Exploitation and Economic Justice in the Liberal Capitalist State

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To

1968

When it was practically impossible not to become politically aware regardless of one's interests and inclinations

Preface

I have been thinking about the issues addressed in this book for many years, but my work on it did not begin in earnest until the financial crisis hit in the summer of 2008. I had been lucky enough to be awarded a faculty fellowship at the Edmund J. Safra Center for Ethics at Harvard University that was set to start the following fall, and my intention was to use the first few months of that fellowship to finish up what I thought would be a short paper on exploitation before getting down to working on the project I planned on devoting most of my fellowship to developing. That short paper turned into a long paper, then a very long paper, then a short book, and eventually into the rather longish book you now have before you. I cannot express my gratitude to the Safra Center enough for providing me such a stimulating and supportive place to develop these ideas. My special thanks go to Arthur Applbaum, then director of the Center, for helping to create and to maintain such an incredibly hospitable scholarly environment, and to Elaine Scarry, senior scholar in residence at the Center while I was there, for providing such an admirable example of how intellectual ideas can be made practical and devoted to matters of real public importance. Thanks also to my fellow fellows: Anne Barnhill, Ulrike Heuer, Tanina Rostain, and Alex Voorhoeve for their helpful criticisms of early versions of the book and for their continuous good-fellowship and encouragement.

In addition to presenting early versions of many of the arguments of the book to those at the Safra Center, I was also privileged to be able to make presentations to and receive feedback from a number of other groups and institutions, including the Harvard Department of Government Political Theory Colloquium, the Manchester Center for Political Theory, the University of Stirling Workshop on Human Rights, the American Association for Political Theory, and the University of Manchester Political Theory Workshop on Exploitation. My thanks to the organizers of these events for inviting me to present my work and to all those in attendance for their comments and suggestions.

A number of individuals have gone out of their way to provide me with feedback on my work and therefore deserve special recognition. F. M. (Mike) Scherer read an early version of the manuscript and commented extensively

on it in writing, and very kindly helped me find my way through what was then for me some unfamiliar territory in economics. Ian Steedman read a later version of the manuscript and helped me catch many errors in my economics, although despite Ian's best efforts I'm afraid some of these errors may embarrassingly remain. Hillel Steiner read the entire manuscript not once, but twice, providing me with detailed written comments that were both thoughtful and thought-provoking on each occasion, and he also spent many, many hours discussing my ideas with me and helping me to see where they needed further development and defense. Michael Davis also read the entire manuscript twice and provided me with two complete sets of extremely important written comments—one at a key developmental stage and another when the manuscript was further along. Jon Quong provided me with very helpful written comments at an early stage, Avia Pasternak did the same at a later stage, and Roberto Veneziani provided a final critique of some of my arguments in economics. Finally, Raymond Plant provided me with an extensive set of written comments at a later stage in the manuscript's development that I can only characterize as inspirational. I am also grateful and indebted to Norman Geras for discussing Marx with me, and to Simon Mohun for sharing some of his work on profit rates with me. Others who contributed to my thinking on these issues in significant ways include Kimberley Brownlee, Nick Charles, Rowan Cruft, Celina Davidson, Harriet Davidson, Antony Duff, Greg Feirman, Eve Garrard, John Henry, Eric Kaufman, Erin Kelly, Saara Koikkalainen, Matt Kramer, Mark Kramer, Joe Lertola, Harry Lesser, Sandra Marshall, Joseph Mazor, Lionel McPherson, David Miller, Onora O'Neill, James Pattison, Tom Porter, Adina Preda, Michael Rosen, Frank Stephen, Zosia Stemplowska, Peter Vallentyne, Qiao Wang, and Stephen de Wijze.

Thanks also to Dominic Byatt, an editor's editor, who guided the manuscript deftly through the review and publication process, and to three anonymous reviewers for Oxford University Press, each of whom made many helpful comments and suggestions. As a result of their assistance, the book you have before you is much better than the manuscript that they were sent.

My final thanks go to my wife Della Davidson, whose loving support and encouragement I was lucky enough to enjoy for twenty-seven years. Her faith in me and her enthusiasm for my work never faded, even when she was forced to embark on a merciless battle with breast cancer during the last year of the book's creation. I could not have written this book without her. I miss her very, very much.

Manchester, England and Sacramento, California
August, 2012

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Introduction

In *The General Theory of Employment, Interest, and Money*, considered even by its critics to be one of the most important and influential works in modern economics, John Maynard Keynes said, "The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes."[1] A great deal has been written about the latter of these problems; about the former, not so much. The reason for this is that there is an important difference between the two faults that Keynes identified. The unemployment problem is almost universally seen as a technical, economic problem. By this I mean that even though there is some debate over how close to full employment an economy should strive to be, almost everyone recognizes that unemployment should be kept relatively low; the only question seems to be how we should go about achieving this, and perhaps what sacrifices we should be prepared to make along the way. The problem of economic inequality, in contrast, raises much more controversial issues. The problem is not just how we should go about eliminating economic inequality, should that be what we decide to do, but whether we should decide to do this in the first place, for there seems to be strong moral and economic arguments both for and against interfering with the existing distribution of wealth and income. The problem of economic inequality is accordingly not typically seen as a merely technical, economic problem; it is seen as a moral and political problem, and a very important one at that. Indeed, along with maintaining international peace and security, addressing the problem of economic inequality and the variety of derivative problems that economic inequality seems to create is seen as something that every polity must do in the course of managing its members' social life.

Despite the huge amount of time and philosophical energy that a large and seemingly ever-increasing number of political philosophers have been

[1] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (San Diego: Harvest/Harcourt edition, 1964), ch. 24, p. 372.

devoting to the issue of economic inequality, however, (or, if one were being cynical, one might say because of this), no one theory of economic justice has emerged as the focus of an overlapping consensus—that is, as the kind of theory that a variety of different comprehensive moral, religious, and political views could each embrace. Instead, a number of different approaches have been developed that have captured different segments of the popular imagination and have also claimed different adherents among the academic, intellectual, and political elite. One such approach is classical libertarianism; another is Rawlsian prioritarianism; and another is luck egalitarianism. I shall describe what each of the views entails in detail in a moment, but for now, the only point I want to make is that each expresses a different view toward economic inequality and whether and to what extent it may be justified. Each of these theories, in turn, has several versions, and there are many other competing theories too.

The attitude these theories express toward economic inequality, however, is not the only point on which the theories differ. In the course of constructing an attitude toward economic inequality, every theory of economic justice must also take account of and express some attitude toward the underlying economic system prevailing in the society in which the problem of inequality happens to arise. In the case of each of the theories I have mentioned, this economic system happens to be capitalism, and each of our competing theories of economic justice has its own idiosyncratic relationship with that system. Libertarianism claims to be the political counterpart of capitalism. Rawlsian prioritarianism, it seems fair to say, sees itself as a critic of capitalism, or at least a critic of *unbridled* capitalism, which other political liberals sometimes refer to as *cowboy* capitalism, the kind of capitalism that remains unmediated by anti-discrimination, consumer protection, environmental, occupational safety, and minimum wage and maximum hour laws. And luck egalitarianism, which borrows certain attitudes from libertarianism but embraces many more moderate attitudes too, sees itself as lying somewhere in between, as capturing the intuitive idea behind libertarianism without giving up so many of the moderating effects that political liberalism otherwise makes available.

Of course, it is probably not correct to characterize any particular liberal capitalist state as wholly exemplifying any one of these attitudes; it is more correct to say that all three attitudes are present in every liberal capitalist state even though they are to some extent conflicting. As a result, every capitalist state is constantly being pulled first in one direction and then another, sometimes even pursuing policy initiatives that move in different directions at the same time. Because of this, and in any event because there is no real society in which one of these theories has overwhelmed the others and actually been implemented consistently and conscientiously in anything but the short term, it is impossible to tell whether any of these approaches can have the benefits in practice that they claim to have in theory. But that is irrelevant for our purposes. All that matters is that so far and for whatever reason, none of these theories of economic justice has proved to be an effective tool for reducing economic inequality. And this is true despite the fact that all of these theories have at least some redistributive aspirations, or at least some anticipated and desired redistributive side effects. In other words, all are liberal egalitarian theories in some sense, for all find some distributions unjust and try to provide a principle for sorting those that are just from those that are not. Rawlsians find inequality unjust unless a lesser inequality would make the least advantaged even worse off; luck egalitarians find inequalities unjust if they stem from luck but not if they stem from choice; all libertarians find inequalities unjust if they arise from violations of the principle of just initial acquisition or the principle of just transfer, and almost all holdings are the proceeds of violations of one of those principles; and left libertarians find inequalities additionally unjust if they result from the uncompensated appropriation of what were in fact jointly owned natural resources. I'll say more about each of these theories later; the only point I want to make now is that under all of these theories, it would seem that there should be a whole lot of redistribution going on, and the fact that there is not should be troubling to everybody. This should be even more troubling when we consider that back in 1936, after Keynes and the Great Depression had focused our attention on these matters but before any of these contemporary theories had been fully articulated and achieved at least some recognition and success, we *did* manage to reduce economic inequality. Indeed, there was some and perhaps even some substantial improvement in each of the areas of Keynes's concern in the immediate aftermath of World War II, with both unemployment and inequality dropping substantially and then remaining relatively stable until about 1970.[2]

Since 1970, however, and especially since the early 1980s, by which time prioritarianism, luck egalitarianism, and right and left libertarianism had each been well and truly introduced, economic inequality has been steadily and dramatically increasing, reaching levels now not seen since those that Keynes had before him in the 1930s.[3] For example, the share of total income enjoyed by those in the top 10 per cent of the income distribution in the United States increased from about 32 per cent in 1970 to 43 per cent in 2002, to 50 per cent

[2] See Thomas Piketty and Emmanuel Saez, "Income and Wage Inequality in the United States, 1913–2002," in *Top Incomes over the Twentieth Century*, ed. A. B. Atkinson and T. Piketty (Oxford: Oxford University Press, 2006), 141–225.

[3] See Piketty and Saez, "Income and Wage Inequality in the United States;" A. B. Atkinson, *The Changing Distribution of Earnings in OECD Countries* (Oxford: Oxford University Press, 2008), 405–8; Louis Uchitelle, "The Richest of the Rich, Proud of a New Gilded Age," *The New York Times* (July 15, 2007); Paul Krugman, "Gilded Once More," *The New York Times* (April 27, 2007).

in 2007, a share they had not enjoyed since 1928, just before the Great Depression.[4] Even within this group, economic inequality was increasing. The gains of the top 10 per cent were mostly the gains of the top 1 per cent, and most of their gains, in turn, were gains of the top 0.1 per cent, and so on up to the top 0.01 per cent, a group consisting now of approximately 15,617 US families.[5] For every additional dollar earned by the bottom 90 per cent from 1950 to 1970, those in the top 0.01 per cent earned "only" an additional \$162.[6] For every additional dollar earned by the bottom 90 per cent from 1990 to 2002, in contrast, those in the top 0.01 per cent earned an additional \$18,000.[7] In 1970, the top 0.01 per cent of all taxpayers had just 0.7 per cent of total income.[8] By 1998, the top 0.01 per cent had 3 per cent of total income, a gain of 428 per cent.[9] And by 2007, the share enjoyed by the top 0.01 per cent—those with incomes *over* \$11.5 million a year—had increased to over 6 per cent of total income, a gain of 857 per cent from 1970.[10] In 1970, those in the top 0.01 per cent were earning 50 times more than the average worker; but by 2002, they were earning 300 times more than the average worker, a level of inequality not seen since 1915.[11] And while that number may have dropped slightly as a result of the Great Recession, it is still at near record levels and is already heading back to its pre-recession highs.

[4] See Piketty and Saez, "Income and Wage Inequality in the United States," 147; and Emmanuel Saez, "Striking it Richer: The Evolution of Top Incomes in the United States" (Update with 2007 estimates) (August 5, 2009), available at <http://elsa.berkeley.edu/~saez/saez-UStopincomes-2007.pdf>.

[5] For a discussion of the relative gains of the top 1 per cent, see Congressional Budget Office, *Trends in the Distribution of Household Income between 1979 and 2007,* Publication No. 4031 (October 2011). For a discussion of the relative gains of groups *within* the top 1 per cent, see Piketty and Saez, supra, the Saez update, Lawrence Mishel and Josh Bivens, "Occupy Wall Streeters are Right about Skewed Economic Rewards in the United States," *Economic Policy Institute* (Briefing Paper No. 331, October 26, 2011), and Tom Dickinson, "How the GOP became the Party of the Rich," *Rolling Stone* (November 24, 2011).

[6] See David Cay Johnston, "Richest are Leaving Even the Rich Far Behind," *The New York Times* (June 5, 2005).

[7] See David Cay Johnston, "Richest are Leaving Even the Rich Far Behind."

[8] See Paul Krugman, "For Richer," *The New York Times Magazine* (October 20, 2002); Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913–1998," *Quarterly Journal of Economics* 118 (2003): 1–39.

[9] See Krugman, "For Richer." See also Thomas Piketty and Emmanuel Saez, "The Evolution of Top Incomes: A Historical and International Perspective," *American Economic Review* 6:2 (2006): 200–5, at 202.

[10] See David Cay Johnston, *Free Lunch: How the Wealthiest Americans Enrich Themselves at Government Expense (and Stick You with the Bill)* (New York: Penguin Books, 2007), 272–82, at 274; Uchitelle, "The Richest of the Rich, Proud of a New Gilded Age;" Saez, "Striking it Richer: The Evolution of Top Incomes in the United States" (Update with 2007 estimates) and Saez, "Striking it Richer: The Evolution of Top Incomes in the United Sates" (Update with 2009 and 2010 estimates) (March 2, 2012), available at <http://elsa.berkeley.edu/~saez/saez-UStopincomes-2010.pdf>.

[11] See Piketty and Seaz, "Income and Wage Inequality in the United States," 148. See also Lawrence Mishel and Natalie Sabadish, "CEO Pay and the Top 1%: How Executive Compensation and Financial Sector Pay Have Fueled Income Inequality," *Economic Policy Institute* Issue Brief #331 (May 2, 2012) (CEO compensation increased 725 per cent from 1978 to 2011 while compensation for the typical worker increased a meager 5.7 per cent over the same period).

At the same time, the poverty rate has been moving up—in 2008, it hit 13.2 per cent, the highest it has been in the United States in twelve years, and median family income fell, wiping out even the minimal gains that median family income had enjoyed over the previous three years.[12] While 65 per cent of American families lived in middle class neighborhoods in 1970, by 2010 that number had dropped to 44 per cent, with a corresponding rise in the number of neighborhoods peopled primarily by either the affluent or the poor.[13] Indeed, by 2010, the number of people living in poverty in the United States hit 46.2 million, the highest level in the fifty-two years the Census Bureau has been tracking such numbers,[14] and those living in "near" poverty—those with incomes just 50 per cent above the poverty line—accounted for another 51 million people, which means that by 2010, 100 million Americans—that is, *one in three*—were either living in poverty or in the fretful zone just above it.[15]

Most disturbingly, while those at almost every level of the income distribution have suffered and have continued to suffer economic reversals as a result of the financial collapse of 2008, those at the top of the income distribution have largely fully recovered their losses and some have even exceeded their prior hyper-privileged positions. Between June 2009, when the Great Recession officially ended, and June 2011, inflation-adjusted median household income fell 6.7 per cent, outpacing the fall that occurred during the period

[12] See Erik Eckholm, "Last Year's Poverty Rate Was Highest in Twelve Years: Median Family Income Fell," *The New York Times* (September 11, 2009). See also Carmen DeNevas-Walt, Bernadette D. Proctor, and Jessica C. Smith, U.S. Census Bureau, Current Population Reports, P60–238, *Income, Poverty, and Health Insurance Coverage in the United States: 2009* (Washington: US Government Printing Office, September 2010).

[13] See Sean F. Reardon and Kendra Bischoff, "Growth in the Residential Segregation of Families by Income, 1970–2009," *US2010 Project* (Russell Sage Foundation/Brown University, November 2011).

[14] See Sabrina Tavernise, "Soaring Poverty Casts Spotlight on 'Lost Decade'," *The New York Times* (September 13, 2011). An even more recent Census Bureau report using an alternative and supposedly more accurate methodology puts the number at 49.1 million. See Census Bureau, *The Research Supplemental Poverty Measure: 2010* (Washington: US Government Printing Office, November 2011), 5. And even this number woefully undercounts those who are living in poverty. First, because it still arguably underestimates the amount of money required to live a minimally decent life (it effectively defines poverty as subsistence plus a little bit, in other words, as only slightly more than one would have to receive under current law if one were a domestic pet), and second, because it expressly includes as income direct government assistance received, such as food stamps, housing assistance, home energy assistance, and the like. In other words, there are 49.1 million people currently living in poverty in the United States *despite* receiving government assistance. Surely the more relevant number for purposes of determining income inequality is the number of people who would be living in poverty *without* government assistance.

[15] See Jason DeParle, Robert Gebeloff, and Sabrina Tavernise, "Older, Suburban, and Struggling, 'Near Poor' Startle the Census," *The New York Times* (November 18, 2011). Even those who consider themselves middle class are becoming increasingly dependent on government assistance. See Binyamin Appelbaum and Robert Gebeloff, "Even Critics of Safety Net Increasingly Depend on It," *The New York Times* (February 11, 2012).

of recession itself.[16] And we continue to endure levels of unemployment unheard of since the Great Depression. Yet those at the very top of the income distribution are once again receiving near record compensation.[17] Since the Great Recession ended, the top 1 per cent has captured an unprecedented 93 per cent of the total real income growth for the entire country.[18] The top 0.1 per cent of earners have collected roughly half of all capital gains.[19] Wall Street firms (independent companies and the securities trading arms of banks) have actually earned *more* since the end of the recession than they did from 2000 to 2008.[20] The investment bank Goldman Sachs and its employees, for example, are currently enjoying one of the richest periods in the bank's 140-year history, or at least they were until very recently.[21] And the average wage for those at the very top of the top of the income distribution—those making $50 million or more—actually *increased* from $91.2 million in 2008 to a staggering $518.8 million in 2009.[22] Indeed, by 2010 total executive pay for *all* S&P 500 companies (not just Wall Street firms) was almost back to where it had been before the crash.[23] If this does not make the disparity between those at the very top of the income distribution and everybody else clear enough,

[16] See Robert Pear, "Recession Officially Over, U.S. Incomes Kept Falling," *The New York Times* (October 8, 2011). Indeed, according to the Federal Reserve, by 2010 the 2008 economic crisis had left the median American family with no more wealth than it had in the early 1990s, wiping away two complete decades of gains. See Binyamin Appelbaum, "Family Net Worth Drops to Level of Early '90s, Fed Says," *The New York Times* (June 11, 2012); Jesse Brickler, et al., "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 98:2 (Washington: Board of Governors of the Federal Reserve, June 2012).

[17] See Jacob S. Hacker and Paul Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer—and Turned Its Back on the Middle Class* (New York: Simon & Schuster 2010), 1–8.

[18] See Emmanuel Saez, "Striking it Richer: The Evolution of Top Incomes in the United States" (Updated with 2009 and 2010 Estimates).

[19] See Matthew O'Brien, "The Rich vs. the Super Rich, in 2 Charts," *The Atlantic* (August 2012).

[20] See Zachary A. Goldfarb, "Wall Street's Resurgent Prosperity Frustrates Its Claims, and Obama's," *The Washington Post* (November 6, 2011).

[21] See Graham Bowley, "Return of Record Paydays: Goldman's Bonus Pool Puts It in a Public Relations Bind," *The New York Times* (October 16, 2009). See also "Pay at Goldman Rebounds," in Jenny Anderson, "As Goldman Thrives, Some Say an Ethos Had Faded," *The New York Times* (December 16, 2009) (showing 2009 compensation for executives at Goldman Sachs as being almost as high as it was just before the 2008 crash), and Susanne Craig, "Wall Street Gets Its Groove Back, and Big Pay, Too," *The New York Times* (November 4, 2010). Goldman did report a loss for the third quarter 2011, its first since the Great Recession and only its second since it went public in 1999, but it remains to be seen whether this is an indication of things to come or just a quarterly one-off and, in either case, whether it will have any effect on the compensation the firm pays its top executives. See Susanne Craig, "Goldman Sachs Reports $428 Million Loss," and "Goldman Loss Offers a Bad Omen for Wall Street," *The New York Times* (October 18, 2011); "Goldman Sachs Cuts a Little Deeper," *The New York Times* (June 4, 2012).

[22] See David Cay Johnston, "Scary New Wage Data," *Tax Notes* 129 (October 25, 2010): 481–4.

[23] See Gretchen Morgenson, "Paychecks as Big as Tajikistan," *The New York Times* (June 18, 2011). The figures here come from Jack T. Ciesielski, "S&P 500 Executive Pay: Bigger Than . . . Whatever You Think It Is," *The Analyst's Accounting Observer* 20:7 (May 23, 2011). This trend has continued into 2011 and 2012. See Natasha Singer, "In Executive Pay, a Rich Game of Thrones," *The New York Times* (April 7, 2012); Susanne Craig and Ben Protess, "A Bigger Paycheck on Wall Street," *The New York Times* (October 9, 2012).

however, consider this: a person who picks tomatoes today receives the same basic rate of pay he received thirty years ago—adjusted for inflation, his pay has actually decreased by half.[24] In contrast, the median pay for top executives at 200 of the biggest corporations went up 23 per cent from 2009 to 2010 alone.[25] We are experiencing a level of inequality last seen in the Gilded Age, and the worst economic downturn since the Great Depression, which is what followed the last Gilded Age (see Figure 1 for a comparison of the US historical data), is already bearing down upon us.[26]

This phenomenon, moreover, is not limited to the United States. The increase in economic inequality in the US has almost been matched by that of the United Kingdom, where "the richest 10 per cent of the population are now 100 times as wealthy as the poorest 10 per cent."[27] And in the UK, just as in the US, the increase in inequality is most pronounced at the very top. When Margaret Thatcher came to power in 1979, just under 6 per cent of the national income went to the top 1 per cent. That figure stood at 9 per cent a decade later and now has risen to over 13 per cent, which means that almost one eighth of the total income earned in the UK now goes to just a tiny portion of the population.[28] And just as in the US, even within this top 1 per cent, inequalities are enormous. According to a recent report by the High Pay Commission, the top 0.1 per cent in the UK consistently takes home a larger percentage of national income than in any other advanced country

[24] See Barry Estabrook, *Tomatoland* (Kansas City, MO: Andrews McMeel, 2011), xiv. Indeed, after adjusting for inflation, the median wage for all hourly workers was actually lower in 2011 than it was a decade earlier. See Michael Cooper, "Lost in Recession, Toll on Underemployed and Underpaid," *The New York Times* (June 18, 2012) (relying on data from Lawrence Mishel, et al., *The State of Working America*, 12th edition (Economic Policy Institute, 2012).

