution of private property a social good is also the very factor that renders its limits, i.e. human flourishing” (Alexander 2009b, 750; similarly Alexander and Penalver 2012, 80–101). From this premise he derives the most general formulation of what he calls a *social-obligation norm*: “[a]n owner is morally obligated to provide the society of which the individual is a member those benefits that the society reasonably regards as necessary for human flourishing” (Alexander 2009b, 774). To develop this view, Alexander turns to Nussbaum’s capability theory, applying it to two types of limits on property: expropriations and restrictions on use.

In the first category an example is the expropriation of a large landowner’s piece of land by the South African state after several hundreds of poor black citizens had invaded the land and refused to leave. The Court refused to send these citizens back into homelessness and accepted the expropriation. At the same time it ordered compensation of the landowner, because the enormous problem of homelessness in South Africa should not fall disproportionately on this landowner, but as far as possible on the community as a whole. Alexander defends this ruling, appealing to capability theory:

The squatters’ access to land for dwellings is surely a component of the minimal material conditions for human flourishing, on almost any conception. The capabilities of life and freedom, for example, are virtually meaningless if one does not have a place one is entitled to be. (Alexander 2009b, 790)

In the second category a good example is the right to public access to beaches that are privately owned. In several cases courts have granted such a right

(without compensation). Alexander defends this practice, in those cases where there are no public beaches available in the surrounding areas. He does so by referring to Nussbaum's capabilities for affiliation and recreation:

recreation is not a luxury, especially for the poor. It is an important aspect of the capabilities of both life and affiliation. With respect to life as a good, ample and growing medical evidence indicates that recreation and relaxation contribute importantly to good health, reducing the risk of diseases ranging from depression to heart disease. . . . The requisite socializing activity—affiliation—often, though not always is site-specific. It cannot be carried on just anywhere but must be done in a particular venue or at least at a particular type of venue. Baseball must be played on an open (hopefully) grassy area, whereas beachcombing requires an unobstructed beach. (Alexander 2009b, 805, 809)

These examples show how in the area of property law the capability approach pays attention to the freedom both of the property-owner (a participatory capability) and of the specific parties that are barred from access to vital consumptive capabilities: housing (for the squatters) or recreation (for those without access to the beach). Of course the judgments made in these contexts are highly context-dependent. The assessments Alexander makes are contingent upon (a) the specific capabilities he treats as basic (following Nussbaum), and (b) the thresholds he—or the judges in the South African case—set in assessing these capabilities. Such weightings are the bread and butter of legal cases, but this does not make them less controversial. The capability approach can here be seen as underlying and acknowledging these controversial assessments. It offers a common language to identify these interests, but cannot decide between them unless a more specific view is offered of how to select basic capabilities and determine thresholds.

2. *Contract law.* Simon Deakin has, in collaboration with others, applied the capability approach to contract law (Browne, Deakin, and Wilkinson 2002, Deakin and Browne 2003, Deakin 2006, 2010). He starts from the observation that contract law has developed considerably from its classical foundations in the eighteenth and nineteenth centuries. The classical view of contract law was built on a notion of (legal) “capacity.” It is a vital precondition of a market economy to determine which contracts will be enforced and for this it is crucial to see who is legally able to make a contract. The doctrine of capacity excluded several categories from this ability. Normal adult citizens are supposed to be able to assess whether the contract they are making is in their own interests. In history, several groups were excluded (think of married women), but now only minors and those with grave mental illnesses are excluded from this contractual capacity. The assumption of having contractual capacity is now more widespread: most people are assumed to be able to make appropriate judgments (Deakin 2006, 322). However, Deakin argues, at the same time more and more restrictions have been placed on specific types of

contracts. His central example is that of labor law. In the twentieth century, more and more mandatory and default terms have been introduced, designed mainly to protect laborers against the bargaining power of employers (Deakin 2006, 352).

For Deakin, these legal interventions are not distortions of the market process, but rather enhance the capacity of market participants, “endowing them with the resources needed to participate in market exchange in more than a purely formal or procedural sense” (Deakin 2006, 333). To theorize this legal change in economic terms, he argues, we have to switch from a standard economic framework to a capability approach. The crucial point is to see contract law as one of the conversion factors. These are the factors that determine how an individual is able to convert a resource bundle into a set of capabilities. The abilities of persons are a function both of resources and of the quality of institutional rules—hence the idea that “institutional rules do not simply constrain, they also empower” (Deakin 2006, 336). A case in point is discrimination law. Against the standard economic view of Gary Becker and others that persisting discrimination may be an efficient response of employers to market circumstances (if they are left unpunished by their customers), Deakin argues that discrimination unjustifiably excludes participants from the market. Anti-discrimination laws are necessary to make sure that markets empower individuals. Elsewhere, he argues that in a more general sense, the capability approach helps to see that social rights need to be inserted into rules structuring market exchanges, rather than being left exclusively to public systems of social provisioning (Deakin and Browne 2003, 39).