[25] See Pradnya Joshi, "We Knew They Got Raises, But This?" *The New York Times* (July 2, 2011). See also Josh Bivens, "CEOs Distance Themselves from the Average Worker," Economic Policy Institute (November 9, 2011) (<http://www.epi.org/publication/ceo-ratio-average-worker/>) (the compensation received by CEOs was 35 times greater than that received by the average worker in 1978, but is now 243 times greater, up from 185 times greater just a few years ago at the height of the Great Recession); Steven Rattner, "The Rich Get Even Richer," *The New York Times* (March 25, 2012) ("the bottom 99 per cent received a microscopic $80 increase in pay per person in 2010, after adjusting for inflation. The top 1 per cent . . . had an 11.6 per cent increase in income.").

[26] For a nice summary of the problems the US economy is now experiencing, see Associated Press, "Economic Recovery is Weakest Since World War II," *The New York Times* (August 15, 2012). For the same on Europe, see Jack Ewing, "For Europe's Economy, a Lost Decade Looms," *The New York Times* (August 16, 2012).

[27] Amelia Gentleman and Hélène Mulholland, "Unequal Britain: Richest 10 per cent are Now 100 Times Better Off than the Poorest," *The Guardian* (January 27, 2010).

[28] See Jonathan Freedland, "It May Be Beyond Passé—But We'll Have To Do Something About the Rich," *The Guardian* (November 23, 2005), 27. For more data on the rise of economic inequality in the UK, see A. B. Atkinson, "The Distribution of Top Incomes in the United Kingdom 1908–2000," in Atkinson and Piketty, *Top Incomes over the Twentieth Century*, 82–140; National Equality Panel, *An Anatomy of Economic Inequality in the UK* (Centre for Analysis of Social Exclusion, January 2010) especially at 30; Francis Jones, Daniel Annam, and Saef Shah, "The Distribution of Household Income 1977 to 2006/07," *Economic & Labour Market Review* 2 (2008): 18–31, 24.

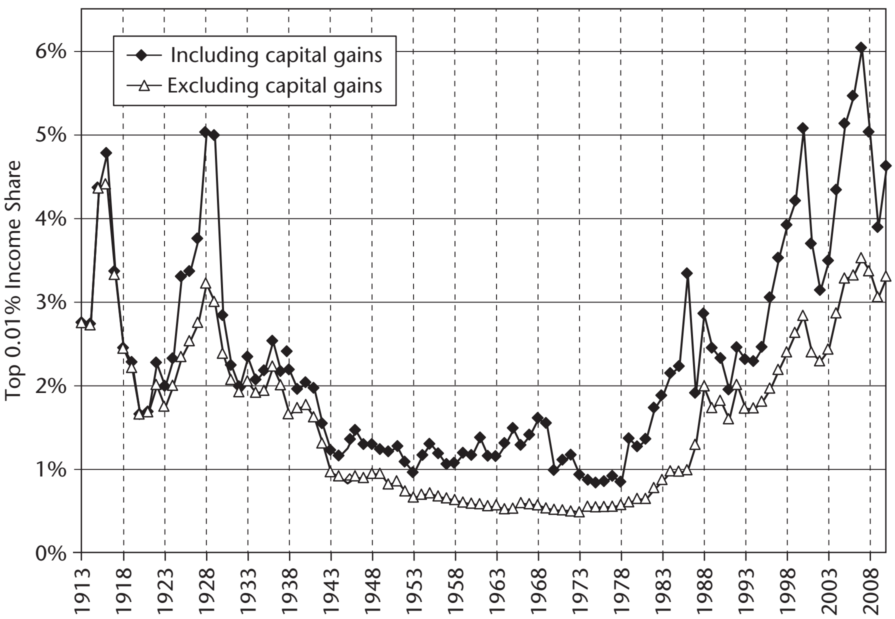

Figure 1. The Top 0.01 per cent Income Share, 1913–2010

Source: Emmanuel Saez, "Striking it Richer: The Evolution of Top Incomes in the United States (Updated with 2009 and 2010 estimates)."

Note: Income is defined as market income including (or excluding) capital gains. In 2010, the top 0.01 per cent includes the 15,617 top families with annual income above $7,890,000.

except the US.[29] In 2010 alone, the richest 1000 individuals in the UK saw their wealth increase an average of £60 million *each*.[30] That was a 20 per cent gain, following a 25 per cent gain the previous year. In 1997, the top 0.01 per cent earned 60 times the average of the bottom 90 per cent. By 2007, this had risen to 95 times the average.[31] In 2010, the chief executives of the 100 largest companies on the London Stock Exchange earned an average of £4.2 million, an increase of 49 per cent over the prior year, while their employees enjoyed an average increase of only 2.7 per cent.[32] And in 2011, the number of people classified as homeless in England jumped 14 per cent, the biggest increase for nine years.[33]

[29] See High Pay Commission Final Report, *Cheques with Balances: Why Tackling High Pay is in the National Interest* (November 22, 2011), 74.

[30] See Michael Robinson, "The Wealth Gap—Inequality in Numbers," *BBC News*, BBC World Service (broadcast January 16, 2012).

[31] See Robinson, "The Wealth Gap."

[32] See High Pay Commission Final Report, 9.

[33] See Simon Rogers, "Homelessness Jumps by 14 per cent in a Year," *The Guardian* (March 8, 2012).

Similar increases in economic inequality have occurred in many other liberal capitalist countries too. Indeed, as James Kenneth Galbraith notes, "there is a strong global pattern to the movement of inequality, with a rise, quite independent of changes in national income, beginning in the early 1980s."[34] The increases in economic inequality occurring in other Anglo-Saxon economies—Canada, Australia, New Zealand, and Ireland—are similar to those being experienced in the UK.[35] And increases are not unique to the Anglo-Saxon world. In India, the shares of the top 1 per cent, 0.1 per cent, and 0.01 per cent, after shrinking from the 1950s to the mid 1980s, are now back up again almost to the level they were at in the 1920s and 1930s.[36] In Argentina, there was an increase in top income shares after the Great Depression, followed by a substantial decline in the populist Peronist years, but since the 1990s these have been steadily increasing, just as they have in Anglo-Saxon economies, and top income shares are now even higher in Argentina than they are in the US and the UK.[37] After peaking sometime in the 1950s, top income shares have been rising since the mid 1990s in Sweden, Finland, and Norway, and are now almost as high as or even higher than they were forty years ago.[38] Although originally founded with socialist ambitions, income inequality in Israel has increased dramatically over the last twenty years, and a small group of families now control some 30 per cent of the economy, giving Israel a greater concentration of wealth than even the US and the UK.[39] Income concentration was extremely high in Japan until World War II, then there was rapid de-concentration with concentration remaining low for the rest of the century, but in the last decade top shares began to increase again as the source of income for those at the top of the income distribution began to shift from capital to employment.[40] Top income shares

[34] James K. Galbraith, "Inequality, Unemployment, and Growth: New Measures for Old Controversies," *Journal of Economic Inequality* 7 (2009): 189–206, at 203. For a comprehensive summary of this trend, see A. B. Atkinson, Thomas Piketty, and Emmanuel Saez, "Top Incomes in the Long Run of History," in *Top Incomes: A Global Perspective*, ed. A. B. Atkinson and T. Piketty (Oxford: Oxford University Press, 2010), 664–760, at 666–7.

[35] See Atkinson, Piketty, and Saez, "Top Incomes in the Long Run of History," at 664–760 and 666–7.

[36] See Abhijt Banerjee and Thomas Piketty, "Top Indian Incomes, 1922–2000," in *Top Incomes: A Global Perspective*, 1–39.

[37] See Facundo Alverado, "The Rich in Argentina over the Twentieth Century," in *Top Incomes: A Global Perspective*, 253–98.

[38] See Jesper Roine and Daniel Waldenström, "Top Incomes in Sweden over the Twentieth Century," in *Top Incomes: A Global Perspective*, 299–370; M. Jäntti, M. Riihelä, R. Sullström, and M. Tuomala, "Trends in Top Income Shares in Finland," in *Top Incomes: A Global Perspective*, 371–447; R. Aaberge and A. B. Atkinson, "Top Incomes in Norway," in *Top Incomes: A Global Perspective*, 448–81.

[39] See Ethan Bronner, "Protests Force Israel to Confront Wealth Gap," *The New York Times* (August 11, 2011); Bank of Israel Annual Report 2010 (May 2011), ch. 8, pp. 311–17 ("the level of inequality in Israel is one of the highest among the developed countries").

[40] See Chiaki Moriguchi and Emmanuel Saez, "The Evolution of Income Concentration in Japan, 1886–2005," in *Top Incomes: A Global Perspective*, 76–170; Norimitsu Onishi, "Revival in

during the colonial period peaked in Singapore in 1951, then declined and remained relatively stable for about twenty-five years, but began to increase during the last ten years and are now higher than they have ever been.[41] Not surprisingly, economic inequality has also risen dramatically in countries like Russia, Hungary, and (to a somewhat lesser extent) the Czech Republic, countries that quickly transformed themselves into more or less liberal capitalist democracies after the fall of communism in 1989.[42] And finally, economic inequality has also been rising in countries like China that are not yet liberal capitalist democracies, but are beginning the transition to such an economic and political structure from one in which the government exercises much more central political and economic control.[43]

Now some people are fond of saying that what we and other nations are experiencing is simply an unusually rough although not unprecedented example of the inevitably bumpy ride produced by the natural business cycle. Things get better, economically, for a time, then they get worse, and sometimes a great deal worse, especially for large segments of the population, then they get better again, and sometimes a great deal better. We may be able to ameliorate the effects of these business cycles to some extent through careful monetary and fiscal policy, as Keynes argued we could and should. (Indeed, this is what Keynes meant when in response to the claim that economic growth would resume all by itself in the long run he said "in the long run we are all dead."[44]) But even with the most enlightened use of these economic tools, we cannot smooth out the business cycle entirely. The downtimes simply have to be endured, for this is the price we all must pay so that there are uptimes to be enjoyed.

But of course, some pay a much greater price than others. When inequality is high, those on the lower end of the income distribution have a much harder time surviving an economic trough than those on the upper end, simply because those with greater resources are in a better position to ride the rough patches out. Even when times are good, however, high inequality is bad for most of those in the income distribution. In the United States, for

Japan Brings Widening of Economic Gap: Egalitarianism is at Stake as Rich-Poor Division Threatens Mobility," *The New York Times* (April 16, 2006), 1.

41 A. B. Atkinson, "Top Incomes in a Rapidly Growing Economy: Singapore," in *Top Incomes: A Global Perspective*, 220–52.

42 See A. B. Atkinson, *The Changing Distribution of Earnings in OED Countries*, 172–84 (Czech Republic), 241–50 (Hungary); James K. Galbraith, Ludmila Krytynskaia, and Qifei Wang, "The Experience of Rising Inequality In Russia and China during the Transition," *European Journal of Comparative Economics* 1 (2004): 87–106.

43 See Galbraith, Krytynskaia, and Wang, "The Experience of Rising Inequality in Russia and China;" Thomas Piketty and Nancy Qian, "Income Inequality and Progressive Taxation in China and India, 1986–2005," in *Top Incomes: A Global Perspective*, 40–75; Thomas Pogge, "Growth and Inequality: Understanding Recent Trends and Political Choices," *Dissent* (Winter 2008).

44 John Maynard Keynes, *A Tract on Monetary Reform* (London: Macmillan, 1923), ch. 3, p. 80.

example, the median earner had to work 62.4 per cent more hours in 2000 than he did in 1970 merely to be able to afford to send his children to an average public school.[45] The most important factor in determining educational success (and therefore future success in the workplace) is now family income, with the gap between the standardized test scores of affluent and low-income students having grown by about 40 per cent since the 1960s, and the gap between affluent and low-income students in college completion having grown by about 50 per cent since the 1980s.[46] Higher economic inequality also means less economic mobility, for the more unequal a society, the more likely it is that its children will end up in the same economic class as their parents. People have less economic mobility in the US, for example, than in almost any other advanced nation, notwithstanding the popular "American Dream" to the contrary.[47] Increases in inequality are also often associated with declines in public health, and not just for the poor—rather, such declines seem to be spread throughout the entire income distribution.[48] A high degree of economic inequality also usually indicates a corresponding degree of inequality in political power, and a greater potential for corruption and polarization of the political process.[49] High levels of inequality can also lead to social unrest,[50] and even without social unrest, there is mounting evidence that high levels of inequality have a negative effect on economic growth.[51]

[45] See Robert H. Frank, "Gauging the Pain of the Middle Class," *The New York Times* (April 4, 2011).

[46] See Sean F. Reardon, "The Widening Academic Achievement Gap between the Rich and the Poor: New Evidence and Possible Explanations," in *Whither Opportunity? Rising Inequality, School, and Children's Life Chances*, ed. Greg J. Duncan and Richard J. Murnane (New York: Russell Sage Foundation, 2011), 91–116; Martha J. Bailey and Susan M. Dynarski, "Inequality in Postsecondary Education," in *Whither Opportunity?*, 117–32.

[47] See Alan B. Krueger, Chairman, Council of Economic Advisors, "The Rise and Consequences of Inequality on the United States," Speech to the Center for American Progress (January 12, 2012, <http://www.whitehouse.gov/sites/default/files/krueger_cap_speech_final_remarks.pdf>, as well as Jason DeParle, "Harder for Americans to Rise From Lower Rungs," *The New York Times* (January 12, 2012); and Jacob S. Hacker and Nate Loewentheil, *Prosperity Economics: Building an Economy for All* (Creative Commons, 2012), 10–11 and fig. F.

[48] See Anna Bernasek, "Income Inequality, and its Cost," *The New York Times* (June 25, 2007); Michael G. Marmot, "Status Syndrome," *Journal of the American Medical Association* 295 (2006): 1304–7; Michael Marmot, "Social Determinates of Health Inequalities," *The Lancet* 365 (2005): 1099–104.

[49] See John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: Harvard University Press, 2001), 131; Paul Krugman, "Plutocracy, Paralysis, Perplexity," *The New York Times* (May 3, 2012).

[50] See Peter Osborne, "The Moral Decay of Our Society is As Bad At the Top As the Bottom," *Daily Telegraph* (August 11, 2011) (arguing that the recent spate of riots in various British cities arose in part out of the sense of selfishness and greed generated by current high levels of inequality in the UK); Eduardo Porter, "Inequality Undermines Democracy," *The New York Times* (March 20, 2012).

[51] See Andrew G. Berg and Jonathan D. Ostry, "Inequality and Unsustainable Growth: Two Sides of the Same Coin?" *IMF Staff Discussion Note* (April 8, 2011); Alberto Alesina and Dani Rodrik, "Distributive Politics and Economic Growth," *The Quarterly Journal of Economics* 109 (1994): 465–90; Jonathan Rauch, "Inequality and Its Perils," *National Journal* (September 28, 2012).

Increases in inequality can also lead to increases in unemployment.[52] And at the very least, increases in inequality mean that while the most frivolous wants of some are satiated, the most urgent needs of many go unfulfilled.[53] There are many other negative effects as well.[54] So regardless of whether the business cycle could be managed better if not totally controlled, it is a grievous fault of our economic system that economic inequality is currently so high and continues to be moving in the wrong direction. What Keynes said in 1936 could not ring more true today.[55]

It is this troubling state of affairs that I hope this book will help to remedy. But note that I will not be advocating a return to one of the settled liberal egalitarian theories of the past. On the contrary, what I intend to do is attempt to articulate and defend a new liberal egalitarian approach to economic inequality, one that is more resistant to being ignored or co-opted by the right, yet one that is also capable of being supported by a wide range of more comprehensive philosophical doctrines, not only of the left, but also of the right. The objective is to develop an approach to economic inequality for a liberal capitalist society, to show how principles that we all (or almost all) already embrace limit but do not prohibit economic inequality. And while this new liberal egalitarian theory of economic justice will require some and in some cases substantial reductions in the level of economic inequality currently obtaining in most liberal capitalist societies, it will also permit us to use the pursuit of profit as an incentive for increasing economic productivity and the economic development that such increased productivity creates.

[52] See James K. Galbraith, *Inequality and Instability* (New York: Oxford University Press, 2012), 291.

[53] See John Rawls, *Justice as Fairness*, sec. 39, p. 130.

[54] For a book length discussion of why inequality is bad for us, see Richard Wilkinson and Kate Pickett, *The Spirit Level: Why Greater Equality Makes Societies Stronger* (New York: Bloomsbury Press, 2009). See also Joseph E. Stiglitz, *The Price of Inequality* (New York: W. W. Norton & Co., 2012). Of course, many people argue that inequality is bad not only because it has bad effects, that is, because it is instrumentally bad, but also that it is bad in itself, that is, intrinsically bad. See Rawls, *Justice as Fairness*, 131–2. But I will leave this issue aside, for even if inequality is not intrinsically bad, it is still bad enough for it to be a moral imperative that we do something about it.

[55] Note that I have not described the increases in economic inequality that have taken place since 1980 by reference to changes in the Gini coefficient, one of the other standard methods that economists use to measure changes in inequality. This is because the Gini coefficient, which is expressed as a number between 0 (representing complete equality) and 1, is not as transparent and readily understandable an indicator as the actual income and wealth figures used in the text. But rest assured, if we were to look at changes in the Gini coefficient over the relevant period or at any other accepted measure of inequality for that matter, they would all reveal similar increases in inequality. See generally Congressional Budget Office, *Trends in the Distribution of Household Income between 1979 and 2007,* Publication No. 4031 (October 2011); A. B. Atkinson, "Measuring Top Incomes: Methodological Issues," in *Top Incomes*, 18–42, 19–20. On the Gini coefficient in particular, see Benjamin I. Page and Lawrence R. Jacobs, *Class War? What Americans Really Think about Economic Inequality* (Chicago: University of Chicago Press, 2009), 7 (Gini coefficient now at its highest level in sixty years). For further discussion of the Gini coefficient and various other methods for measuring inequality, see Frank A. Cowell, *Measuring Inequality*, 3rd edition (Oxford: Oxford University Press, 2011).

In short, the theory I will develop is intended to be both liberal and capitalist, and to show how those who see these two characteristics of many modern developed societies as contradictory are making a mistake.

This book is accordingly designed to be a work of political philosophy or, to be slightly more specific, of political economy. Because the latter term has been used in different ways, however, and in any event is poorly understood, I want to say something more about it here. I take political philosophy to be about the moral basis of social order—to concern what rights we have, both against each other and against our government, what roles we have in making social cooperation a successful enterprise rather than a destructive one, and how social conflicts are to be resolved when they inevitably occur.[56] I take political economy, in turn, to be a special part of political philosophy, the part that refers to how our economic relations should be organized and regulated. Political economy is economic in its subject matter because it focuses on issues such as unemployment and economic inequality, and sometimes in its method, but not in every case and most importantly not in this case. In other words, this book is not an exercise in formal economics designed to be accessible only to the specially-trained mathematically-savvy few who are already able to speak the very exclusive symbolic language that has become so popular now within contemporary economics. Indeed, this book has almost no formal economics in it. It is a book about economic *justice*, designed to be accessible to all those who are concerned about the moral status of our current economic relations and what we might do to put those relations right.[57]

While I shall focus most of my attention in this book on the problem of economic inequality, first with regard to income, and then with regard to wealth, I shall say something about unemployment too, for a concern for unemployment is often trotted out in an attempt to suppress a concern for inequality by those who contend that the solutions to these two problems are necessarily inconsistent. But I intend to resist this view. Following Keynes, I will argue that unemployment and inequality are connected, but not in the way that classical and neoclassical economists assume. Rather than increase unemployment under most conditions, reductions in inequality should increase a society's marginal propensity to consume. This, in turn, should increase the demand for goods, and the consequence of such increased

[56] Note also that I take the term "political philosophy" to be synonymous with "political theory" and use these terms interchangeably throughout.

[57] Remember also that the heavily mathematized nature of much current economic argument is a relatively recent development. The predominant method used by economists through the 1930s and 1940s is much closer to that still used today by analytic political philosophers such as John Rawls, Ronald Dworkin, and G. A. Cohen. See Alessandro Vercelli, *Methodological Foundations of Macroeconomics: Keynes & Lucas* (Cambridge: Cambridge University Press, 1991), 5 n. 5.

demand should be a *decrease* in unemployment. In other words, the views of the anti-Keynesians notwithstanding, there are good reasons to believe that we can have full or close to full employment *and* an equitable or at least less inequitable distribution of wealth and income in our society without compromising any of the fundamental principles of either economics or political morality that most of us already accept. Indeed, what I shall argue is that our failure to restrain the growth of economic inequality much less reverse it is in large part due to our failure to take the principles that we already accept seriously enough.

What these principles are, and what they logically require, I will begin discussing in a moment, but for now, I simply want to give a brief description of the most important policy implications of the theory of exploitation for which I will be arguing. First, using this theory, we can determine the morally permissible price of labor, and this has two important implications. One is that we are currently paying those at the bottom of the wage scale far too little; in order to correct this, and to prevent the continued exploitation of the most vulnerable members of our workforce, those who are unskilled, substantial increases in the minimum wage will be required. Indeed, the minimum wage must be sufficient not to only satisfy each worker's basic needs, but also to acknowledge the dignity of the worker's labor—to ensure that the worker has the means to feel that he is a full member of the society to which his work contributes, and not merely a servant to it.

This contention, I recognize, is both morally and economically controversial, and I will spend a great deal of time defending it, but in some ways, the second implication of coming up with a way of determining the morally permissible price of labor is even more controversial, for it is this: not only does justice require that we raise the existing minimum wage for unskilled labor, it also requires that we impose a *maximum* wage on those who have the privilege to be at the top of the income distribution, those who are members of top management of certain major corporations or traders or executives working in the financial industry. Simply put, those at the top are currently being paid far too much, much more than can be morally or economically justified, and one of the things I will do in this book is provide an explanation for why the imposition of certain limits on their compensation is morally required and how we can arrive at a principled calculation of what these limits are.

In addition to justifying the imposition of both maximum and minimum limits on the price of labor, the theory of exploitation I will argue for in this book also justifies the imposition of similar limits on the price of goods and services, limits that will still allow for the pursuit of very generous profits but which will not allow the pursuit of profits that are unreasonable or excessive, a distinction that I will go to some lengths later to define. Indeed, the limits for which I shall argue will largely track those currently in force under the antitrust laws of most liberal capitalist countries, but some aspects of the limits I will suggest here may be controversial even so. For one, I will argue that a certain portion of the receipts of highly profitable activities be redistributed to those who helped create them, not only to those at the very top, but to *all* workers, managers, suppliers, and service providers who contributed to these profits, according to the value of their respective contributions, an amount that the theory of exploitation I will develop and defend will allow us to define. For another, I will argue that at a certain point particular activities may become so profitable that the pursuit of even greater profits must not be allowed. While these claims will no doubt provoke a strong reaction, the reach of these limitations should not be overestimated; while they will prune the current shape of our economic activities of some of its most egregious injustices, no wholesale remaking of the economic landscape will be required, for the limits I will propose are likely to be breached only rarely. In the overwhelming majority of cases, implementation and enforcement of my theory of exploitation will require only minor administrative changes to the way we currently do business; in most cases, only the most extreme versions of ordinary transactions will be subject to more substantial interference and revision.

There is one kind of transaction, however, that will be subject to substantial supervisory regulation, and this is any transaction that is a form of what I call pure speculation, whether this involves purchases of real estate for quick resale, the trading of certain kinds of options on recognized stock or commodities exchanges, or the currently unregulated sale and purchase of various exotic derivatives such as the by now infamous credit default swap. Some of these transactions are wholly or at least substantially driven by good business reasons, at least on one side, but many are motivated by pure speculation on both sides. Such purely speculative transactions, it should by now be clear, are at least partially and most likely substantially responsible for the worldwide economic collapse that we recently experienced, and there is little economic reason to permit them, despite the spin put on these activities by those who profit from them. But whatever we may think of the economic effect of these activities, what I will show is that there is no moral basis to allow them. What I will show is that purely speculative transactions are necessarily exploitive, and therefore can and should be banned, regardless of the economic arguments that can be made for them.

Another major policy implication of the theory of exploitation I shall develop in this book has to do with the federal estate tax. One of the things my theory does is justify the imposition of such a tax, although with generous exemptions that leave it applicable only to the wealthiest individuals. Under my theory, as in the past, almost all estates would pass tax free. But the huge concentrations of wealth that the elimination of the estate tax would allow and which some have gone to great lengths to protect simply cannot be justified, for reasons that I will go on to describe in great detail. Indeed, if we actually believe in what both liberalism and capitalism necessarily demand, the inheritance of such large concentrations of wealth should and must be banned, or at least so I shall argue.

Finally, the theory of exploitation I will develop in this book has some implications for the problem of climate change. Indeed, what I hope to show is that many of the disputes that have currently paralyzed our efforts to deal effectively with this problem can be avoided if we focus on the nature of the transactions that can produce climate change rather than on these transactions' cumulative effects. By treating climate change as a global problem that requires a global solution, we must overcome what have so far proved to be insurmountable obstacles to coordinated collective action. But using the moral transactional analysis that my theory of exploitation allows us to develop and refine, I will argue that we can avoid these obstacles. What I will argue is that we have an obligation to take various preventative and remedial actions now with regard to climate change regardless of what others do, for such actions are in fact required not merely by general principles derived from concepts such as the common good but also and in this case more importantly by the rights against exploitation of living individuals.

If these various proposals seem rather radical, either in whole or in part, I assure you that they are a lot less radical than they seem. For within these (what in theory may seem like very strict but in practice will be very broad) moral limits on economic activity, limits that touch upon only the most extreme types of market transactions, I will argue that the market should be left free to operate. Indeed, nothing I will say in this book requires us to abandon any of our core beliefs or add to them in any way. My argument is that the principles we already accept limit but do not prohibit economic inequality, and that if we simply do as they require, a few may lose some special privileges that they currently enjoy but which they have obtained wrongfully and in any case do not deserve, while the vast majority of us will finally be able to live the kind of economically stable and rewarding lives that liberal capitalism promises to everyone and is currently in a position to actually deliver.

To develop these arguments, I will construct my theory of exploitation using two tools or concepts: the just price, and intolerable unfairness. The first has a long history; indeed, like many concepts in law, politics, and philosophy, the idea of the just price can trace its roots back to the ancient Greeks. The concept of intolerable unfairness, in contrast, is a more modern concept, one largely of my own invention, but as I hope to eventually make clear, it is what makes my theory liberal—it is the interaction between toleration—a key element of liberalism under almost every definition of that concept—and the reconceived notion of the just price I shall develop that will allow us to create a conception of exploitation that will regulate but not prohibit economic inequalities within a capitalist society.[58] In making my argument, then, I will proceed as follows. In Chapter 1, I will offer a working definition of my conception of exploitation, briefly describe its limits, and place that conception in some context by comparing it to the conception of exploitation employed by Marx and certain others as well as to the broader conceptions of economic justice employed by some of the most influential political theorists of today. In Chapter 2, I will discuss the doctrine of the just price, describe its historical rise and fall, and explain how it is connected to the concept of exploitation. In Chapter 3, I shall take the various limits on my theory of exploitation that I mentioned in Chapter 1 and discuss these in much greater detail, paying particular attention to how conceptions of gift and exchange, commodification, legality, capacity, voluntariness, and value relate to my conception of exploitation. In Chapter 4, I shall discuss the critical element of price, and develop a new, objective, cost-of-production-based conception of what makes a price unjust. Chapter 5, then, is one of the most critical chapters of the book, for this is where I shall discuss the concept of intolerable unfairness and show how we can use this concept to limit what would otherwise be the uncomfortably broad implications of a cost-of-production-based concept of the just price in an avowedly capitalist state. Chapter 6 takes the more theoretical points I have developed in the first five chapters of the book and connects these to a variety of concrete issues of public policy, and demonstrates how my theory of exploitation might be implemented and enforced without imposing untoward shocks on our economic system or disrupting ordinary economic life in any deleterious way. Finally, in Chapter 7, I shall close the book by arguing that the various theoretical and practical recommendations I make throughout the work can be readily embraced by adherents of a wide variety of comprehensive moral and political theories on both the left and the right. I shall also discuss the overall relationship between exploitation as I have defined it and economic inequality, and offer some final reflections on both the degree of inequality my theory of exploitation would allow and the demographics of any economic inequality that would obtain in a liberal capitalist society in which the policies suggested by my theory of exploitation were implemented and enforced.

[58] For an extended discussion of the concept of intolerable unfairness, although in a slightly different context, see my *Punishment, Compensation, and Law: A Theory of Enforceability* (Cambridge: Cambridge University Press, 2005), 151–9.

Before I embark on my exploration of the concepts of exploitation, the just price, and intolerable unfairness, however, there is one preliminary point I want to emphasize. While the theory I shall develop and present in this book is a theory of distributive justice, it is not a *comprehensive* theory of distributive justice. By that I mean it is intended to apply only to the distribution of wealth and income, and within that narrow area of concern, the area of economic justice, only to the distribution of wealth and income resulting from exchange transactions. With regard to the distribution of rights, liberties, and opportunities, and with regard to whether we have obligations to provide financial assistance to the poor, the injured, the ill, the handicapped, and the unemployed, it is silent. But what I have to say about exchange transactions will have substantial ramifications for and a significant effect on these other important distributive questions. Accordingly, my theory is not neutral with regard to the question of whether these other aspects of our social life are appropriate matters for moral concern. On the contrary, my theory is specifically designed to work within a wider liberal theory of distributive justice. There are a number of possible theories that would fit this bill, and between members of this group my theory of exploitation is indeed neutral, but I do assume that we have already accepted some conception of liberalism as one of the background conditions under which my theory of exploitation is to operate.

Because liberalism is itself a rather broad concept, however, I want to say a little more about it here. In common speech, the word "liberal" is often used as a shorthand way of referring to a set of substantive political positions that are typically associated with the moderate left. Used in this sense, the word "liberalism" refers to any political theory or program dedicated to the elucidation and promotion of these particular leftish concerns. But that is not how I will be using the word. On the contrary, I will be using the word "liberalism" to refer to a collection of fundamental presuppositions or concepts that provide the background constraints within which a certain kind of political life can take place. While I will not say much in defense of my definition of liberalism here, for purposes of this book I will take liberalism to encompass the following beliefs: that government should be neutral toward and tolerant of different conceptions of the good, that religious and political authority do not mix well and should accordingly be kept separate; that government should respect the liberty of its citizens and the rule of law even when faced by threats to its authority or to national security; that the best route to scientific truth is to be found in reason, in the dispassionate and rational evaluation of empirical evidence and the use of deductive and inductive argument, rather than in faith; that the individual rather than the community is the fundamental social unit, and while the value of community is important, it is important only as means to individual self-realization, and not as an end in itself; that all members of a political community should have an opportunity to participate in political decision-making and be provided the information and education necessary to responsibly take advantage of this opportunity; that the purpose of public discourse and debate is to persuade others of the rightness of one's position by resorting to arguments that one's opponents cannot reasonably reject; that all people have equal intrinsic moral worth; and that at least within one's own community, government should treat everyone's interests with equal concern and respect.

I do not deny that some of these presuppositions may be more important than others, or that some could perhaps be folded into or derived from other, more fundamental presuppositions, or that there may be some that I have improperly included or left out. I do not contend that my list is necessarily exhaustive or reduced to only its most fundamental components. And of course, there are many ways each of these presuppositions can be cashed out. Depending how they are cashed out (both broad and narrow conceptions of each presupposition are possible, as well as everything in between), liberals can derive a wide variety of conflicting policy proposals from these presuppositions while at least arguably staying faithful to their fundamental overriding concerns. Accepting my list of presuppositions, therefore, does not tell us what a liberal society should do—it merely gives us a very general description of the kinds of concerns that liberal societies take seriously and the way they approach and frame certain questions for moral debate. And of course, no society fully lives up to any of these presuppositions in practice no matter how committed it is to them in theory. Rather than a set of necessary and sufficient conditions for a society to be properly characterized as liberal, these presuppositions are simply a common set of aspirations that liberal societies typically embrace but satisfy in varying degrees. While the wholesale rejection of a majority of these presuppositions would suggest a society's commitment to liberalism should be questioned, I think it is safe to say that under this broad definition all the developed capitalist democracies would qualify as systems in which some conception of liberalism currently prevails.

I shall often refer to this conception of liberalism as *political* liberalism, a term also used by Rawls.[59] But when I am using this term I am doing so only to distinguish the category of political theories I have in mind from theories of *economic* liberalism, the view that the best way to promote economic development and general economic welfare is to remove the fetters from a private-enterprise economy and leave it alone.[60] So while I will be using a term that Rawls does, I do not mean to suggest that my theory assumes we have

[59] See John Rawls, *Political Liberalism*, 2nd edition (New York: Columbia University Press, 2005).
[60] See Joseph A. Schumpeter, *History of Economic Analysis* (Oxford: Oxford University Press, 1954), 394.

necessarily adopted the Rawlsian view as to precisely what political liberalism entails. On the contrary, any conception of liberalism of the political sort will do, including at least some forms of libertarianism and even traditional (as opposed to neo) conservatism. The only *political* theories I mean to exclude are theories of a *perfectionist* nature; that is, theories that embrace a specified comprehensive set of substantive moral values and contend that we should organize our political and social life in such a way as to ensure that all the members of our community embrace these values. The kind of perfectionism I mean to exclude is accordingly not *moral* perfectionism—a vision of the ideal life for a person, for everyone, including liberals, has such a vision. On the contrary, what I mean to exclude is *political* perfectionism, a vision of a very specific kind of ideal society, one where state power is used to ensure the creation and proliferation of a certain type of ideal person. For my purposes, then, perfectionism is to be understood as a certain kind of teleological theory, one that defines the good by reference to a particular view of communal excellence and makes achievement of this good the central goal of political life.

Note that the definition of perfectionism that I have offered is similar but probably broader than that employed by Rawls, for Rawls may not have intended to include conceptions of perfection that are theologically based within his definition, but only those that are based on theories of human nature or culture.[61] Under my definition, there is no such limitation, and perfectionism can be (and often is) theologically based. Note also that the kind of perfectionism I have in mind is sometimes referred to as *hard* perfectionism, which is to be distinguished from *soft* perfectionism (also sometimes called liberal perfectionism), a view advocated by Joseph Raz, Steven Wall, Thomas Hurka, George Sher, the so-called communitarians, and many others. Unlike hard perfectionists, soft perfectionists reject some presuppositions of modern liberalism, such as neutrality, but embrace others, such as toleration, or at least claim they do. Their commitment to the use of state power to create and to maintain their particular vision of an ideal society therefore purports to be stronger than that of more traditional liberals, but weaker than that of hard perfectionists. Because of this, even soft perfectionists would be considered liberals under the broad view of liberalism I am taking here. Only those who qualify as hard perfectionists would be excluded.

As an historical matter, the most common expression of political perfectionism to have actually held national power somewhere in the world is communism, but there are other significant forms of political perfectionism as well, such as those associated with various forms of politically-directed

[61] See John Rawls, *A Theory of Justice* (Cambridge, MA: Harvard University Press, 1971, rev. ed. 1999), at 22.

religious fundamentalism, including, of course, radical Islamic fundamentalism, a version of which currently holds power in Iran. American neoconservatism may also be flirting with perfectionism, for while neoconservatism is both virulently anti-communist and anti-Islamic fundamentalist, at a higher level of abstraction it shares these other movements' rejection of many if not all the presuppositions of political liberalism. But the purpose of this book is not to attempt to defend political liberalism from neoconservative or other forms of perfectionist attack—that task I have undertaken elsewhere.[62] I shall simply take political liberalism as given, and therefore as providing the preexisting superstructure within which any theory of economic justice must fit if it is to provide practical guidance on how wealth and income should be distributed in the kind of capitalist society in which we currently live.

Having said something about political liberalism and how my use of that term should be understood, I should also say something about what I mean by capitalism. Helpful definitions of capitalism, however, are curiously hard to come by. In his monumental work on the history of economic thought, Joseph Schumpeter characterizes most definitions of capitalism as surprisingly vague.[63] Indeed, definitions of capitalism can range from being quite thin to quite thick, the latter being packed with all sorts of political propositions that in effect make capitalism a political theory as well as an economic one. This is not to say that even a purely economic theory of capitalism would not have some political ramifications (Marx, among others, shows how it would), but we already have a political theory—political liberalism—to give us political direction, so our conception of capitalism should at least avoid incorporating any expressly political presuppositions. For our purposes, then, a rather thin definition of capitalism should suffice. The precise scope of the political limits that should be impressed upon capitalism will then depend on how one cashes out the various theories that make up political liberalism (including traditional conservatism and right and left libertarianism), and I shall spend a great deal of time discussing this, but I shall do so separately, not as a matter of presupposition. I will accordingly take capitalism to include only the following presuppositions: that property may be acquired, transferred, and privately owned; that the bulk of the means of production are to be held in private hands; that resources and other factors of production should be allocated and exchanged through the workings of competitive markets wherever possible rather than by central planning; that the role of government with regard to the day-to-day management of the economy is therefore primarily to police such markets for fraud, theft, anti-competitive, and other wrongful

[62] See Mark R. Reiff, "The Attack on Liberalism," in *Law and Philosophy*, ed. Michael Freeman and Ross Harrison (Oxford: Oxford University Press, 2007), 173–210.

[63] See Schumpeter, *History of Economic Analysis*, 78.

behavior rather than to make substantive allocative decisions itself; that people need economic incentives to be maximally productive; and finally, that maximizing economic productivity is the ultimate goal of capitalism, and all of the preceding presuppositions are to be interpreted with this in mind.

These presuppositions, I think it is fair to say, are present in all liberal capitalist societies and in plenty of non-liberal capitalist ones as well. And while we might quibble about whether any further presuppositions should be added to this list, it seems that these are enough if what we are trying to do is capture what these various capitalist systems have in common. More presuppositions would likely make our definition too controversial; less would make it unrepresentative and seriously incomplete. Of course, as I stated with regard to political liberalism, it might be possible and perhaps even desirable to raise some moral objections to one or more of these presuppositions, but that is not what I intend to do here. Because we are constructing a theory of economic justice for the liberal capitalist state, I shall simply take these presuppositions as given, and endeavor to construct a theory of economic justice that works within the framework that these presuppositions provide. Whether capitalism itself can be morally justified is accordingly a debate that I will assume has already taken place.

What is still up for debate is what justice requires within the presuppositions that allow the liberal capitalist state to exist. What do these presuppositions require us to do, if anything, about the distribution of wealth and income in our society? Obviously, given the degree of economic inequality we that are experiencing today, it is worth thinking about whether all is as it should be, but rest assured, this book is not designed to speak exclusively to those who already believe that something is seriously wrong with the way wealth and income is distributed in their country and need an outlet for their outrage, one that tells them what they already know or think they know or at least know they would like to hear. On the contrary, it is a sustained philosophical argument about what justice requires under the conditions in which we actually find ourselves, intended to convince not only the already converted or sympathetic but also those (indeed, especially those) who currently bristle at the idea of government interference with economic markets. What this book presents is an almost entirely positive argument for a new theory of economic justice, rather than a negative argument against the popular theories of the day. And to the extent that it includes arguments against any existing theories it takes on theories from the left and right alike. For one of the things I believe is that we have all become too comfortable with the theories of economic justice currently on offer. If we are going to move on into the future, we have to let go of theories that have not worked, or have not attracted enough popular support to be seriously tried. This is hard to do, for many of these theories, as theories go, are very appealing. They *should* work, we think, and if we can only get them right, tweak them a bit here and there, and make a serious rather than the usual half-hearted attempt to follow them, they can lead us to the Promised Land, for what they claim to be able to deliver seems to be hovering just beyond the horizon.

There is a reason, however, why these theories have not worked as well as it seems they should, and it is not just because each has to date been implemented only incompletely and inconsistently. As it turns out, the most popular theoretical approaches to the problem of economic justice do not really promote visions of an ideal world that we can approach even if not fully instantiate. Instead, they are more like interesting and thought-provoking dreams, too unconnected with reality to be reliable guides for what we should do now, but self-revealing in some sense nonetheless. We need not abandon the search for what would be ideal, of course, but we should not allow that search to monopolize our creative energies to such an extent that we cease worrying about how to deal with a world that is all too real. The job of the political philosopher is not just to theorize about a far-off world that we can reconstruct in such a way so as to make our current problems disappear, but to come up with practical ideas about what to do to address the problems that confront us in the here and now. Indeed, to paraphrase Isaiah Berlin, "we are all in trouble if the search for such ideas comes to be neglected by those whose job it is to attend to them, for we may not like the ideas that may otherwise arise to take their place."[64] Of course, the possibility that we could actually achieve economic justice has been and continues to be a dream of many, not only because the kind of extreme economic inequality we are experiencing now threatens the very viability of our democracy, equality of opportunity, and the rule of law, but also because the existence of such inequality is widely perceived as an injustice, one that diminishes us all no matter whether we are one of those who suffer because of it or one of those who benefit from its instrumental effects.[65] To achieve this dream, however, we are going to have to narrow our focus a little bit. We are going to have to stop thinking exclusively on such a grand scale and trying to develop broad principles about how to redesign our political and economic institutions, and start focusing on how to achieve economic justice given the political and economic institutions that we actually have. What we need is a theory that does not require us to abandon either of the twin towers of political liberalism and economic

[64] Isaiah Berlin, "Two Concepts of Liberty," in *Liberty*, ed. Henry Hardy (Oxford: Oxford University Press, 2002), 166–217, at 167.

[65] Indeed, a solid majority of Americans, including a majority of members of both major parties and even a majority of the rich believe that economic inequality is currently too high in America, even though many of these people also vastly *underestimate* what top earners actually make. See Page and Jacobs, *Class War?*, 34, 38, 40–1. If people were better informed about the levels of compensation the highly-compensated now enjoy, these percentages would presumably be even higher still.

capitalism on which our society currently is built. We do not need another macro-theory of economic justice that can be used to critique and then reconstruct the existing political and economic infrastructure; what we need is, but a micro-theory that has important and profound macro-effects given the infrastructure we actually have. In short, what we need is a theory that tells us how to achieve economic justice in a liberal capitalist state. It is in search of such a theory that we now set out.