In terms of the capability framework presented above, Deakin’s position strongly emphasizes the participatory capabilities of (potentially excluded) market participants, such as groups that are threatened with marginalization on the labor market. He never explicitly trades these off against the capabilities of other groups. His argument may be understood as implicitly claiming that these groups suffer from subthreshold levels of labor market participation (where such participation may be both intrinsically valuable and valuable for the instrumental benefits it brings, such as a wage). On the other side of the equation, there are the capabilities of employers who have to carry costs to comply with anti-discrimination laws and see their freedom of contract restricted, and the capabilities of consumers, who may have to pay for these costs in terms of increased prices. The framework invites us to balance benefits and costs in capability terms, under the crucial presupposition that improving the position of groups whose capabilities are in a subthreshold state should be prioritized to improving the position of groups whose capabilities are already at an above-threshold level.

Both illustrations from existing work in property and contract law show how the capability approach can be fruitfully applied to market regulation. It provides a paradigm shift compared to the standard (law-and-)economics

approach. The framework in this section structures these applications by pointing to the need for a systematic inventory of all relevant capabilities and clarity about thresholds and weightings of these capabilities. Most importantly, the applications show that these types of regulation are not simply about “redistribution” between groups or “paternalism” vis-à-vis individuals, but ultimately about ensuring the capabilities necessary to act as autonomous agents, both on the market and outside of it.

3.6 REGULATING FINANCIAL MARKETS

The capability framework outlined above can also be applied to financial markets. Indeed, very often criticisms of standard economic approaches to financial markets can be systematized by making use of this framework; something like a capability approach can be reconstructed as a necessary ground for these moral evaluations. Let me close this chapter by illustrating this point with respect to the arguments of three of the chapters included in this volume.

In Chapter 13 Anat Admati argues that financial market regulation after the Great Financial Crisis of 2007–9 continues to be inadequate, so that too many risks remain hidden in the system. She attributes this to a misalignment between the interests of those working in the system and the interests of the public at large. The latter can best be understood along the lines of what I called *consumptive capabilities*, in so far as consumers of financial products often have a very basic interest in access to the financial system in order to buy a house or take out a small business loan, and *third-party capabilities* in as far as they relate to people who do not consume financial products themselves but whose interests are nonetheless negatively affected by a financial crisis (as taxpayers, as workers who lose their jobs, etc.). These capabilities have to be set against the *participatory capabilities* of bankers and others working in the system, who value maximum freedom to arrange transactions as they see fit. As with many other instances of consumer regulation, these serve the purpose of protecting consumers who suffer from information asymmetries (stretching, in some cases, into deception, manipulation, and fraud). The ultimate moral value at stake here is not consumer welfare, but the basic functionings of consumers. Given the necessity of taking out credit for many normal life plans, autonomous agency requires a financial system serving consumers well. These capabilities need to be balanced, and the sufficientarian framework advocated here suggests that consumers’ capabilities are more basic for agency than the participatory capabilities of bankers who would like to take high risks.⁶

⁶ Elsewhere, I argued that this requires a new social contract between the financial industry and society, determining the appropriate level of risk within the system. See Claassen 2015.

What is striking about Admati's text is that it then moves the discussion to a higher level: why does regulation continue to fail consumers and the public? Her suggestion is that regulatory capture, inadequate media coverage, and corporate lobbying are an important part of the answer. This points us to the political game about market regulation. This suggests an even further extension of the capability framework offered here, in two senses. One is that the level of *financial literacy* of consumers needs to be raised, so that they can adequately evaluate offers by the financial industry. Financial literacy (like literacy generally) is a capability in its own right. While general literacy is a basic capability (in Nussbaum's sense), financial literacy can best be reconstructed as part of consumers' participatory capabilities. For consumers to be able to act as agents on financial markets, they need this kind of training. A second extension is to the political process. In the end, all the capabilities of individuals on financial markets mentioned so far are determined by the political system—hence citizens' *political capabilities* to organize themselves and to provide a counterweight to the lobbying of financial corporations are crucial. This may be reconstructed as instrumental to their first-order market-based capabilities, but is crucial nonetheless.

In Chapter 12 Roseanne Russell and Charlotte Villiers discuss the issue of gender justice in financial markets. This is a topic also regularly discussed within the capability approach (e.g. Robeyns 2003). Russell's and Villiers's main target is an economic approach that aims to enhance women's participation in corporate decision-making just because this kind of diversity maximizes profits: women in the boardroom are "good for business." This "business case" for gender equality is problematic, they hold, because it focuses on individuals instead of groups, and because it instrumentalizes the issue of social justice between the groups of men and women (equal opportunity on the labor market). As a result, gender justice as a whole may not be served by having more women in leading positions, since these are currently coopted by male elites and may therefore tend to adopt masculine norms and remain passive about the rights of women lower down the chain (there is no "trickle down" of gender concerns). Instead, Russell and Villiers advocate an approach that broadens attention beyond the quota for women in the boardroom, toward the corporation as a whole where women need to be included at all levels. Moreover, they advocate focusing on empowerment and representation of women as a group instead of the "1% feminism" which characterizes the business case for gender diversity.