1

Exploitation and Justice

I will begin by noting that there are (at least) two ways we can understand justice. We can think of justice in the distributive sense, in which case what we have in mind is how the burdens and benefits of social cooperation should be allocated across the various segments of society. In this case, exploitation and justice are related if the particular conception of exploitation we have in mind expresses some form of distributional concern and would have society-wide distributional effects. Alternatively, we can think of justice in the commutative sense (sometimes also called the corrective sense), in which case what we have in mind is how individuals, corporations, and certain other entities may and may not interact with one another. Such entities have both legal and moral rights and corresponding duties, and those who neglect their duties and violate another's right have a further duty to make recompense and, in some cases, to accept punishment as well. If we think of justice in this sense, exploitation and justice are related if there is such a thing as a right against exploitation or, to put it in a slightly different way, if exploitation refers to some required feature of an exchange transaction that someone has at least a moral if not a legal right to enforce.[1]

Note that there can be and often is a conflict between these two kinds of justice. The violation of a specific right transcends the more general concerns of distributive justice, and this violation gives rise to remedies that are independent of how the benefits and burdens of social cooperation ought to be distributed. In other words, following the violation of a right, one can have a moral duty to make recompense even if doing so would make the pattern of

[1] The distinction between distributive and commutative justice, of course, goes all the way back to Aristotle. See Aristotle, *Nicomachean Ethics*, ed. Roger Crisp (Cambridge: Cambridge University Press, 2000), bk. 5, pp. 83–102. Hobbes also made the same distinction. See Thomas Hobbes, *Leviathan* (Indianapolis, IN: Hackett, 1994), pt. 1, ch. 15, para. 14–15, pp. 94–5. For an exhaustive discussion of this distinction and how these two types of justice are and are not related, see Peter Benson, "The Basis of Corrective Justice and Its Relation to Distributive Justice," *Iowa Law Review* (1992): 515–624.

distribution then obtaining in society morally worse, for the existence of a general injustice does not license its correction by a specific injustice, even if that injustice is committed against someone who may be in part responsible for or at least a beneficiary of that general injustice. When a poor man steals a loaf of bread from a rich man, for example, commutative justice requires that he give it back, or return its value, and may even require that he be punished, even though this may result in the return to a state of affairs that represented a very serious distributive injustice. Remedying this distributive injustice is simply not something that can be rightfully done through this kind of self-help. Even when remedying a commutative injustice turns out to be consistent with the dictates of distributive justice, however, this is usually simply a coincidence rather than a reflection that there is a connection in the particular case between the two. So when a rich man steals a loaf of bread from a poor man and commutative justice requires him to give it back or return its value, this will usually further the concerns of distributive justice too, depending, of course, on the particular conception of distributive justice one has in mind, but when it does, it does so merely as a matter of happenstance and not *because* this would further the requirements of that particular conception of distributive justice.

Of course, almost any concept of commutative justice can be rephrased as a concept of distributive justice by simply refocusing on what is to be distributed; therefore it is possible to view the conflict between commutative and distributive justice as reducing to a conflict over purely distributive ideas. For example, when the poor man steals a loaf of bread from the rich man, both bread and autonomy (in the sense of security of the person and the power to control the disposition of one's possessions) have been redistributed. Even if the resulting redistribution of bread is consistent with distributive justice, the redistribution of autonomy may not be. Instead of a conflict between commutative and distributive justice, we would have a conflict between two kinds of distributive justice, or rather the application of principles of distributive justice to two different kinds of goods. But even so, the point I am making about the relationship between distributive and commutative justice would not change; only the names applied would have to be adjusted. We would still have to decide which of the two kinds of injustice that resulted were we most interested in remedying when we could not further both and, in most cases, it still seems likely that our more traditionally distributive concerns are unlikely to prevail.

As a moral concept, however, exploitation is one of those rare notions that need not subordinate the distributive concerns it reflects to the more traditional concerns that define the scope of rights protecting individual freedom and autonomy. This is because exploitation can be seen as an expression of *both* commutative justice *and* distributive justice rather than an expression of merely one or the other. In other words, an act of exploitation might be a violation of another's right, depending, of course, on how exploitation is defined, in which case exploitation is an act of commutative injustice; or it could refer to either an inherent or common feature of a certain kind of activity—say, an exchange transaction, that has wide-ranging distributional effects, again depending on how exploitation is defined, in which case exploitation is a distributive injustice; or it could be defined in such a way that it is at one and the same time an expression of both. This gives theories of exploitation a potential advantage over more general theories of distributive justice, for when a theory of exploitation is an expression of both commutative and distributive justice, it is not subject to being trumped by supposedly opposing rights.[2]

This, as I hope to make clear, is the category into which my theory of exploitation is designed to fall. Indeed, I shall define exploitation as "the unjust extraction of value from another as part of a voluntary exchange transaction not otherwise prohibited by law." I shall provide explanations of what I mean by "value," "voluntary exchange transaction," and "otherwise prohibited by law" and impose some further qualifications on this working definition later, but for now these explanations and qualifications are not important. What is important is that under this definition, an act of exploitation is not merely a violation of the injured party's rights; it is a violation of right that can be generalized into a principle of distributive justice. For if exchange transactions do not produce unjust extractions of value, then this will go some way to ensuring that the overall societal distribution of benefits and burdens is consistent with justice too, at least once a just distribution is first established, and perhaps even if it is not. The latter case, in fact, is the one I shall attempt to prove, but it will take some time to develop my argument to the point where such a proof can be proposed. I will get to this point only toward the end of the book, so for now, this particular state of affairs will have to remain a mere possibility, rather than the probability I hope to eventually show it is.

In any event, it is always best to begin not at the end but at the beginning. And the best way to begin to explore the nature and potential of the

[2] For further discussion of this feature of theories of exploitation, see James Gordley, "Contract Law in the Aristotelian Tradition," in *The Theory of Contract Law*, ed. Peter Benson (Cambridge: Cambridge University Press, 2001), 265–334, 307–18. Not that a right against exploitation is the only right that exhibits this feature. Many people contend this is also true of many of the rights that comprise tort law, contract law, and unjust enrichment—in other words, they contend that rules in these areas of law are expressions of both distributive and commutative concerns. See, e.g. Jules Coleman and Arthur Ripstein, "Mischief and Misfortune," *McGill Law Journal* 41 (1995): 91–131 (tort law); Anthony T. Kronman, "Contract law and Distributive Justice," *Yale Law Journal* 472 (1982): 472–511 (contract law); Hanoch Dagan, "The Distributive Foundation of Corrective Justice," *Michigan Law Review* 98 (1999): 138–66 (unjust enrichment).

conception of exploitation I have proffered is to place it in its proper context. This means comparing it to the various theories with which it potentially competes—that is, not only other rights-based or quasi rights-based conceptions of exploitation, but also certain currently popular general conceptions of distributive justice. Unfortunately, in this chapter, these comparisons will by necessity be somewhat brief, but I will return to them here and there whenever this enables me to better illustrate my argument, and I shall focus exclusively on them in my closing chapter. In any event, the point now is not to exhaustively analyze what is currently out there—it is merely to sketch the scene in which the philosophical action that will take up the rest of the story of this book will take place. And to do this, there is no better place to begin than with the theory of exploitation developed by Karl Marx.

1.1 Exploitation and Marx

In setting forth his theory of exploitation, the theory that formed the foundation of his critique of capitalism, Marx argued as follows. Socially necessary labor time determines value. The value of the goods a society produces is accordingly the socially necessary labor time required to produce them. This amount, in turn, is equal to the amount of socially necessary labor time required to produce the means of subsistence for the worker, for only if he is able to exist is what he produces able to exist. To the extent that the worker labors more than this—that is, to the extent that the amount of labor time necessary to produce the goods he actually produces exceeds the amount of labor time necessary to produce the means of his own subsistence, the worker has created a surplus, what Marx calls surplus value. But under capitalism, this surplus is neither retained by the worker nor returned to him in the form of wages, what Marx calls variable capital. On the contrary, because his only other option is to starve, the propertyless worker is effectively forced by circumstance to allow this surplus to be appropriated by the capitalist because the capitalist owns the means of production and therefore is in a position to demand that the worker devote himself to the capitalist's projects in exchange for whatever wages the capitalist is willing to pay. Under capitalism, the worker is accordingly exploited to the extent that produced value exceeds variable capital or, to put it another way, to the extent that the labor time necessary to produce whatever the worker produces exceeds the labor time necessary to produce whatever he may purchase with the wages paid to him by the capitalist.[3]

[3] See Karl Marx, *Capital: Volume 1: A Critique of Political Economy* (London: Penguin, 1992). Note that what I have set forth in the text is intended as a rough and ready approximation of Marx's

Now there is some controversy over whether Marx thought that exploitation was unjust. Marx's definition of exploitation is purely descriptive: it requires merely that there be a surplus of actual labor over necessary labor. Every society, even a socialist one, would require such a surplus if it is to provide health care for its citizens, public education, national defense, and other public goods. If the mere existence of such a surplus is unjust, then all societies are unjust. For Marx, then, characterizing exploitation as unjust would be meaningless, for there would be no other way a society could function. What we might characterize as unjust, however, is that in capitalist societies the worker does not control the surplus value that his labor happens to create. But Marx himself denies that this is so. He says that once the capitalist has contracted for the labor of the worker, he has a right to that labor and its fruits, and the mere fact that this labor creates a surplus for the capitalist "is a piece of good luck for the buyer, but by no means an injustice towards the seller."[4] In other words, according to Marx, exploitation is neither an act of commutative nor distributive injustice. But that did not make it just, either. On the contrary, Marx simply thought that economics came before justice—that is, the question of justice only made sense within the confines of a pre-existing commitment to a specific economic system. Without such a pre-existing commitment, exchange transactions could be neither just nor unjust. And avoiding such a pre-commitment was exactly what Marx was trying to do, for this is the only way he could be in a position to criticize capitalism "from the outside," as he was attempting to do. So it makes sense to think that for Marx, exploitation was simply a necessary by-product of all exchange transactions, and not something that he saw as meaningfully subject to moral evaluation, at least not from the perspective he was trying to adopt.[5]

On the other hand, Marx often characterized exploitation as "robbery" and "theft," words that clearly imply he thought of exploitation as unjust in the *commutative* sense, at least when the worker's surplus was being appropriated by the capitalist. And he did suggest that the worker was coerced into providing that surplus to the capitalist, which if true, would give us another reason to consider capitalist exploitation commutatively unjust without suggesting that

argument, and I do not mean to suggest that this is the only or even the best way to interpret his concept of exploitation. But it is not necessary to delve into any of these issues of interpretation here. All that is required for the arguments I am about to make is an understanding that Marx used the concept of exploitation as a basis for his critique of capitalist society. For a discussion of how Marx's argument might be restated and refined, see G. A. Cohen, "The Labor Theory of Value and the Concept of Exploitation," *Philosophy and Public Affairs* 8 (1979): 338–60.

[4] Marx, *Capital: Volume I*, 301.

[5] See John Rawls, "Marx II: His Conception of Right and Justice," in *Lectures on the History of Political Philosophy* (Cambridge, MA: Harvard University Press, 2007), pp. 335–53, at sec. 2, pp. 337–42. For an example of someone who thinks that according to Marx, capitalist exploitation is not necessarily unjust, see Allen W. Wood, "Exploitation," *Social Philosophy and Policy* 12:2 (1995): 136–58, and Allen W. Wood, *Karl Marx* (London: Routledge, 1981), especially 131.

exploitation would necessarily be unjust were this surplus provided to the community or even to the capitalist voluntarily—that is, under circumstances in which people were not forced to choose to either work or starve. And there are also reasons to see a connection between Marx's conception of exploitation and *distributive* justice. Marx's principle "from each according to his ability, and to each according to his needs,"[6] certainly *sounds* like a principle of distributive justice, and this principle is clearly violated by the process of exploitation as Marx defined it, at least in a capitalist society. And while Marx claims that economics comes before justice with regard to the moral evaluation of exchange transactions, he does not deny that the distribution of freedom and self-realization are subject to moral evaluation regardless of the economic system that is actually in place. If these are matters for distributive justice no matter what, why is the distribution of the proceeds of surplus labor not also? All of which suggests that while Marx may have *thought* he was not using the term exploitation in a morally pejorative sense, he actually was doing so. Indeed, this is precisely what a number of prominent theorists—both Marxist and non-Marxist—contend.[7] They claim that Marx *did* think that capitalist exploitation was unjust; he just did not consciously realize that he thought so.[8]

But I shall pass over this controversy here. The definition of exploitation I have offered is significantly different than the one adopted by Marx, not only given the qualifications I have attached to it in the form of the "otherwise prohibited by law" provision, the "voluntariness" provision, and the open conception of "value" it employs, but also in the fact that it expressly applies only to "unjust" extractions of value. In other words, a connection between exploitation and justice is actually built into my conception of exploitation. Whether Marx considered exploitation as he conceived it to be unjust is really beside the point of any argument I will be making; what is important is to see how Marx's conception of exploitation and injustice *could* be related. Of course, because my conception of exploitation is not only very different substantively from Marx's but also designed to function *within* an existing

[6] Karl Marx, "Critique of the Gotha Program," in *The Marx-Engels Reader*, ed. Robert C. Tucker, 2nd edition (New York: W. W. Norton, 1978), 525–41.

[7] See, e.g. Rawls, "Marx II: His Conception of Right and Justice," sec. 3, pp. 342–5; G. A. Cohen, "Exploitation in Marx: What Makes it Unjust?" in *Self-Ownership, Freedom, and Equality* (Cambridge: Cambridge University Press, 1995), 195–208; Norman Geras, "The Controversy About Marx and Justice," in *Literature of Revolution: Essays on Marxism* (London: Verso 1986), 3–57; and Norman Geras, "Bringing Marx to Justice: An Addendum and Rejoinder," *New Left Review* I/195 (1992): 37–69.

[8] For additional references to some of the literature on this controversy, see Geras, "Bringing Marx to Justice," at 38 n. 1 and 2, and Jeffrey Reiman, "Exploitation, Force, and the Moral Assessment of Capitalism: Thoughts on Roemer and Cohen," *Philosophy and Public Affairs* 16 (1987): 3–41, at 5 n. 4. See also Richard J. Arneson, "What's Wrong with Exploitation?" *Ethics* 91 (1981): 202–27.

liberal capitalist society rather than *above* all existing systems as Marx's conception of exploitation is, nothing in Marx's theory suggests that such reconceived acts of exploitation could not be unjust, no matter how Marx's theory is interpreted. But I shall not worry about whether my conception of exploitation can be comfortably recast to fit within an overall Marxian analytical framework. The point is that while the relationship between exploitation and justice under Marx's conception of exploitation is an open question, under my conception it is not. Under my conception, that relationship is presupposed or, to put it slightly differently, the relationship between justice and exploitation is established by express assumption.

One reason that I can afford to make such an assumption is that there is an important difference between Marx's conception of exploitation and the one I am proffering. Under mine, it is not true by definition that all economic systems must be comprised of widespread acts of exploitation without exception. There is accordingly no reason to think that it will not be possible to sort unjust exchange transactions from just ones in a liberal capitalist society. But my most important reason for expressly assuming a connection between exploitation and distributive and commutative injustice is simply that there is no accepted canonical non-Marxist definition of exploitation.[9] Without such a definition, there is no fixed point from which to get a discussion about the relationship between certain kinds of transactions and justice started. Some fixed point must accordingly be established by stipulation.

But this stipulation is less significant than one might think. What I have set forth is a definition of the *concept* of exploitation. This concept can be cashed out in many ways, each of which would constitute a different *conception* of exploitation.[10] By defining exploitation as unjust I am accordingly not committing myself to the view that any particular transaction that otherwise falls within my definition of exploitation—that is, that represents an extraction of value from another as part of a voluntary exchange transaction not otherwise prohibited by law—is in fact unjust, in either the commutative or distributive sense. On the contrary, by defining exploitation as unjust, I am simply defining the boundaries within which an analysis of a certain kind of transaction is to take place. The same arguments that address whether exploitation is unjust under some other presupposition are simply rephrased under the framework established by my definition as arguments about whether a *putative* conception of exploitation is an *actual* conception of exploitation or something else. Indeed, there is nothing about defining exploitation as I have that entails

[9] For an extensive but still incomplete list of the various definitions of exploitation that appear in the literature, see Alan Wertheimer, *Exploitation* (Princeton: Princeton University Press, 1996), 10–12.

[10] For a discussion of the difference between a concept and a conception, see Ronald Dworkin, *Law's Empire* (Cambridge, MA: Harvard University Press, 1986), 70–2.

a commitment to the idea that *any* instances of exploitation actually exist. The set of voluntary exchange transactions that constitute an unjust extraction of value from another not otherwise prohibited by law may in fact be empty. What assumption one begins with when analyzing the relationship between certain kinds of transactions and distributive justice is ultimately merely a question of semantics.[11]

1.2 Exploitation after Marx

Not surprisingly, because the concept of exploitation has been so closely associated with Marx, and because the relationship between Marxian exploitation and injustice is an open question, non-Marxists have tended to eschew reliance on a conception of exploitation when devising theories of distributive justice for capitalist societies, even when they are devising theories that deal exclusively with *economic* justice, which I take to be a part of but not coextensive with distributive justice. For example, the concept of exploitation plays no role whatsoever in the theories of distributive justice advanced by John Rawls, or Robert Nozick, or Ronald Dworkin, or any of the myriad political theorists who have built upon their respective works.[12] And while "analytical Marxists" such as G. A. Cohen, John Roemer, and Jon Elster have attempted to take Marx's theory of exploitation forward and revise it in ways that would allow its application to and provide a justification for democratic socialism,[13] almost no one has attempted to develop and defend a theory of exploitation that can apply to and regulate but not prohibit inequalities in a liberal capitalist welfare state.

[11] There is accordingly nothing in what I have said so far that suggests I disagree with Wood's argument that exploitation is not (necessarily) unjust. See Wood, "Exploitation." To compare Wood's position with mine one would first have to rephrase either his argument or mine using the other's terminology. Although this means there is some additional work to do when comparing our respective arguments, using the term exploitation as I have done will make the argument I intend to make both clearer and easier to set forth, primarily but not exclusively because we would otherwise lack a suitable word to describe transactions that are unjust in the way I am about to describe, so any extra work is worth the effort. In any event, many theorists assume as I do that exploitation *is* unjust, so some degree of rephrasing would be necessary to compare the arguments of exploitation theorists regardless of the assumption with which one begins.

[12] See John Rawls, *A Theory of Justice* (Harvard, MA: Harvard University Press, 1971, rev. ed. 1999); Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974); and Ronald Dworkin, "What is Equality? Parts I and II," *Philosophy and Public Affairs* 10:3 and 10:4 (1981): 185–246 and 283–345. To be fair, I should note that Nozick does discuss Marx's theory of exploitation, but only to reject it, and neither Marx's theory of exploitation nor any other plays a role in Nozick's own theory of distributive justice. Compare Nozick, ch. 8, pp. 253–62 with Nozick, ch. 7, pp. 149–231.

[13] For more on the analytical Marxists and examples of their work, see *Analytical Marxism*, ed. John Roemer (Cambridge: Cambridge University Press, 1986). For criticisms of some of the analytical Marxists, see Philippe Van Parijs, *Real Freedom for All: What (If Anything) Can Justify Capitalism?* (Oxford: Oxford University Press, 1995), 152–4, 169–77.

There are, however, two exceptions to this. The first is A. C. Pigou, the Cambridge economist who was Alfred Marshall's student and Keynes's teacher. The second is Hillel Steiner, a contemporary, left-libertarian political philosopher who has been developing what he calls a liberal theory of exploitation in a series of papers for the last twenty-five years. I shall describe Steiner's theory and explain how it differs from mine in some detail in a moment; first, however, I want to focus on Pigou.

Pigou, of course, is most famous for his work on externalities, the cost and benefits that can be imposed or conferred on non-parties to a transaction, and that work shall indeed play an important role in my development of a reconceived notion of the just price. But at this point we are interested only in Pigou's theory of exploitation, a theory he set out in *The Economics of Welfare,* published in 1920.[14] While Pigou's theory was taken up and further developed by Joan Robinson in *The Economics of Imperfect Competition*, published in 1933,[15] I think it is fair to say that as of today Pigou's theory of exploitation has no adherents and hardly even any discussants. Nevertheless, there are some important insights to be gained from examining it, so some discussion of it here is both necessary and appropriate.

Under Pigou's theory, workers are exploited whenever they are paid "less than the value their marginal net product has to the firms employing them;" that is, less than the amount the last worker hired adds to the value of the total output of the firm.[16] Value, in turn, is understood not as some amount of socially necessary labor time as in Marx but simply as money—the amount of money that the worker is paid and which his marginal product generates for the firm. In other words, Pigou's theory does not treat value as established by the cost of production, but as a measure of economic utility—the actual revenue that labor can generate and produce under the law of supply and demand given currently applicable economic conditions. Moreover, while Pigou may have limited his theory to the exchange of wages for labor, it can be generalized and applied to any factor of production that does not receive its marginal product; that is, the product of one additional unit of that factor. To put Pigou's theory in Marx's terms, then, each factor of production is entitled to receive a share of the surplus value that labor creates. Surplus value should not all go to the owner of the means of production or to the worker, but to each factor of production according to its marginal product. When and only when this does not occur would Pigou say there has been exploitation.

[14] See A. C. Pigou, *The Economics of Welfare*, 4th edition (London: Macmillan, 1932), ch. 14, pp. 549–71.

[15] See Joan Robinson, *The Economics of Imperfect Competition*, 2nd edition (London: Macmillan, 1969), ch. 25 and 26, pp. 281–304.

[16] See Pigou, *The Economics of Welfare*, at ch. 14, sec. 3, p. 551.

But Pigou's alternate formulation of the meaning of exploitation is not the only thing that is significant about Pigou's theory. While Marx's attitude toward exploitation is at best uncertain, Pigou expressly described his own version of exploitation as unfair, thereby making the connection between justice and his conception of exploitation clear. But to make this connection, Pigou used pure consequentialist moral reasoning. Pigou was heavily influenced by utilitarian thinking, and thought exploitation unfair because he believed that society should strive to maximize the general welfare of its members. To him, this meant that society's resources must be allocated in the most efficient way possible. If labor is exploited—in other words, if it is paid less than its marginal net product, resources will be inefficiently allocated, the net output of the economy will be reduced, there will be fewer goods for the economy to distribute (what Pigou calls "the national dividend"), and society will accordingly provide a level of economic welfare to its members that is necessarily lower than it has the power to achieve.[17] So while Pigou considers exploitation to be unfair, it is unfair only if one adopts Pigou's particular conception of the good and accepts all the causal connections on which he relies.

Pigou, of course, did not develop his theory of exploitation out of whole cloth. He drew not only on the work of Marshall, but also on other neoclassical sources, including John Bates Clark's *The Distribution of Wealth*, published in 1899, where Clark (one of the founders of the American Economic Association) said:

> The welfare of the laboring classes depends on whether they get much or little: but their attitude toward other classes—and, therefore, the stability of the social state—depends chiefly on the question, whether the amount they get, be it large or small, is what they produce. If they create a small amount of wealth and get the whole of it, they may not seek to revolutionize society; but if it were to appear that they produce an ample amount and get only a part of it, many of them would become revolutionaries, and all would have a right to do so. The indictment that hangs over society is that of "exploiting labor." "Workmen," it is said, "are regularly robbed of what they produce. This is done within the forms of law, and by the natural workings of competition." If this charge were proved, every right-minded man should become a socialist; and his zeal in transforming the industrial system would then measure and express his sense of justice. If we are to test the charge, however, we must enter the realm of production. We must resolve the product of social industry into its component elements, in order to see whether

[17] See Pigou, *The Economics of Welfare*, ch. 14, sec. 7–8, pp. 556–663. For further discussion of Pigou's theory, see Mark Blaug, *Economic Theory in Retrospect*, 5th edition (Cambridge: Cambridge University Press, 1996), 409–11.

> the natural effect of competition is or is not to give to each producer the amount of wealth that he specifically brings into existence.[18]

Clark, as one can see clearly from the above, was sympathetic to some of Marx's concerns, but wanted to defend capitalism from the accusation that because it was exploitive in the Marxian sense it was unjust.[19] And he did this by arguing that as long as each factor of production received its marginal product, it *was* just, because this is the amount of wealth that each factor of production actually *creates*, and as long as competition was robust, this was indeed the reward that under capitalism each factor of production would tend to receive. Justice under capitalism could accordingly be achieved simply by removing or at least regulating obstacles to competition, like corporate trusts and unions.

Pigou, of course, was much less afraid of unionization than Clark appeared to be (Pigou thought labor was much more likely to be the exploited than the exploiter), and he was much more concerned than Clark by the potential for anti-competitive behavior even after regulatory action was taken against corporate trusts. And unlike Clark, who based his claim about the justice of capitalism on the connection between the wealth a factor creates and the wealth a factor receives, Pigou based his claim about the justice of capitalism on the connection between economic efficiency and the general welfare. But otherwise, what Pigou did was to take some of the general ideas of Clark and other marginalists forward and develop them into a full-fledged theory of exploitation. Although Pigou does not actually pitch his theory this way, Pigou's theory of exploitation can accordingly be seen as a response to Marx, one that takes the question of both distributive and commutative justice seriously and tries to show that whatever Marxian exploitation is, it is not unjust. That critique must be reserved for the failure to give each factor production its marginal product.

Why Pigou's theory of exploitation never caught on, even though it did clearly tie exploitation to both distributive and commutative justice, is probably the result of several factors. First, Pigou's reclusive and socially-awkward nature made it difficult for him to attract followers, and therefore limited his appeal among his contemporaries. Second, Keynes gave Pigou such a drubbing in *The General Theory* that even though Keynes never criticized Pigou's theory of exploitation directly, all things Pigou (except, as we shall see, his work on

[18] John Bates Clark, *The Distribution of Wealth* (New York: Macmillan, 1899), 4. For an excellent critical analysis of Clark's book, see John F. Henry, *John Bates Clark: The Making of a Neoclassical Economist* (London: Macmillan, 1995), 71–88.

[19] See John F. Henry, "John Bates Clark and the Marginal Product: An Historical Inquiry into the Origins of Value-Free Economic Theory," *History of Political Economy* 15 (1983): 375–89; John M. Clark, "J. M. Clark on J. B. Clark," in *The Development of Economic Thought*, ed. Henry William Spiegel (New York: John Wiley & Sons, 1952), 592–612, at 610.

externalities) effectively lost credibility thereafter—at least, no one seems to have taken Pigou's theory of exploitation seriously since. Third, Pigou's theory seemed to make inefficiency, not injustice, the real target, for Pigouvian exploitation could only occur under conditions of imperfect competition, and calling a particular type of inefficiency "exploitation" seemed to add little of substance to the terms of the existing debate. Finally, and perhaps most importantly, Pigou's theory raised a variety of questions that for the most part neither Pigou nor anyone else ever managed to satisfactorily answer.

For example, how are we to calculate a factor's marginal productivity? While this is a key step in applying Pigou's theory, calculating the marginal productivity of anything turns out to be a rather elusive and therefore controversial task.[20] Not all factors of production are infinitely variable, and it is not always or even often possible to vary just one factor while holding all others constant, as Pigou's theory seems to require if we are to calculate marginal productivity. Indeed, estimates of average Pigouvian exploitation in the United Sates range from barely above zero to over 100 per cent, depending on how the idea of marginal productivity is cashed out, giving the US either one of the lowest or one of the highest rates of exploitation in the developed world.[21] Obviously, any theory that depends on a calculation this indeterminate is going to prove less than helpful as a guide for shaping public policy.

Second, why assume that improved economic *efficiency* always translates into greater general *welfare*? For one thing, to believe this we must believe that interpersonal comparisons of welfare are possible, and this, to say the least, is doubtful. Even if we ignore this problem, however, and believe that the general welfare is something that can be measured and therefore increased, why assume that eliminating Pigouvian exploitation will accomplish this? True, it will increase economic efficiency, or at least simulate increased economic efficiency, for Pigouvian exploitation can only take place under conditions of imperfect competition, but efficiency does not map onto justice as completely as Pigou seemed to believe. Surely there is some point where a marginal increase in economic efficiency is not worth the cost in terms of other important values. Indeed, later in his career Pigou himself acknowledged this.[22] If we are to improve upon Pigou's theory, then, we should keep our eye

[20] See Joseph Persky and Herbert Tsang, "Pigouvian Exploitation of Labor," *The Review of Economics and Statistics* 56 (1974): 52–7, at 52 n. 3; Milan Zafirovski, "Measuring and Making Sense of Labor Exploitation in Contemporary Society: A Comparative Analysis," *Review of Radical Political Economics* 35 (2003): 462–84, at 467.

[21] Compare William M. Boal and Michael R. Ransom, "Monopsony in the Labor Market," *Journal of Economic Literature* 35 (1997): 86–112, at 108 with Persky and Tsang, "Pigouvian Exploitation of Labor," at 52 n. 5 and Zafirovski, "Measuring and Making Sense of Labor Exploitation in Contemporary Society," at 472.

[22] See A. C. Pigou, "Some Aspects of Welfare Economics," *American Economic Review* 41 (1951): 287–302, at 287–8.

out for a theory that contains some mechanism for making these trade-offs between efficiency and other values.

Third, even if we ignore the trade-off problem, there are many economically efficient outcomes—why assume that eliminating Pigouvian exploitation would necessarily produce an economically efficient outcome that is just? As Rawls notes,

> The marginal product of labor depends on supply and demand. What an individual contributes by his work varies with the demand of firms for his skills, and this in turn varies with the demand for the product of firms. An individual's contribution is also affected by how many offer similar talents. There is no presumption, then, that following the precept of contribution leads to a just outcome unless the underlying market forces, and the availability of opportunities they reflect, are appropriately regulated. And this implies, as we have seen, that the basic structure as a whole [must first be made] just.[23]

In other words, unless the basic structure of society is first made just, eliminating Pigouvian exploitation may simply produce a *different* allocation of surplus value rather than a just one.

Fourth, except in the unusual case where there are constant returns to scale, the sum of the marginal products of each factor will not equal the total productivity of all factors taken as a whole.[24] On the contrary, if there are economies or diseconomies of scale—that is, if there are efficiencies to be gained or lost as output increases or decreases, as there usually are, the marginal productivity of each unit of each factor depends on the order in which each unit is employed. If we try to compensate each unit according to the marginal productivity of the last unit, there will either be not enough total production to go around or some production will be left over, a fact which at the time was described as "the problem of product exhaustion" but which has since come to be known more colloquially as "the adding-up problem."[25] Of course, compensating each unit of each factor according to its marginal product cannot be just if we end up with a remainder or a shortfall. What we want is a theory that will tell us how to distribute all and only all of the surplus value that labor creates, not one that is going to leave this question in most cases either over- or underdetermined.

In fairness, I should note that there is a way around this particular problem with Pigou's theory. This is to calculate the *average* marginal net product of each unit over all possible orderings, a figure called the Shapley value, after

[23] Rawls, *A Theory of Justice* (rev. ed. 1999), 271.

[24] See Knut Wicksell, *Lectures on Political Economy Volume I: General Theory* (London: Routledge, 1934), 126–9.

[25] See, e.g. Ingrid Hahne Rima, *Development of Economic Analysis*, 5th edition (London: Routledge, 1996), 287–8.

Lloyd Shapley, who invented it.[26] At least this solves the adding-up problem. It is not clear, however, that it solves the adding-up problem in a way that ensures the result is just. Why is it just for an individual to receive the *average* marginal net product his factor category creates rather than his actual *individual* net product? Why shouldn't order of contribution matter? Is this really morally arbitrary? Do not the first workers who come on board take a greater risk than later workers? And this problem becomes even more acute if we recognize, as is almost certainly the case, that some workers are more productive than others regardless of their order of hire. Remember, the whole basis of this way of thinking about exploitation, at least according to J. B. Clark if not Pigou himself, is the belief that justice requires that everyone receive exactly what they actually create, no more no less. So how is averaging out—which gives some workers less than they actually create and some workers more—fair? There is also an inconsistency in the Shapley procedure itself, in that it generates different results in some cases depending on the total number of sets of similar factor relationships. In other words, factor units that make identical contributions to the productivity of their respective firms over all possible orderings may receive different amounts depending on how many sets of similarly related factor units each firm employs.[27] Because it seems arbitrary for ultimate shares to turn on this, problems remain with using marginal productivity as a test for just distribution even so.[28]

Finally, why assume that eliminating Pigouvian exploitation would necessarily produce a wider diffusion of income? Pigou *wanted* his theory to produce a wider diffusion of income, and he thought it would, for he thought that his theory would require paying the working poor more, and that given the declining marginal utility of money, paying the working poor more would increase the general welfare even if this meant paying the rich less by whatever amount would be required to make up this difference.[29] Indeed, the unifying theme of his welfare economics was to identify instances where the pursuit of private gain would not necessarily redound to the general welfare without some form of government interference to overcome distorting market imperfections.[30] But some contemporary economists claim that contrary to Pigou's

[26] See H. P. Young, "Individual Contribution and Just Compensation," in *The Shapley Value: Essays in Honor of Lloyd S. Shapley*, ed. Alvin E. Roth (Cambridge: Cambridge University Press, 1988), 267–78.

[27] For further discussion and illustration of this problem, see H. Peyton Young, *Equity: In Theory and Practice* (Princeton: Princeton University Press, 1994), 71.

[28] For a description of even more technical problems with marginal productivity theory, see Mark Blaug, *The Methodology of Economics*, 2nd edition (Cambridge: Cambridge University Press, 1992), 174–7.

[29] See Pigou, *The Economics of Welfare*, 87–97, and "Some Aspects of Welfare Economics," at 299–302.

[30] See Henry William Spiegel, *The Growth of Economic Thought*, 3rd edition (Durham, NC: Duke University Press, 1991), 572–4, especially 574.

expectations and general common belief, Pigouvian exploitation is not limited to low-wage jobs, but is also likely and perhaps even more likely to occur in high-wage jobs, at least of a certain kind.[31] If this is correct, then eliminating Pigouvian exploitation might actually make current inequalities in the distribution of income worse. Instead of protecting those at the bottom of the income distribution, as Pigou thought it would, Pigou's theory might be most protective of those who are already in the best position to protect themselves. Accordingly, if preventing exploitation is to be a way of improving distributive justice, it is going to have to be pegged to something other than marginal productivity.

We turn then from Pigou, in whom interest has already come and gone, to the contemporary political philosopher Hillel Steiner, the only other non-Marxist to have exhibited an interest in exploitation theory as a way of approaching wider questions of distributive justice. Steiner, however, uses the term "exploitation" to describe a very different set of transactions than the ones on which I will be focusing. Steiner uses it to describe voluntary exchange transactions that are unjust because the price paid is higher or lower than it otherwise would have been but for the existence of some prior rights violation.[32] Steiner's theory is accordingly a causal theory about how far forward we should trace the effects of prior rights violations and treat a current transaction as morally tainted. Under his theory, there is no right against exploitation; exploitation is simply the term used to describe a form of cognizable damage that results from a prior violation of some other substantive moral right. Under my theory, in contrast, there *is* a right against exploitation. Rather than using the term to describe a certain kind of effect caused by a prior rights violation, I will be using it to refer to a separate and independent moral wrong—a transaction in which the price paid is unjust because of the relationship between that price and the value of the goods involved, regardless of whether the terms of the transaction have been affected by some sort of prior moral wrong. Which means that even though our respective theories of exploitation are quite different, they are complementary, not inconsistent.

[31] See Coldwell Daniel, III, "Pure Neoclassical Exploitation and the Level of Wages," *American Journal of Economics and Sociology* 49 (1990): 21–33. It is perhaps easier to see this if we take an example from the sports and entertainment industry rather than from a more traditional business, although there is no reason to think the problem is limited to the former. Think, for example, of the American basketball star Lebron James. Despite his enormous salary, his compensation was almost certainly only a fraction of his marginal productivity, that is, the amount of wealth his labor created for the Cleveland Cavaliers, or would create for any of the teams that were wooing him after he declared free agency, depending, of course, on how you characterize exactly what it is that a basketball team is producing.

[32] See, e.g. Hillel Steiner, "A Liberal Theory of Exploitation," *Ethics* 94 (1984): 225–41; Hillel Steiner, "Exploitation: A Liberal Theory Amended, Defended, and Extended," in *Modern Theories of Exploitation*, ed. Andrew Reeve (London: Sage, 1987), 132–48; Hillel Steiner, *An Essay on Rights* (Oxford: Blackwell, 1994), 178–87.

Because they refer to very different kinds of transactions, they could both be implemented in a society that was so inclined. Indeed, not only is my theory completely independent of Steiner's, nothing I say anywhere in this book will require the rejection or even the modification of anything in Steiner's theory, other than perhaps his use of the term "exploitation" to identify the particular set of transactions he has in mind.

Of course, there are other contemporary theorists besides Steiner who have developed what they call "theories of exploitation." But these theories all belong to a different family than Marx's, Pigou's, Steiner's, and mine. Rather than attempt to define exploitation by focusing exclusively on exchange transactions and the relationship between the price paid and some specified baseline, these theories all try to offer much more comprehensive definitions of exploitation. By that I mean they try to identify what all the acts we might be inclined to call exploitive have in common, and to come up with a theory of exploitation that explains why we have a similar reactive attitude toward all these acts. Usually this common unifying factor is described as some form of "taking unfair advantage," a phrase that is itself open to many interpretations, because one needs to know not only what constitutes "taking advantage" but also when taking advantage is "unfair."[33]

There are several possible theories I could mention here, but the one I will focus on is the theory of exploitation that David Gauthier and Gijs van Donselaar have developed out of the Lockean proviso. The Lockean proviso, you may recall, imposes a limit on the amount of property people are entitled to appropriate by mixing their labor with natural resources in the state of nature. Locke said that such appropriation was just "at least where there is enough, and as good left in common for others."[34] Later, in the course of

[33] For descriptions of the various ways that "taking advantage" can be "unfair" or otherwise "wrongful," see Joel Feinberg, *Harmless Wrongdoing* (Oxford: Oxford University Press, 1990), ch. 31; Alan Wertheimer, *Exploitation* (Princeton: Princeton University Press, 1996); Ruth Sample, *Exploitation: What It Is and Why It's Wrong* (Lanham, MD: Rowman and Littlefield, 2003), especially 7–16; and most recently, Gijs van Donselaar, *The Right to Exploit: Parasitism, Scarcity, Basic Income* (Oxford: Oxford University Press, 2009). I should note, however, that not all of those who adopt the "taking unfair advantage" approach apply it to all forms of interaction. David Miller, for example, applies it only to market transactions. See, e.g. David Miller, "Exploitation," in *Market, State, and Community: Theoretical Foundations of Market Socialism* (Oxford: Oxford University Press, 1989), 175–99, 186–7. Indeed, Miller applies his test to an even narrower class of transactions than that: he applies his taking unfair advantage test only to transactions that are not at what he calls "the equilibrium price," defined as the price someone would have paid in a perfectly competitive market where all existing holdings are justly possessed. Miller, "Exploitation," at 187–9. He concedes, however, that no market is perfectly competitive and that the question as to whether current holdings are justly possessed is highly controversial. As a practical matter, then, his test is going to be very difficult to apply to any real world transaction even if we could come up with a determinate definition of what constitutes taking unfair advantage.

[34] See John Locke, "Second Treatise on Government," in *Two Treatises on Government*, student edition, ed. Peter Laslett (Cambridge: Cambridge University Press, 1988), pp. 265–428, sec. 27, p. 288.

discussing his own principle of just initial acquisition, Nozick adopted Locke's proviso, but considered it too limiting, or at least potentially too limiting depending on how it was interpreted, and so revised it to provide that appropriation, whether accomplished by mixing one's labor with natural resources or in some other way, was just as long as it did not leave anyone worse off than they would have been in the state of nature.[35] In developing his own contractarian theory of justice, Gauthier, in turn, took Nozick's revised proviso and revised it even further. In Gauthier's version:

> The proviso prohibits bettering one's situation through interaction that worsens the situation of another. This, we claim, expresses the underlying idea of not taking advantage. . . . To require that, as a condition of bettering one's own situation, one must better the situation of others, would be to require that one give free rides. But no one is free to better their own situation through interaction worsening the situation of another. To allow that, in order to better one's situation, one may worsen the situation of another, would be to allow one to be a parasite.[36]

Gauthier accordingly turned what Nozick had turned into a rather weak constraint back into one that potentially had some teeth, for it incorporated a rough principle of reciprocity (I say rough because equal betterment is not required; all that is required is that one not better oneself at the *expense* of others). Finally, Gijs van Donselaar, writing very recently, takes Gauthier's definition of parasitism and suggests that it can also function as the basis of a definition of exploitation—to exploit another means to engage in parasitism as Gauthier has previously defined it.[37]

The problem with this approach, of course, is that there are many kinds of interactions that can leave one person better off at the expense of another, or to use economic terminology, there are many kinds of interactions that do not result in a state of affairs that is Pareto superior to the status quo, and I doubt we would want to classify all these as exploitive. Lawful competition, for example, would presumably not be considered exploitive even when it does end up bettering one person at the expense of another. In other words, before we can decide whether any action is parasitic and therefore exploitive under this definition, we must first have a theory of rights—a theory that describes the ways in which we are allowed to use others. Only when one betters oneself at the expense of others in a way that one has no right to do can this be exploitive.

[35] Nozick, *Anarchy, State, and Utopia*, 174–82.

[36] David Gauthier, *Morals by Agreement* (Oxford: Oxford University Press, 1986), 205–6.

[37] See Gijs van Donselaar, *The Right to Exploit*, 4–6, 16–19. Gauthier may have actually done this himself, although he only mentions it once and the reference is somewhat ambiguous, so whether he really intended to equate parasitism and exploitation is not entirely clear. See Gauthier, *Morals by Agreement*, 287.

Even this restatement of van Donselaar's claim, however, may not be correct, for using others in a way one has no right to do may be a sufficient but not a necessary condition for a finding of exploitation. In some situations—indeed, in the very situation that van Donselaar describes in the beginning of his book, that of *Mayor of Bradford v Pickles*,[38] the supposed act of exploitation is something that the alleged exploiter has a right to do. Exploitation, therefore, may be not only parasitic behavior that no one has a right to do, but also parasitic behavior that somehow constitutes an "abuse of rights," which then also needs to be separately defined. Now I think the whole concept of abuse of rights is not actually helpful—what we are really doing when we are defining what constitutes an abuse of rights is simply going back and defining the right involved with greater specificity so that it does not include the right to engage in the questioned behavior.[39] But whether this is the better way to think about what we are doing in abuse of rights cases or not does not matter. Either way, all the real work that has to be done to define exploitation under the Gauthier/van Donselaar approach has to be done off stage by some other theory.

van Donselaar does his best to articulate such a theory. He says that parasitic behavior is exploitive when "A is worse off than she would have been had B not existed or if she would have had nothing to do with him, while B is better off than he would have been without A, or having nothing to do with her, or vice versa."[40] What this works out to, van Donselaar claims, and what amounts to an abuse of rights, is that while people may be and indeed often have a right to be a nuisance to others, and say, divert a stream that crosses one's land and would otherwise provide water to someone down the road, they may not exploit their capacity to be a nuisance to others, that is, they may not engage in activity that makes them a nuisance *solely* for the purpose of getting those adversely affected to pay them to do something else.[41] At least I think that is a reasonable interpretation of what van Donselaar is saying if we were to put what he is saying in its best possible light.