These concerns align very well with the capability approach advocated here. Three steps are necessary for the framework to apply to these issues. One is that the labor market, given its specific nature, requires special conceptualization. People's own time, energy, identity, and need for recognition are at stake in work; work is much more than financial remuneration (Gheaus and Herzog 2016). Laborers' "consumptive capabilities" here refer to these material and immaterial things they get out of work; since the laborer is the supplier of work

we could better call this *productive capabilities*. Moreover, the chapter focuses on the subcategory of women laborers and their demands for equal inclusion (like that of other groups demanding equal opportunity), which can best be conceptualized as a participatory capability. To be able to effectively participate in the labor market, the male-dominated social norms within this market need to be transformed. In the capability approach, these social norms are one of the conversion factors that make it the case that an equal bundle of resources can nevertheless translate into unequal capabilities sets for individuals. It should be noted, however, that although the sociological analysis of these conversion factors needs to be sensitive to the stigmatizing effects on groups as a whole, the ultimate moral concern in the capability approach remains with the individual and his or her equal opportunities. There is a difference between ethical and methodological individualism—the capability approach adopts the first but not the second. Third and finally, the issue of gender equality also points us to the need for adequate *political capabilities* to bring about change (Russell and Villiers briefly discuss this need for a reinvigorated social movement and collective action).

Finally, in Chapter 11 Boudewijn de Bruin discusses the role of justice with respect to rating agencies. He observes that they have received much criticism after the financial crisis, but ultimately finds this to rest on a faulty ascription of responsibilities. As private agents, businesses should be responsible for their own risk assessments. They should not rely on rating agencies, who have no moral duty to provide accurate information. Likening this to a newspaper which only publishes gossip, De Bruin qualifies such behavior as unvirtuous, but not violating any moral rights. The investors (buyers of bonds or securities) should beware of the risks they run. In addition, De Bruin criticizes the US government for having required many institutional investors to take the information of rating agencies into account, and to disinvest when ratings drop below a certain level. This has gained the agencies an audience that should have remained free to decide whether or not to take the agencies' information into account. The right approach to risk assessment on financial markets, then, is deregulation instead of more regulation.

De Bruin's chapter raises crucial questions about what I have called participatory capabilities. In particular, the question is whether every citizen in a society has a right to be included in every market. This question necessitates making a distinction between *general* participatory capabilities—to be able to hold property and make contracts in ways protected by the general civil code—, and *particular* participatory capabilities which are only relevant for certain markets. While we need to accept the equality of citizens in terms of these general capabilities, this is an open question for the specific capabilities. The concept of agency goes beyond merely formal freedoms to require that people actually have the capacities for autonomous decision-making in the relevant context. However, people may suffer from “autonomy gaps,” that is,

gaps between what the policy requires from them and what capacities they have. At least two solutions offer themselves: either a policy to enhance people's capabilities or a policy that requires suppliers to lower the complexity of their products (J. Anderson 2014). De Bruin opts for a third option: letting these gaps subsist. This hands-off approach may be justified if a specific market does not fulfil a vital interest (i.e. in terms of necessarily contributing to a basic capability), so that participation is truly optional. Whether this is the case for rating agencies would require more discussion about the specific content and weight of these capabilities. At any rate, the capability framework does not point to any of these three options as the a priori best one.

This brief overview is far from conclusive with respect to the specific arguments made in the financial context. It does however show that the capability framework can be fruitfully linked to issues within concrete markets. Moreover, as the discussion shows, consideration of these cases has helped us to refine and extend the framework, including new capabilities and subdivisions within existing ones (see Table 3.1). More applied work on financial markets could help to bring out this potential even further. In this chapter I have tried to clear the theoretical ground for this, by trying to show how the capability approach can help us to frame the existing normative grounds for regulating markets into a unified and powerful normative framework.

Table 3.1. Framework of capabilities relevant to market regulation

1. Participatory capabilities—i.e. capabilities to participate on the market as agents
a. general: capability to hold property and contract (as protected by civil law)
b. market-specific capabilities, e.g. financial literacy
2. Instrumental capabilities:
a. Consumptive capabilities—i.e. capabilities of consumers (e.g. to housing, as dependent on the financial system)
b. Productive capabilities—i.e. capabilities of laborers (e.g. women laborers in financial organizations)
3. Third-party capabilities—e.g. those of citizens not directly involved in the financial system but suffering from the economic consequences of financial crises
4. Political capabilities—i.e. capabilities for political action to influence regulation about the other categories of capabilities

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