It is unclear whether van Donselaar's definition would capture the kind of exploitation I have in mind—certainly it is not obvious that it would, and it would therefore have to be further cashed out in exactly the right way for it to do so. So there is at least some reason to question whether van Donselaar's definition is as comprehensive as it purports to be. But even setting that issue

[38] In *Mayor of Bradford v Pickles*, [1895] AC 587 (HL), Mr. Pickles had diverted a stream that passed through his property solely to prevent it from supplying the City of Bradford with water, offering to restore its flow only upon payment of a price. See van Donselaar, *The Right to Exploit*, 3.

[39] For further argument on this point, see Mark R. Reiff, "Proportionality, Winner-Take-All, and Distributive Justice," *Politics, Philosophy, and Economics* 8 (2009): 5–42, 27–31.

[40] van Donselaar, *The Right to Exploit*, 4.

[41] van Donselaar, *The Right to Exploit*, 4–6.

aside, there are a number of important differences between van Donselaar's approach and the more targeted approach I am offering here. For one, it seems that in each of its various iterations, the proviso (and whatever theory of exploitation we base thereon) is intended to apply to utilities, not value. For another, the thrice revised proviso prevents one from bettering oneself at the expense of another, at least in some circumstances, but as long as this is not done (as long as we do not make someone else worse off), it imposes no limits on how much better off one party can emerge from interaction with another. For yet another, what this last version of the proviso defines as exploitation is actually closer to my reconceived notion of the just price than to my definition of exploitation, and the differences between these two concepts are important, although we will have to explore these differences later. Finally, while my theory is narrower in one sense than this and other attempts to devise more comprehensive theories of exploitation, in another sense, it is broader.

My theory is broader in the sense that under this and various other attempts at a more comprehensive definition of exploitation, some independent criteria of unfairness must be explicitly or implicitly satisfied, and this usually requires duress or some other form of involuntariness, although the relevant theorists here disagree over whether involuntariness requires outright coercion or can be established merely by showing some kind of defect in consent that may not itself amount to an otherwise cognizable wrong.[42] My theory, however, expressly rejects involuntariness as a factor, no matter how it is defined. It also rejects the need for finding any other basis of unfairness that does not arise out of the relationship between the price paid and what I will specify as the appropriate moral baseline. In other words, my theory can find exploitation even when there has been no involuntariness, or even a lack of consent that does not by itself constitute a stand-alone violation of law, or any other separate kind of unfairness, while these more comprehensive attempts to define exploitation are unable to do this.

My conception of exploitation is also broader than these more comprehensive conceptions in another sense. These theories are more comprehensive in the sense of the kinds of acts they address, but my theory is more comprehensive in the sense of the kinds of justice it concerns and reflects, for unlike these other theories, my theory reflects a concern for both distributive and commutative justice. For example, we may indeed think that a psychotherapist who enters into a sexual relationship with his patient has taken unfair advantage of and therefore exploited her, and we might want to prohibit such an act as a

[42] See, e.g. John Lawrence Hill, "Exploitation," *Cornell Law Review* 79 (1993–1994): 631–99; David Miller, "Exploitation in the Market," in *Modern Theories of Exploitation,* ed. Andrew Reeve (Beverley Hills, CA: Sage Publications, 1987), 149–65.

result, but this impulse is not based on what we typically think of as a concern for distributive justice. Indeed, preventing this kind of exploitation may or may not have positive distributive effects, in the sense of making the overall distribution of wealth and income in society more just. As we shall see, however, under my theory an extraction of value is "unjust" only if it is a violation of the doctrine of the just price. In other words, the exclusive object of concern expressed by my theory is the concern that arises regarding the appropriate relation between price and value, and this is a matter on which distributive and commutative justice intersect. I shall explain what I mean by this in great detail later; the only point I am making now is that because more comprehensive conceptions of exploitation try to capture all instances of exploitation, their commutative function loses its necessary relationship to distributive justice. What remains is a right whose only necessary relationship is with commutative justice, which means violation of that right may require recompense even when this makes the overall pattern of distribution obtaining in society morally worse. Under my theory, in contrast, all instances of required recompense are, at least in the long run, consistent with the view of distributive justice my theory happens to express.

1.3 Exploitation as a Liberal Egalitarian Theory of Distributive Justice

I now want to briefly discuss the two main liberal theories of economic justice with which my theory of exploitation might be said to most directly compete. These are, of course, prioritarianism, as embodied in John Rawls's difference principle, the second part of the second principle of Rawls's now famous principles of justice as fairness;[43] and luck egalitarianism, first introduced by Ronald Dworkin but since taken up and developed by G. A. Cohen, Thomas Nagel, Erik Rakowski, John Roemer, Richard Arneson, Philippe Van Parijs, and many others, although each elaborates the content of luck egalitarianism in different ways.[44] Unlike Steiner's theory, these theories relate economic inequality directly to distributive justice, and find certain kinds of inequalities to be examples of separate and independent moral wrongs. But like Steiner's theory, they both focus on the overall circumstances and systemic effects of prior acts to determine whether an inequality is justified rather than looking into the details of the exchange transaction itself. In other words, the wrongs

[43] See Rawls, *A Theory of Justice*, 65–73; John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: Harvard University Press, 2001), 42–3, and 61–6.

[44] See Richard J. Arneson, "Luck Egalitarianism and Prioritarianism," *Ethics* 110 (2000): 339–49, at 339.

they identify are exclusively distributive wrongs, not commutative ones. No one has a duty not to engage in the acts that produce economic inequality under these theories. And since no one has such a duty, no one has a corresponding *right* that could be violated if that duty were not fulfilled. The moral wrong that these theories recognize is an injustice, but it is purely a distributive injustice—it is not a violation of any individual's right, at least not in the commutative sense, meaning there is no one in particular we can indentify as having violated a correlative duty.

Let us first consider Rawls's two principles of justice as fairness. These provide: (1) each person has the same indefeasible claim to a fully adequate scheme of equal basic liberties, which scheme is compatible with the same scheme of liberties for all; and (2) social and economic inequalities are justified only if (a) they are attached to offices and positions open to all under conditions of fair equality of opportunity, and (b) they are to the greatest benefit of the least advantaged members of society, meaning that some lesser degree of inequality would make the least advantaged even worse off. The first principle has lexical priority over the second, meaning that basic liberties cannot be sacrificed for greater equality of opportunity or wealth or income, and the first part of the second principle has lexical priority over the second, the part Rawls called the difference principle, meaning that equality of opportunity cannot be sacrificed for greater social and economic equality.[45]

Note that the principle of fair equality of opportunity could be interpreted to prevent most and perhaps even all economic inequalities from ever arising, and some commentators on Rawls (for example, Brian Barry) have argued that it should, leaving little actual work for the difference principle to do.[46] But I do not think that such a broad interpretation of the principle of fair equality of opportunity is consistent with the weight of the textual evidence. In the preface to the 1999 revised edition of *A Theory of Justice*, for example, Rawls noted that the role of the difference principle varied depending on whether it was being applied in the context of a property-owning democracy (or a liberal socialist regime) or a welfare state.[47] In a property-owning democracy, which is the type of system that Rawls favored, the state tries to prevent large inequalities from arising by putting everyone on an equal footing at the beginning of the relevant period and then ensuring fair equality of opportunity for all. "The background institutions of a property-owning democracy work to disperse the ownership of wealth and capital, and thus to prevent a small part of society from controlling the economy, and indirectly, political

[45] See Rawls, *Justice as Fairness*, 42–3.

[46] See, e.g. Brian Barry, *Why Social Justice Matters* (Cambridge: Polity, 2005).

[47] See Rawls, *A Theory of Justice* (rev. ed. 1999), xv. For a similar discussion, see Rawls, *Justice as Fairness*, 135–7.

life as well."[48] In other words, in a properly functioning property-owning democracy, there should indeed be little work for the difference principle to do.

Bet we do not live in a property-owning democracy; we live in a welfare state. In a welfare state, rather than preventing large economic inequalities from arising the state tries to ameliorate the effects of these inequalities by redistributing income from the most advantaged to the least at the end of each relevant period.[49] Under Rawls's own conception, then, there is *more* inequality at the end of each relevant period in a welfare state than there is in a property-owning democracy. So it is hard to see how Rawls could have thought that the difference principle had a *lesser* role to play in this context. Indeed, if anything, most liberal capitalist democracies have recently moved right, away from the welfare state toward something even further away from a property-owning democracy or liberal socialist regime, thereby making the role of the difference principle even more important. And Rawls obviously thought that there would be *some* unjustified inequality arising in this context after the principle of fair equality of opportunity did its job, for if there was so little work for the difference principle to do no matter what kind of society was at issue there would simply have been no need for the difference principle to exist.

Finally, even if we assume that the principle of fair equality of opportunity was intended to *contribute* toward controlling economic inequality in a welfare state and its even more *laissez-faire* cousins, it is difficult to see how it could function as the *primary* way of controlling economic inequality in such a context. How, for example, do we tell how much inequality would be *too* much using only the principle of fair equality of opportunity to do so? Rawls said nothing about this, and actually conceded just before his death that the principle of fair equality of opportunity remained "a difficult and not altogether clear idea."[50] But he did suggest that giving the principle of fair equality of opportunity lexical priority over the difference principle might be "too strong, and that either a weaker priority or a weaker form of the opportunity principle would be better."[51] Thus, rather than minimize the importance of the difference principle, it seems that Rawls recognized that despite its lexical inferiority the difference principle had an important role to play, and did not want his comments about the priority of the principle of fair equality of opportunity to mislead us into thinking otherwise. In any event, whatever Rawls actually thought, I think it is fair to say that not only Rawls's critics but

48 Rawls, *Justice as Fairness*, 139.
49 Rawls, *A Theory of Justice* (rev. ed. 1999), xv.
50 Rawls, *Justice as Fairness*, 43.
51 Rawls, *Justice as Fairness*, 163 n. 44.

also most Rawlsians themselves view the difference principle as the primary tool within Rawls's system of justice as fairness for regulating economic inequality, not one of Rawls's other principles of justice, at least in the kind of society in which we currently live.[52] It is therefore the difference principle on which I shall concentrate my attention here.[53]

Note that the difference principle is not strictly egalitarian. It does not prohibit all economic inequalities; it merely prohibits those that do not make the least advantaged better off—it gives improving the situation of the least advantaged priority over banning economic inequality, which is why the ideal the difference principle is thought to express is sometimes called "prioritarian" rather than "egalitarian."[54] Indeed, many of Rawls's critics on the left think the difference principle allows *too much* inequality, and argue for a much stricter principle that would severely limit and perhaps even prohibit economic inequality except in the most extreme circumstances. Yet the difference principle is also vigorously attacked by those on the right, who claim that it justifies what they consider to be an undue amount of government interference with the pattern of distribution resulting from the interplay of free market forces. And this, of course, is the difference principle's strength—its imposition of some restrictions on economic inequality distinguishes it from the principles advocated by those on the free market right, and its recognition that some level of inequality in society is morally justified because this improves the life chances of the least advantaged distinguishes it from the more radical principles of redistribution advocated by those on the strict egalitarian left. In contrast to these more extreme views, the difference principle seems to represent a moderate approach, a way of justifying some redistribution of wealth and income while at the same time acknowledging that some degree of economic inequality might actually be justified.

This is also the approach our theory of exploitation takes, but as we shall see, it goes about this in a different manner, for there is a problem with the mechanics of how the difference principle is supposed to work. Note that in order to apply the difference principle, one must make predictions about the future economic effect of current public policies, predictions that are notoriously difficult to make. There is always some possibility that any policy will

[52] We can be sure of this, I think, given the sheer magnitude of literature the difference principle has generated, something that would not have happened if the difference principle was widely believed to be an unimportant part of Rawls's overall theory. See, e.g. *The Cambridge Companion to Rawls*, ed. Samuel Freeman (Cambridge: Cambridge University Press, 2003), 524–31, 537–9 (listing just some of the hundreds of books and articles dealing with the difference principle, at least in part).

[53] For those who would like to see further argument about the proper interpretation of the scope of the difference principle vis à vis Rawls's two prior principles of justice, see Mark R Reiff, "The Difference Principle, Rising Inequality, and Supply-Side Economics: How Rawls Got Hijacked by the Right," *Revue de Philosophie Économique/Review of Economic Philosophy* (2012) (forthcoming).

[54] See, e.g. Derek Parfit, *Equality or Priority?* (The Lindley Lectures: University of Kansas, 1995).

make the least advantaged better off, and there is always some possibility that it will make them worse off still. To apply the difference principle, we accordingly need a principle of decision-making that will tell us what risks we can and cannot take with the future of the least advantaged. If we used maximin—the decision-making principle that recommends we always choose the best worst outcome and which Rawls uses to justify selection of the difference principle in the first place, at least in part—we would assume that any policy which could make the least advantaged worse off, no matter how unlikely this might be, would do so. This would effectively turn the difference principle into mere surplusage, for under it all economic inequalities would be effectively prohibited. Maximin accordingly cannot be the principle of decision-making that Rawls had in mind. On the other hand, if we used maximax—the decision-making principle that recommends we always choose the best best outcome—we would assume that any policy which could make the least advantaged better off, no matter how unlikely this might be, would do so, in which case again the difference principle would be mere surplusage, for now all economic inequalities would be permitted. So once again, this cannot be the principle that Rawls had in mind. If the difference principle is to limit but not prohibit inequality, something in between maximin and maximax is going to be required.

Unfortunately, Rawls never told us what this principle might be. And without some way of deciding what attitude toward risk justice as fairness requires, there is no way to ensure that the difference principle will work as Rawls imagined. Of course, it might be possible to find a single principle of decision-making that would express the appropriate attitude toward risk here, but for reasons that I have set out in detail elsewhere, I do not believe this is the case.[55] Nevertheless, I do not intend to reprise my arguments about this here, for nothing in my theory of exploitation turns on this. For purposes of the argument I will be making, all we need to note is that because there is empirical disagreement as to the future economic effect of specific economic policies, and because there is uncertainty regarding what attitude toward risk the difference principle requires even in the absence of empirical disagreement, there is going to be disagreement about what the difference principle advises us to do, and therefore what economic policies we should adopt, even in a society that unequivocally endorses its underlying ethos. If we truly want to decrease economic inequality from its current levels, the assistance of some

[55] See Reiff, "The Difference Principle, Rising Inequality, and Supply-Side Economics: How Rawls Got Hijacked by the Right." The difference principle also has another problem—its underlying assumption that human nature is always egoistic when in fact it is at least sometimes economically masochistic. But once again, nothing in my present argument turns on whether this particular criticism hits its mark. For those who are nevertheless interested in a discussion of this issue, see Mark R. Reiff, "The Politics of Masochism," *Inquiry* 46 (2003): 29–63.

other principle would accordingly be helpful, even if the difference principle can be interpreted in such a way that such help is not technically required.

Luck egalitarianism, in turn, suffers from a similar type of problem. Like prioritarians, luck egalitarians believe that some but not all economic inequalities are morally permissible, but luck egalitarians reject the idea that the critical factor in determining which are and which are not is whether that inequality works to the benefit of the least advantaged. Luck egalitarians are concerned not only with how things turn out, but also with the assignment of responsibility for how things turn out. For luck egalitarians, what matters is whether the inequality is a product of luck or choice.[56] But like the difference principle, the ultimate effect of luck egalitarianism is uncertain, for this depends on how its central distinction between luck and choice is cashed out. Almost any state of affairs can be meaningfully said to result from both luck and choice, and there does not seem to be a principled way of drawing a distinction between the two.[57] Like prioritarianism, luck egalitarianism can accordingly be read to allow almost all inequalities, almost none, or anything in between. Indeed, according to G. A. Cohen, luck egalitarianism seems to drop us smack into the middle of the problem of free will:

> The distinction between preferences and resources is not metaphysically deep, but it is, by contrast, awesomely difficult to identify what represents *genuine* choice. Replacing Dworkin's cut [between preferences and resources] by the one I have recommended [between choice and luck] subordinates political philosophy to metaphysical questions that may be impossible to answer.[58]

Although as Cohen also notes, this "is not a reason for not following the argument where it goes," it does mean that when confronted by an inequality, luck egalitarians, like prioritarians, are not always going to agree on precisely what their guiding principle advises us to do.

But once again, nothing in the argument I will be making here turns on this. Even if there is a principled way of sorting the effects of luck from the effects of choice, there is still room within luck egalitarianism to focus on the justice of

[56] Luck egalitarians do sometimes express the central distinction on which they focus in different terms. The comparatives used include choice and circumstance, ambitions and endowments, brute luck and option luck, and there are others still. While there might be slight differences in meaning between these various sets of terms for some purposes, for our purposes these do not matter—all these ways of expressing what luck egalitarians have in mind ultimately reduce to the distinction between luck and choice.

[57] For further discussion of the problem of indeterminacy and luck egalitarianism, see S. L. Hurley, *Justice, Luck, and Knowledge* (Cambridge, MA: Harvard University Press, 2003), 162–6; Peter Vallentyne, "Brute Luck, Option Luck, and Equality of Initial Opportunities," *Ethics* 112 (2002): 529–57, at 531–8; and Will Kymlicka, *Contemporary Political Philosophy* (Oxford: Oxford University Press, 2002), 75–86.

[58] G. A. Cohen, "On the Currency of Egalitarian Justice," *Ethics* 99 (1989): 906–44, 934.

an exchange transaction itself. The big picture, after all, is composed of many, many, little pictures, and one can change the overall composition of a picture by changing the composition of the little pictures that make it up as well as by changing (or attempting to change) the composition of the picture as a whole. Luck egalitarianism, like prioritarianism, is a big-picture changing theory. My theory of exploitation, in contrast, takes the other tack. It attempts to deal with the problem of economic inequality not by addressing the conditions that may or may not have caused it, and not by addressing the degree of economic inequality obtaining in society as a whole, but by addressing the degree of economic inequality obtaining in all the countless exchange transactions that actually make it up. It looks at justice at an atomistic level, rather than an holistic one, even though holistic inequality is the ultimate object of my concern. As we shall see, however, it is because our aim is more narrow and precise that the overall effect of our efforts can be more predictable and complete.

For now, however, the only point I want to make is that nothing in the conception of exploitation I am proposing requires that either of these liberal egalitarian theories of distributive justice be abandoned even if my criticisms of them are well founded. All that matters is that we recognize that whatever effect these theories should have in theory, they have some problems in practice. And in light of the dramatic rise in economic inequality during the period in which these theories have come to the fore, I think it is fair to say that for whatever reason, neither has produced any real, substantial reductions in inequality, nor probably even managed to slow its rise, despite their popularity among those who see this as a goal. It therefore would be helpful if there were some other principle we could use to directly attack the underlying transactions that tend to produce and then maintain overall societal economic inequality—a principle that would act not as a replacement for these existing theories, but as a supplement to them. From here on, I shall accordingly be concentrating on providing a purely positive argument for how such a new, liberal theory of economic justice might be constructed and applied. The idea is, like Marx, to rest economic justice on a conception of exploitation, but unlike Marx, to develop a conception that does not amount to a demand that capitalism be abandoned. On the contrary, the whole point of developing a liberal theory of exploitation is to design a theory that can sit comfortably within the contours of capitalism and regulate but not prohibit the inequalities that capitalism would otherwise invariably produce. With this in mind, we can turn our attention to the first task I want to undertake—explaining the connection between my concept of exploitation and the doctrine of the just price.

2

Exploitation and the Just Price

2.1 The Just Price in the Ancient World

Like many concepts in justice and philosophy, the idea of the just price goes back to Aristotle. Aristotle argued that when people voluntarily engage in any sort of exchange, the principle of reciprocity demands that each receive an amount of value from the other that is equivalent to the amount each transferred to the other. Only then is the exchange just, and only when exchange relations between members of society are predominately just can the bonds that hold society together solidify and survive. If a builder were to enter into an exchange with a shoemaker, for example, he would not do so if all he were to receive is a single pair of shoes in exchange for a house, and if this is all he did receive, the exchange would not be just. For such an exchange to be just, and in any event for any rational builder to be willing to agree to it, the value of what the builder receives from the shoemaker must be at least roughly equivalent to the value of the house, which in all but the most unusual of circumstances is going to be many times the value of a single pair of shoes. Indeed, it is precisely because of the dramatic difference in value of the goods that each party is able to produce that money was invented, Aristotle notes, for while the division of labor offers the opportunity for more efficient and extensive economic growth, these gains would be lost if an exchange like this could not take place without the builder having to go into the business of bartering shoes in order to dispose of the numerous pairs he would otherwise receive.[1]

[1] Aristotle's discussion of this is contained in Book V of the *Nicomachean Ethics*. See Aristotle, *Nicomachean Ethics*, ed. Roger Crisp (Cambridge: Cambridge University Press, 2000), bk. 5, chs 4–5, pp. 87–92, 1132a–1134a. Note that this Aristotelian principle of reciprocity in exchange is not to be confused with the much more general principle of reciprocity in social relations used by some modern theorists to generate what they claim are entire comprehensive (or at least much more wide-ranging) theories of distributive justice. See, e.g. Stuart White, *The Civic Minimum* (Oxford: Oxford University Press, 2003); Lawrence C. Becker, *Reciprocity* (New York: Routledge, 1986).

Of course, telling us that each party to the transaction should receive an amount of value equivalent to their respective contribution does not tell us anything about how value is to be determined. For Aristotle, value was to be determined by need or want, although this is usually translated less precisely as "demand." Need or want both motivates the transaction and establishes the criterion against which the respective value of each party's contribution is to be measured. The house is of greater value than a pair of shoes because it satisfies a greater need or want than a pair of shoes. And this, in turn, means that for Aristotle value was subjective, for need and want can vary from individual to individual, whereas labor and materials and other costs normally associated with the cost of production are objective, for they may vary according to time and place, but not usually accordingly to individual preferences or tastes.

Even for Aristotle, however, value was not *purely* subjective. A house does not satisfy a greater need or trigger a greater want than a pair of shoes for a shoeless wanderer. While Aristotle thought value was to be determined by need or want, he accordingly did not mean *idiosyncratic* need or want, but rather *common* need or want. In other words, Aristotle's theory of value was at least to some extent a cross between a subjective and an objective theory, or perhaps it is best characterized as a subjective theory with objective limits. Rather than turn on the whims and desires of any particular individual, it turned on the wants and needs of the general public or, to put it in more modern terms, the needs and wants of the "reasonable" man, a hypothetical construct designed to represent the needs and wants of the market as a whole, needs and wants that were in some sense normal, natural, typical, and on that basis justifiable. What it did not turn on, however, was the kind of objective factors normally associated with the cost of production.[2]

The concept of the just price also played a (now often unnoticed) role in Roman law.[3] While Roman law placed great emphasis on the doctrine of freedom of contract—the idea that sellers and buyers should be free to outwit one another when negotiating an exchange, that doctrine was not unlimited. A buyer who paid less than half the just price, again determined by need or want or demand or by what we would in most cases call the market price, was

Because nothing I shall say in this book depends on these more comprehensive theories being correct or even defensible, I shall say nothing more about them.

[2] See Joseph A. Schumpeter, *History of Economic Analysis* (Oxford: Oxford University Press, 1954), 61–2.

[3] Throughout my discussion of Roman law, and in the discussion of Canon law that follows, I have relied heavily on John W. Baldwin, "The Medieval Theories of the Just Price: Romanists, Canonists, and Theologians in the Twelfth and Thirteenth Centuries," *Transactions of the American Philosophical Society* 49 (1959): 1–92. Those who are interested in a further and much more in-depth discussion of these historical issues and in specific references to the original works of the theorists in question should consult this thorough, comprehensive, and engaging work.

subject to an action for *laesio enormis*, which literally means "enormous loss," but is perhaps more accurately thought of as "excessive harm" or "excessive violation" given that relief only became available upon a significant deviation from the just price. If the action were successful, the seller could recover the unreciprocated portion of the value of what he had exchanged or set aside the transaction altogether, at his option.

According to the Justinian Digest, the action of *laesio enormis* was first made available in AD 285 by the Emperor Diocletian. Initially, it was available only to sellers of land, but it was then extended to sellers of both real and personal property and, eventually, to buyers as well, although there was some disagreement about when the right of action for buyers would kick in. At first, it was available only to those buyers who had paid twice as much as the just price, again using the market price as a guide, at least in most cases.[4] Eventually, however, the prevailing view became that if sellers had a remedy when they received less than 50 per cent of the just price, then buyers should have a remedy when they paid 50 per cent more than the just price, not 100 per cent. In either case, however, the remedy available to buyers paralleled that available to sellers—the buyer had the right to demand a refund of the excess paid, or to set aside the transaction altogether, at his option.[5]

There is also another provision of Roman law that seems to have been driven by the same concerns that were behind the doctrine of *laesio enormis*, although it seems never to have been used to remedy violations of the doctrine of the just price. This is the action for unjust enrichment, which was typically used to allow the claimant to recover goods or funds that had ended up in the defendant's hands by mistake or without some otherwise wrongful act such as a breach of contract or a tort having taken place, but it was nevertheless thought unjust to allow the defendant to keep the goods in question.[6] Theoretically, this action could have been used to recover the goods or the amount under- or overpaid in circumstances where there had been a violation of the doctrine of the just price, but for reasons that are not entirely clear, it was not. This is somewhat surprising, for given the similarity between the concerns expressed by the two forms of action it would be reasonable to

[4] The principle exception to equating the just price with the market price was when the particular good at issue was available locally only from a monopolist. In these cases, the just price would be determined either by reference to the sale of like goods in like places where there was a competitive market, or failing this, by some other method, perhaps even by reference to the cost of production.

[5] See Baldwin, "The Medieval Theories of the Just Price," 16–31; Alan Watson, "The Hidden Origins of Enorm Lesion," *Journal of Legal History* 2 (1981): 186–93; J. B. Thayer, "Laesio Enormis," *Kentucky Law Journal* 27 (1937): 321–41, 321–6.

[6] See generally James Gordley, "The Principle of Unjustified Enrichment," in *Foundations of Private Law: Property, Tort, Contract, and Unjust Enrichment* (Oxford: Oxford University Press, 2006), 419–57; Peter Birks, "Unjust Enrichment and Wrongful Enrichment," *Texas Law Review* (2001): 1767–94.

assume that one doctrine must have influenced the development of the other. But there is no evidence that any cross-fertilization of these two forms of action ever took place. While both doctrines seem to have developed from similar concerns, and in large part took parallel tracks, they seem to have developed completely independently of each other.[7] So when it comes to Roman law, the form of action that was used to deal with violations of the doctrine of the just price was exclusively *laesio enormis*.

Roman law, however, is not the only legal source we must consult if we are looking to construct a history of the development of the doctrine of the just price. Even after the reception of Roman law into Europe, Europe was still governed by Canon law. While Canon law did not apply to the general public, it did apply to members of the Catholic Church, and that included a lot of people. Accordingly, the same transaction could sometimes be subject to the jurisdiction of both the ecclesiastical and the secular courts. And the concept of the just price also had a place in Canon law. Under Canon law, the sale of anything for more than its just price was considered *turpe lucrum*, or ill-gotten gain, and prohibited. But this prohibition did not apply to everyone within the Catholic Church. In a nod to the reality of the rising merchant class and the growing profit-driven market economy this merchant class created, only members of the clergy and official Church bodies and institutions were prohibited from selling at more than the just price—mere lay members of the Church were subject only to the limitations of *laesio enormis*, which Canon law incorporated by reference. While Canon law like Roman law equated the just price with the market price, however, it also expressly recognized some exceptions. The intentional pursuit of extraordinary profits was prohibited. One could not engage in speculation or take advantage of changes in circumstances such as droughts or wars or crop failures that had an impact on demand unless this was an unintended benefit of purchases made for some other purpose. Unless this was the case, the fact that a good was sold at the market price would not immunize the profits earned from attack. Ordinary profits, on the other hand, were justified on the grounds that these were not really profits at all, but merely compensation for the labor and expenses incurred in bringing the goods to market. Artisans and craftsmen, for example, added value to goods by laboring on them and transforming them into something else, and even merchants who added nothing to the goods

[7] They also seem to have had similar histories. Both were accepted parts of Roman law, but neither managed to find a place within modern legal doctrine until relatively recently. Indeed, unjust enrichment has only recently been rediscovered as a unifying concept for various kinds of legal actions (for Anglo-American law, the date for this is commonly put at 1936, when the *Restatement of Restitution* was first promulgated by the American Law Institute, or 1937, when it was published). As we shall see, however, the action of *laesio enormis* is largely still awaiting its incorporation into modern law.

themselves contributed value to the goods in which they dealt by providing transportation, consolidation, inspection, valuation, and coordination services. In other words, while merchants did not add labor or materials to goods, they did incur expenses in making these goods more easily accessible and, in some cases, were even responsible for what we would today call "making the market." They also assumed the risk of loss of the goods while in their care and therefore were entitled to compensation for that. In these cases, there was accordingly no reason to go behind the market price and question whether this price was indeed just.[8]

2.2 The Just Price in the Medieval World

While discussions of the just price were to be found exclusively in the work of Roman and Canon lawyers and commentators until the beginning of the thirteenth century, a re-examination of the work of Aristotle at around that time brought on a renewed interest in developing a comprehensive conception of justice among Catholic theologians, who until then had largely ignored what they apparently considered more "mundane" moral matters such as the ethics of buying and selling.[9] One of the first of the medieval theologians to focus on the ethics of exchange and the doctrine of the just price was Albertus Magnus, whose remarks on the matter are similar to Aristotle's. Like Aristotle, Albertus Magnus assigned a role to use and need in determining the value of a good. But unlike Aristotle, Albertus Magnus suggested that use and need were not all that mattered—indeed, the overall purpose of preserving equality in exchange is to ensure the repayment of labor and expenses:

> The carpenter ought to receive the product of the tanner and in turn pay the tanner that which according to a just exchange is his . . . And when this equality is not preserved, the community is not maintained, for labor and expenses are not repaid. For all would, indeed, be destroyed if he who makes a contract for so much goods of such a kind, does not receive a similar quality and quantity. For the state cannot be built up of one type of worker alone. Properly, therefore, these things are exchanged not absolutely but with a certain comparison to their value according to use and need. Otherwise there would be no exchange.[10]

[8] See Baldwin, "The Medieval Theories of the Just Price," 31–58.

[9] See Baldwin, "The Medieval Theories of the Just Price," 59.

[10] B. Alberti Magni, *Opera Omnia* (Paris: Vivés 1891), vol. vii, *In Librum V Ethicorum*, Tract. 2, ch. 9, no. 31. The quote from Albertus Magnus is translated by and set forth in E. A. J. Johnson, "Just Price in an Unjust World," *International Journal of Ethics* 48 (1938): 165–81, at 167.

With these (albeit somewhat equivocal) remarks, then, Albertus Magnus is taken to have introduced the idea that the cost of production, understood as including not only labor but also expenses, and not the market price, or at least not exclusively the market price, could provide the doctrine of the just price with its underlying theory of value.[11]

The most important of the theologians to turn their attention to the just price, however, was not Albertus Magnus but his pupil Thomas Aquinas, but not because the latter would have substantially more or something substantially more interesting to say about the doctrine of the just price. Indeed, his comments on the just price are no more extensive or any less open to conflicting interpretations than those of Albertus Magnus. Aquinas looms as a much larger figure in the history of the development of the doctrine of the just price simply because Aquinas took a much more comprehensive approach in his discussions of ethical matters and was therefore ultimately to have far greater influence on the whole category of ethical thought than his master.

Aquinas's thought on the doctrine of the just price is contained in several articles of the *Summa Theologica*; three on Aristotle's discussion of distributive and commutative justice, and two on fraud in buying and selling.[12] In one of these, Aquinas argues vociferously against what he saw as the laxity of the positive law, whether Romanist or Canonist, which would enforce violations of the doctrine of the just price only when there had been substantial deviations from its requirements. Aquinas, in contrast, insisted that

> [While] human law requires restitution if one should be cheated by more than half on the amount of the just price . . . divine law lets nothing contrary to virtue go unpunished. And so divine law reckons buying and selling illicit whenever buyers and sellers do not observe the equality required by justice. And those who gain more than they should are obliged to recompense those who have suffered more than they should, if the loss be significant.[13]

In other words, human law had to make all sorts of compromises for all sorts of reasons, but divine law brooked no compromises. Any deviation from the just price, even a penny, was a violation of divine law and therefore morally prohibited according to Aquinas. While the only sanction for such a violation in this life would be moral regret, those who were intent on living a moral life

[11] See Mark Perlman and Charles R. McCann Jr., *The Pillars of Economic Understanding: Ideas and Traditions* (Ann Arbor: University of Michigan Press, 1998), 22–3.

[12] See Thomas Aquinas, *On Law, Morality, and Politics*, 2nd edition (Indianapolis: Hackett, 2002), st. 2–2, question 61, art 1–3, pp. 123–9, and question 77, art. 1 and 4, pp. 143–8.

[13] Aquinas, *On Law, Morality, and Politics*, st. 2–2, question 77, art. 1, p. 145 (a footnote referencing the provision under Roman law authorizing the action of *laesio enormis* has been omitted).

and avoiding sanctions in the afterlife would do well to strictly observe the requirements of the just price in their transactions with their neighbors.[14]

But Aquinas's greatest contribution to just price theory is not his demand for strict observance of the doctrine; it is his discussion of how the just price is to be determined. First, Aquinas makes it clear that need or want does not justify variations in the just price:

> If the buyer benefits greatly from the goods received from the seller, and if the seller suffers no loss by being without the goods, the latter should not raise the price. The seller should not raise the price because the benefit accruing to the buyer does not come from the seller but results from the condition of the buyer, and no one can sell to another what is not one's own, although one could charge another for the loss one suffers.[15]

Of course, as was the case with Aristotle, one could take these remarks to mean that it is common or *general* need or want, rather than what may in fact be idiosyncratic or *individual* need or want, that determines the just price. But this seems inconsistent with Aquinas's reasoning. One cannot own the need or want of another man, whether it is general or individual; therefore it cannot be the seller's property to sell. Indeed, it may be the case that need or want is not something that *anyone* can own, although later I will argue that one's *own* need and want is part of what makes one a particular person and therefore *is* something that one can and in fact does own. But resolution of this particular sub-issue is not relevant to any point Aquinas is making here. As long as one cannot sell the need or want of another man, as Aquinas claims, then need or want, whether general or individual, may *motivate* the sale, but it cannot be a factor in determining the just price of what is sold. And if the need or want of another man cannot be a factor in determining the just price, then this means that the justness of a price cannot be determined by the law of supply and demand. One must use the cost of production for this.

Second, Aquinas clearly rejects the idea of pursuing profit for its own sake, which he says "seems chiefly to be the case when one sells unaltered goods more dearly" than one has paid for them.[16] He does allow the pursuit of a "moderate" business profit when this is necessary to support the seller and his family, however, or to support the needy,[17] and he also says that "one can lawfully [sell goods for more than one has paid for them], either because one has improved the goods, or because a different place or time has affected the price of the goods, or because of the danger one incurs in moving goods from one place to another or in having another do so. And neither the buying nor

[14] See Baldwin, "The Medieval Theories of the Just Price," 58–71.
[15] Aquinas, *On Law, Morality, and Politics*, 145.
[16] Aquinas, *On Law, Morality, and Politics*, 145.
[17] Aquinas, *On Law, Morality, and Politics*, at art 4, p. 147.

the selling involved is unjust."[18] In other words, when one has bought cheap and sold dear but done nothing to improve the goods involved or incurred no other costs or risks, one has in all likelihood sought profit for its own sake and violated the doctrine of the just price, at least if there have been no changes in conditions. But when one *has* improved the goods involved, or incurred other costs or risks, then one is entitled to compensation for this, the compensation to be in the form of a proportional amount of profit. While the remark about changes in condition clouds Aquinas's thinking somewhat, this may be a reference to the effects of what we understand to be inflation, and in any event, taking these remarks as a whole, they once again suggest that for Aquinas, it is the cost of production, not the market price, which determines whether a price is indeed just.

Finally, in interpreting Aquinas's views about the just price, it is important to take note not only of what Aquinas did say but also of what he did not say. And one thing he did not say—despite being aware that the just price was determined by the market price under both Roman and Canon law (indeed, it is impossible to believe that he could have been unaware of this yet aware enough of the remedy that the law provided for deviations from the just price to attack it as insufficient)—was that the market determined the just price under divine law. Even more tellingly, he made no mention of the effect of monopoly conditions or other aspects of imperfect competition that were recognized as creating exceptions to the market price theory of the just price under both Roman and Canon law. Had he seen the just price as being even partially determined by the market price, surely he would have made some reference to these widely accepted exceptions, for it is clear that in the presence of market failures, the mere fact that something represents the market price has limited or no moral force. The absence of any such comment on these exceptions must accordingly be seen as indicating once again that Aquinas considered the cost of production, not the market price, to be the more appropriate referent for determining the just price.

This, in any event, is the view endorsed by Aquinas's most immediate followers. John Duns Scotus, for example, the great Franciscan theologian of the High Middle Ages and a (much younger) contemporary of Aquinas's, also thought it was not just to profit from another man's need. Scotus said:

> If someone has great need of his property and yet is induced through the aggressive urging of another to sell or exchange it for something else, since he could compensate himself for the sizable damage he suffers, he can charge more dearly than he would otherwise do if he suffered no such harm. But if the one buying it gains considerable advantage from what is sold to him, the vendor cannot charge

[18] Aquinas, *On Law, Morality, and Politics*, at 148.

> him more dearly. For just because what I own is of greater benefit to him does not make it more precious in itself, or any better to me, and therefore I should not raise the price. But it is otherwise when I am harmed, because then what I own is more precious to me, although it is not so in itself.[19]

Scotus also emphasized that risk was a cost for which recompense was due, even if that risk never materialized, something that Aquinas said too but did not focus on to the same degree. On this, Scotus said:

> Beyond the rules which have been given above as to what is just and what is not, I add two. The first is that such an exchange be useful to the community, and the second, that such a person shall receive in the exchange recompense according to his diligence, prudence, trouble, and risk . . . This second rule follows because every man who serves the community in an honest function ought to live by his work. But such a one as transports or stores goods is of honest and useful service to the community, and should, therefore, live by his work. And, moreover, one can sell his effort and care for a just price. But great industry is required of one who transports goods from one country to another inasmuch as he must investigate the resources and needs of the country. Therefore may he take a price corresponding to his labor beyond the necessary support for himself and those of his establishment employed according to his requirements, and thirdly, something beyond this corresponding to his risk. For if he is a transporter or custodian of goods (e.g. in a warehouse), he does this at his own risk and for this risk he is in all conscience entitled to some recompense. And this is especially true if, now and then, through no fault of his own in such service to the community he suffers a loss; for a merchant engaged in transport now and then loses a ship laden with fine wares, and the custodian occasionally loses in an accidental fire, the valuable goods which he stores for the commonwealth.
>
> It is evident from these two conditions requisite in just business how some are called business men in a vituperative sense, those to wit who neither transport, nor store, nor by their own industry better a saleable article, nor guarantee the worth of some object for sale to one who lacks the necessary knowledge of the worth of it. These people who buy only to sell immediately, under none of the above conditions ought to be crushed by the community and exiled.[20]

In other words, Scotus expressly condemned the pursuit of profit that did not represent compensation for labor, expenses, or risk incurred, and saw the measure of the just price as the cost of production, plus any special losses suffered by the seller in parting with the good, not the market price subject to

[19] John Duns Scotus, *Political and Economic Philosophy*, trans. Allan B. Wolter (St. Bonaventure, NY: The Franciscan Institute, 2001), 47.

[20] Joannis Duns Scoti, *Opera Omnia* (Paris: Vivés, 1894), vol. 18, "Quaestiones in Quartum Librum Sententiarum," dist. 15, quaestio 2, no. 22, pp. 117–18. The passage is cited and translated in Bernard W. Dempsey, "Just Price in a Functional Economy," *American Economic Review* 25 (1935): 471–86, at 482–3. It is also translated by Wolter in Scotus, *Political and Economic Philosophy*, at 57–9, with similar effect.

some exceptions as many of his predecessors claimed. And while the later scholastics, especially those from the School of Salamanca, tended to favor the more traditional market-based theory of the just price, a few such as Pedro de Valencia, John Mayor, John Consobrinus, and the Viennese scholar Henry of Langenstein followed Scotus and based their conception of the just price on the cost of production.[21] Langenstein was particularly important because his formulation of the doctrine of the just price was viewed by more modern writers as characteristic of the scholastic view,[22] and for the next six hundred years or so, a good number of important Schoolmen in general and Aquinas in particular were understood as having rejected the Romanist, Canonist, and even the Aristotelian market-based conception of the just price, and as having endorsed the idea that the just price was to be determined by the cost of production.[23]

In the middle of the twentieth century, however, a series of books and articles began to appear suggesting that this represented a misreading of Aquinas's work. Despite what many of Aquinas's previous interpreters had thought, these revisionists claimed, Aquinas never held a cost-of-production view of the just price. On the contrary, like Aristotle, Aquinas simply saw the just price as the market price subject to some exceptions for market failures, a principle he never mentioned because it was by this time so obvious, and Aquinas's discussion of the cost of production was merely an attempt to

[21] See Marjorie Grice-Hutchinson, *Early Economic Thought in Spain 1177–1740* (London: George Allen & Unwin, 1978), 98–102; Marjorie Grice-Hutchinson, *The School of Salamanca* (Oxford: Oxford University Press, 1952), 24–35, 89–119; Raymond de Roover, "The Concept of the Just Price: Theory and Economic Policy," *Journal of Economic History* 18 (1958): 418–34, 424; Jeffrey T. Young and Barry Gordon, "Economic Justice in the Natural Law Tradition: Thomas Aquinas to Francis Hutcheson," *Journal of the History of Economic Thought* 14 (1992): 1–17, 4.

[22] See Roover, "The Concept of the Just Price," at 419, 420; O. F. Hamouda and B. B. Price, "The Justice of the Just Price," *European Journal of the History of Economic Thought* 4 (1997): 191–216, 194–5, 199–201; Young and Gordon, "Economic Justice in the Natural Law Tradition," 4.

[23] See, e.g. Selma Hagenauer, *Das "justum pretium" bei Thomas von Aquino* (Stuttgart: W. Kohlhammer, 1931); R. H. Tawney, *Religion and the Rise of Capitalism* (New York: Harcourt, Brace & Co., 1926), 40; Rudolf Kaulla, *Theory of the Just Price: A Historical and Critical Study of the Problem of Economic Value*, trans. Robert D. Hogg (London: George Allen and Unwin, 1936, 1940), 37–8; Hannah Robie Sewall, "The Theory of Value Before Adam Smith," *Publications of the American Economic Association* 2 (1901): 539–666, 565; Lewis Watt, "The Theory Lying Behind the Historical Conception of the Just Price," in *The Just Price: an Outline of the Mediaeval Doctrine and an Examination of its Possible Equivalent Today*, ed. V. A. Demant (London: Student Christian Movement Press, 1930), 60–75; William James Ashley, *An Introduction to English Economic History and Theory, Part I* (London: Longmans Green & Co. 1911), 138. Like his counterparts among the scholastics, Maimonides, the great medieval Jewish scholar, also had a cost-based conception of the just price, at least for certain goods, although for other goods he seemed to suggest it was just to look to the market price. See Salo Wittmayer Baron, "The Economic Views of Maimonides," in *Essays on Maimonides*, ed. Salo W. Baron (New York: Columbia University Press, 1941), 127–264, at 174–5. On the just price in Talmudic literature more generally, see Ephraim Kleiman, "'Just Price' in Talmudic Literature," *History of Political Economy* 19 (1987): 23–45, and A. Ehrman, "*Pretium Iustum* and *Laesio Enormis* in Roman and Jewish Sources," *The Jewish Law Annual* 3 (1980): 63–73; H. F. Jolowicz, "The Origins of *Laesio Enormis*," *Juridical Review* 49 (1937): 50–72.

explain why the market price was just, for in a perfectly competitive market the long-run market price would in fact equal the cost of production.[24] Curiously, none of these revisionists mention Aquinas's claim that one cannot own the need or want of another man and therefore cannot profit from it, or how this is supposed to be understood if Aquinas actually had a market-based rather than a cost-of-production based conception of the just price. Nevertheless, similar claims were made about Albertus Magnus too.[25] Only Scotus was acknowledged by the revisionists to have actually held a cost-of-production conception of the just price.[26]

Unfortunately, the revisionist interpretation of the scholastics' view of the just price had great influence for a time. Indeed, even Rawls may have accepted it.[27] Recently, however, a kind of counter-revisionist movement has begun to develop. According to the counter-revisionists, Aquinas and Magnus *are* to be credited with tying the doctrine of the just price to the cost of production, although they are also to be criticized for having inconsistently tied calculation of the just price to elements of the market price too.[28] Obviously, this attempt at rehabilitation of the original reading of the scholastics is somewhat equivocal, and as a result some theorists today seem to think that attributing a coherent view to these scholastics is actually hopeless—the various statements about the just price by Aquinas and his fellow scholastics are sufficiently ambiguous that they can be taken to support any reading.[29]

[24] See, e.g. Schumpeter, *History of Economic Analysis*, 93; Roover, "The Concept of the Just Price" and "Joseph A. Schumpeter and Scholastic Economics," *Kyklos* 10 (1957): 115–43; John T. Noonan, "The Concept of the Just Price," in *The Scholastic Analysis of Usury* (Cambridge, MA: Harvard University Press, 1957), 82–99, 84–8.

[25] See Watt, "The Theory Lying Behind the Historical Conception of the Just Price," at 62–3.

[26] See, e.g. Roover, "Joseph A. Schumpeter and Scholastic Economics," at 147. But see Odd Langholm, *Economics in the Medieval Schools: Wealth, Exchange, Value, Money and Usury according to the Paris Theological Tradition 1200–1350* (Leiden: E. J. Brill, 1992), 411–12.

[27] See Rawls, *A Theory of Justice* (1971 ed.), 271; (1991 rev. ed.), 239–40. Note, however, that what we have here is a single, off-hand remark, which may or may not have been equivalent to Rawls's considered opinion had he looked into the matter more deeply.

[28] See David D. Friedman, "In Defense of Thomas Aquinas and the Just Price," *History of Political Economy* 12 (1980): 234–42; Samuel Hollander, "On the Interpretation of the Just Price," *Kyklos* 18 (1975): 615–34, 618; Stephen Theodore Worland, *Scholasticism and Welfare Economics* (Notre Dame: University of Notre Dame Press, 1967), 210–33. Friedman argues that Aquinas did indeed see the cost of production as the measure of the just price under certain conditions; Worland argues that Aquinas saw the cost of production as an element but not the only element of the just price; Hollander argues that Aquinas saw the cost of production as determinative no matter what.

[29] See George W. Wilson, "The Economics of the Just Price," *History of Political Economy* 7 (1975): 56–74, 59–60; Stephen T. Worland, "*Justum Pretium:* One More Round in an 'Endless Series,'" *History of Political Economy* 9 (1977): 504–21, 505–6; André Lapidus, "Norm, Virtue and Information: The Just Price and Individual Behaviour in Thomas Aquinas' *Summa Theologiae*," *European Journal of the History of Economic Thought* 1 (1994): 435–73, at 439. Some commentators took this position even before the first revisionist movement. See, e.g. Marjorie Grice-Hutchinson, *The School of Salamanca*, 28–9.

But while a proper exposition of Aquinas's works is of some historical interest, it is not important to us here. What is important is that Aquinas is viewed by many as a precursor to Marx in the sense that Aquinas is seen as responsible for visibly connecting the concept of the just price with the cost of production and otherwise bringing the idea of the cost of production to the fore.[30] And it is this focus on the cost of production, in turn, that at least some believe led to the development of the labor theory of value, for this seemed to be the natural way of reducing the cost of production to a single, uniform unit of measure. Indeed, as R. H. Tawney famously (albeit some think mistakenly) said, "The true descendant of the doctrines of Aquinas is the labor theory of value. The last of the Schoolmen is Karl Marx."[31]

2.3 The Just Price in the Renaissance, the Age of Enlightenment, and on into the Modern World

Before we get to Marx, however, there is a lot of philosophical ground to cover, for Marx will not appear for another five hundred years. Or rather, there should be a lot of philosophical ground to cover. Especially since Martin Luther, when kicking off the Reformation, did not reject the views of Scotus, Aquinas, Magnus, and the other Schoolmen who had spoken of the just price as determined by the cost of production, but rather followed their views on this, at least in part, so a concern for the just price is also a Protestant phenomenon.[32] Indeed, in his 1524 sermon *On Trade and Usury* Luther said:

> Among themselves the merchants have a common rule which is their chief maxim and the basis of all their sharp practices, where they say: "I am free to sell my goods as dear as I can." They think this is their right. Thus occasion is given for avarice, and every window and door to hell is opened. What else does it mean but this: I care nothing for my neighbor; so long as I have my profit and satisfy my greed, of what concern is it to me if it injures my neighbor in ten ways at once? There you see how shamelessly this maxim flies squarely in the face not only of Christian love but also of natural law. How can it be without sin when such injustice is the chief maxim and rule of the whole business? On such a basis trade can be nothing but robbing and stealing the property of others.
>
> When once the rogue's eye and greedy belly of a merchant find that people must have his wares, or if the buyer is poor and needs them, he takes advantage of him and raises the price. He considers not the value of the goods, or what his own efforts and risk have deserved, but only the other man's want and need. He notes it

[30] See Baldwin, "The Medieval Theories of the Just Price," 71–80.
[31] Tawney, *Religion and the Rise of Capitalism*, 36.
[32] See Odd Langholm, "Martin Luther's Doctrine on Trade and Price in Its Literary Context," *History of Political Economy* 41 (2009): 89–107, 95–7.

> not that he may relieve it but that he may use it to his own advantage by raising the price of the goods, which he could not have raised if it had not been for his neighbor's need. Because of his avarice, therefore, the goods must be priced as much higher as the greater need of the other fellow will allow, so that the neighbor's need becomes as it were the measure of the goods' worth and value. Tell me, isn't that an un-Christian and inhuman thing to do? Isn't that equivalent to selling a poor man his own need in the same transaction? When he has to buy his wares a higher price because of his need, that is the same as having to buy his own need; for what is sold to him is not simply the wares as they are, but the wares plus the fact that he must have them. Observe that this and like abominations are the inevitable consequences when the rule is that I may sell my goods as dear as I can.
>
> The rule ought to be, not, "I may sell my wares as dear as I can or will," but, "I may sell my wares as dear as I ought, or as is right and fair." For your selling ought not to be an act freely within your own power and discretion, without law or limit, as though you were a god and beholden to no one...
>
> You ask, then, "How dear may I sell? How am I to arrive at what is fair and right so I do not take increase from neighbor or overcharge him?" Answer: That is something that will never be governed by writing or speaking; nor has anyone ever undertaken to fix that value of every commodity, and to raise or lower prices accordingly. The reason is this: wares are not all alike; one is transported a greater distance than another and one involves greater outlay than another. In this respect, therefore, everything is and must remain uncertain, and no fixed determination can be made, anymore than one can designate a certain city as the place from which all wares are to be brought, or establish a definite cost price for them. It may happen that the same wares, brought from the same city by the same road, cost vastly more one year than they did the year before because the weather may be worse, or the road, or because something else happens that increases the expense at one time above that at another time. Now it is fair and right that a merchant take as much profit on his wares as will reimburse him for their cost and compensate him for his trouble, his labor, and his risk.[33]

In the interest of completeness, I should note that in the same sermon Luther goes on to acknowledge that it may be impossible to make these calculations in many situations, in which case "the next best thing" is to charge the price the market has set, making his view less than unequivocal (although not now, given the advent of modern accounting), but even so, I think it is fair to say that Luther believed no one should ever *knowingly* charge more than the cost of production, which included compensation for the seller's trouble, labor, and risk, and that everyone had some obligation to do their best to calculate

[33] Martin Luther, "On Trade and Usury," in *Selected Writings of Martin Luther: Volume 3: 1523–1526*, ed. Theodore Gerhardt Tappert (Fortress Press, 1967), 71–150, at 88–9.

this.[34] Nevertheless, Luther's views on the just price seem to have had little impact on the philosophers of the time or even on other theologians and have rarely been noted since.

Indeed, despite the intense interest in the doctrine of the just price exhibited by the Schoolmen, there is very little attention paid to it by anybody thereafter. While John Calvin rails against fraud and sharp dealing in trade, and bemoans the oppression of the poor, he says nothing about the just price.[35] There is almost no mention of the doctrine by the philosophers of the Renaissance. And the philosophers of the Enlightenment—the precise individuals whom we would think of as being naturally inclined to embrace the doctrine of the just price and establish it as one of the fundamental rights of man, seem more interested in setting the doctrine back, if they have anything to say about it at all. Thomas Hobbes, for example, does not discuss the issue of justice in exchange, but simply asserts that there can be no injustice between a willing seller and a willing buyer: "for commutative justice placed in buying and selling, though the thing bought be unequal to the price paid for it; yet forasmuch as both the buyer and the seller are made judges of the value, and are both satisfied: there can be no injury done on either side, neither having trusted, or covenanted with the other."[36] Hugo Grotius, following and indeed citing Aristotle, simply asserts without discussion that the just price is the market price, and describes the legal willingness to intervene only when deviation was considerable as a sensible practical compromise undertaken to limit the proliferation of lawsuits.[37] And while Samuel Pufendorf has a long discussion on exchange value and how such values are set, he does little more than restate the prevailing Aristotelian view that the just price is the market price unless there has been a market failure—he never mentions Luther's more cost-of-production orientated views on this, despite being the son of a Lutheran pastor.[38]

For something that represents real engagement with the doctrine of the just price we have to wait for John Locke. Locke does not mention the doctrine of

[34] See generally Tawney, *Religion and the Rise of Capitalism*, 79–102. A similar reading of Luther is given by Murray Rothbard, no fan of the cost-of-production view, in his *Economic Thought before Adam Smith* (Brookfield: Edward Elgar, 1995), 139–40.

[35] See André Biéler, *Calvin's Economic and Social Thought*, trans. James Greig (Geneva: World Alliance of Reformed Churches, 2005), 396–400.

[36] Thomas Hobbes, *Human Nature* and *De Corpore Politico* (Oxford: Oxford University Press, 1994) pt. 1, ch. 16, para. 5, pp. 89–90. See also Thomas Hobbes, *On the Citizen* (Cambridge: Cambridge University Press, 1998), 47 ("we do not do a wrong to a buyer if we sell our property at the best price we can get for it, since he wanted it, and sought to get it").

[37] Hugo Grotius, *The Rights of War and Peace* (Indianapolis: Liberty Fund, 2005), bk. 2, ch. 12, sec. 12–14, pp. 741, 743–5.

[38] Samuel Pufendorf, *On the Duty of Man and Citizen* (Cambridge: Cambridge University Press, 1991), bk. 1, ch. 14–15. For further discussion of the views of Grotius and Pufendorf and how they represented a move away from the views of the Schoolmen, see John Salter, "Justice and Price: Comment on Jeffrey T. Young," *History of Political Economy* 29 (1998): 675–84, at 681–3.

the just price in his major works, although he does of course discuss how people come to own things and contributes much to the development of what will become the labor theory of value.[39] But in an unpublished essay from 1695, Locke acknowledges that he follows the Aristotelian view (although he does not mention Aristotle by name), and claims that the just price is the market price at the time and in the community where the sale is to take place. Indeed, if you did not sell at the market price you would be a fool, Locke says, for another would surely buy your goods to resell them and reap this profit in your stead. The only offense one could commit against justice in the context of a commercial exchange, according to Locke, would be to refuse to sell necessities like foodstuffs at the market price hoping to extort an even greater price from a community in special need, a price that would leave them otherwise unable to pay for their subsistence, or to sell above the market price to an individual who had some special need that for some reason he could not turn to the market to fulfill.[40]

If we are looking for someone other than Luther after the Schoolmen to advocate the cost-of-production rather than the market-based approach to determining the just price, however, we find only Francis Hutcheson. Today, Hutcheson is probably most famous as Adam Smith's teacher at the University of Glasgow, but he was also a prominent philosopher in his own right. And Hutcheson did something very creative with the doctrine of the just price—he took the ideas of the Protestant natural lawyers Grotius and Pufendorf and harmonized them with ideas of the Catholic Thomas Aquinas, or so shall I interpret him here. Thus, Hutcheson first ties the concept of price to the laws of supply and demand:

> [T]he price of things will be in a compound proportion of the *demand* for them, and the *difficulty* in acquiring them. The *demand* will be in proportion to the numbers who are wanting them, or their necessity to life. The *difficulty* may be occasioned many ways; if the quantities of them in the world are small; if any accidents make the quality less than ordinary; if much toil is required in producing them, or much ingenuity, or a more elegant genius in the artists; if the persons employed about them according to the custom of the country are men in high account, and live in a more splendid manner; for the expense of this must be defrayed by the higher profits of their labours, and few can be thus maintained.[41]

[39] John Locke, *Two Treatises of Government*, student edition (Cambridge: Cambridge University Press, 1988). For an extensive and helpful discussion of the development of the labor theory of value, see Peter C. Dooley, *The Labor Theory of Value* (London: Routledge, 2005).

[40] See John Locke, "Venditio," in *Locke on Money*, ed. Patrick Hyde Kelly (Oxford: Oxford University Press, 1991), vol. 2, 496–500.

[41] Francis Hutcheson, *A Short Introduction to Moral Philosophy* (Glasgow: University of Glasgow, 1747) reprinted in *Collected Works of Francis Hutcheson* (Hildesheim: George Olms, 1969), vol. 4, ch. 12, pp. 209–13, at p. 209.

But Hutcheson does not stop there. He then goes on and ties the concept of the *just* price to the labor, expenses, and risk involved in bringing goods to market:

> In the honorous contracts, or these made for valuable consideration, the parties profess or undertake to transfer mutually goods or rights of equal value. . . . From what we said about the grounds of price, 'tis plain that in estimating the value of goods in any place, we are not only to compute the disbursement made in buying, importing, and keeping them safe, with the interest of money thus employed; but also the pains and care of the merchant; the value of which is to be estimated according to the reputable condition in which such men live, and to be added to the other charges upon such goods. This price of the merchant's labour is the foundation of the ordinary profit of merchants. But as goods exported or imported are subject to many accidents, by which they may even perish altogether; this is a natural reason for advancing the price of such goods as are safe. And as merchants are liable to losses when the prices of such goods, as they are well stored with, by any unexpected plenty happen to fall; to make good such casual losses they have a right to take a larger profit, when the goods they are well stocked with happen by any accidental scarcity of them to rise in their prices.[42]

Of course, one could interpret these passages as simply advocating a mixed view of the just price, under which supply, demand, *and* the costs of production are all factors in the determination of what price is just.[43] Had this been Hutcheson's intent, however, one would have expected him to explain how such a mixed view was to be applied when the factors to be taken into consideration seemed to point in different directions, such as when demand is low but the cost of production is high, given his devotion of several chapters to the discussion of justice in exchange in his treatise on moral philosophy. In light of his failure to discuss these problematic cases, it seems more reasonable to interpret him, like the Schoolmen, as arguing that while *price* may be determined by supply and demand, the *justness* of that price is determined by the cost of production.

Unfortunately, it seems that with regard to this particular issue, no one took note of Hutcheson's views, and he ultimately had little influence on others in his day or on those who came after him, including Adam Smith, his own pupil. Indeed, it is most instructive that Smith does not even discuss the issue of price in *A Theory of Moral Sentiments*, his treatise on moral philosophy, but only addresses it in *The Wealth of Nations*, his treatise on economics. The reason this is so important is that there is a significant difference in the approach of the two works. In *A Theory of Moral Sentiments*, Smith argues

[42] Hutcheson, *A Short Introduction*, ch. 13, sec. 4, pp. 216–17.

[43] For this interpretation of Hutcheson's views, see Young and Gordon, "Economic Justice in the Natural Law Tradition."

that we can abstract out from our own self-interest by referring to the "judge within," the hypothetical impartial spectator who we have no desire to offend, to find guidance toward the proper balance between our own interests and those of others that morality requires.[44] Had Smith addressed the issue of the just price in *A Theory of Moral Sentiments*, he would accordingly have had to come up with an explanation of what price the impartial spectator would have favored. But he makes no reference to the theory of the impartial spectator in *The Wealth of Nations*. The key action-guiding theory of the one work is thus completely missing from the other.[45] Not surprisingly, then, while Smith does discuss the issue of price in *The Wealth of Nations*, he does not discuss whether and if so in what sense the price at which goods exchange must be *just*. Instead, he speaks only of the "natural" price of commodities, which he distinguishes from their market price and which he traces to the cost of production, including wages, rents, and profits, the return on labor, land, and capital.[46] His comments on the natural price are accordingly not meant to suggest that this is a price that should somehow be enforced—he sees the natural price as "natural" merely because the market price will ultimately tend toward this level under sufficiently competitive conditions and not because he thinks the natural price is something that is independently required by natural law or justice. On the contrary, he effectively drains the concept of price of all of its previously associated normative considerations; price is now simply an effect of market forces that need to be independently understood. Under the right conditions, the natural price will be produced by the "invisible hand" of competition between purely self-interested individuals; there is no need to look for guidance from the impartial spectator or otherwise encourage those among us to abstract out from their own self-interest. It is *competition*, not its presumed effects, which government must strive to ensure.[47]

With Smith, then, "just price" theory becomes "price" theory, moving away from the normative domain to one that is purely descriptive. What had been a matter for philosophers is now a matter for economists, and Smith sees himself primarily as the latter as far as this issue is concerned. And while an economist has to have a theory of value, that theory is designed to answer a

[44] See Adam Smith, *The Theory of Moral Sentiments* (Cambridge: Cambridge University Press, 2002), pt. 3, ch. 3, sec. 1, pp. 155–6.

[45] For a discussion of this tension and the various attempts to resolve it, see Jeffrey T. Young, "The Impartial Spectator and Natural Jurisprudence: An Interpretation of Adam Smith's Theory of the Natural Price," *History of Political Economy* 18 (1987): 365–82; Jeffrey T. Young and Barry Gordon, "Economic Justice in the Natural Law Tradition"; Jeffrey T. Young, "Natural Jurisprudence and the Theory of Value in Adam Smith," *History of Political Economy* 27 (1995): 755–73.

[46] See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Oxford: Oxford University Press, 1976), vol. 1, bk. 1, ch. 6–7, pp. 65–81.

[47] See Smith, *Wealth of Nations*, vol. 1, bk. 4, ch. 2, p. 456.

very different set of questions than the set that intrigued moral philosophers. For economists, the idea is to reduce the concept of value to its most fundamental element, whether that be land, or labor, some combination of the two, or something else altogether, rather than to ponder how morality directs our concept of value to be constructed. Indeed, economists tend to think that when it comes to economic matters, morality is a side effect, not a constitutive matter. To them, it is not necessary to worry about the effect on others of a society driven exclusively by competition between self-interested individuals, for achieving economic efficiency is the best way for a society to improve the overall general welfare, which conveniently makes the existence of the relatively new field of economics morally justifiable without requiring that moral considerations be incorporated into economic concepts. Understanding the foundations of value and the relationship between value and price are important problems, but they are economic, not moral. Thus, after Smith, justice no longer seems to have anything to do with the project in which those studying such problems are engaged.[48]

Given the ever-widening gap between the relatively new discipline of economics and the age-old discipline of philosophy as the Enlightenment progressed, however, it is perhaps not surprising that the doctrine of the just price began to attract less and less philosophical attention. Once philosophers began retreating from the scholastic position that associated the just price with the cost of production to the Aristotelian position that the just price was the price set by the market, there seemed to be very little interesting philosophical work for the doctrine of the just price to do. In these circumstances, enforcement of the just price simply becomes synonymous with ensuring competitive markets, a technical problem that seemed clearly more appropriate for economists to address than philosophers. And as more and more theorists began to see themselves as one rather than the other, those with a more philosophical bent naturally stopped writing about what makes a price *just*, and those with a more economic bent became preoccupied with developing ever-more sophisticated theories of market behavior, thereby leaving the doctrine of the just price to be "banished to the attics" of economics and

[48] Indeed, not only does Smith appear to see no need for government to be concerned about enforcing a just price, he also appears to see no need for government to be concerned about remedying whatever injustice might have occurred in connection with the initial acquisition of natural resources—or at least, no need for government to make devising such a remedy an independent objective, for the rich would be "led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interests of society, and afford the means to the multiplication of the species." See Smith, *A Theory of Moral Sentiments*, pt. 4, ch. 1, para. 9, pp. 215–16. But see Emma Rothschild, "Adam Smith and the Invisible Hand," *American Economic Review* 84 (1994): 319–22 (arguing that Smith did not intend these references to "the invisible hand" to be taken as a serious argument against government intervention in the market).

philosophy.[49] In short, those with the ability to take the doctrine further either abandoned the project entirely or became distracted by the seemingly more interesting problem of understanding the workings of the intricate economic systems around them. The normative project of developing a theory of the *just* price was displaced by the descriptive project of developing a theory of *price*, full stop.

Perhaps this is why neither Kant nor Hume nor Rousseau nor any of the other usual philosophical suspects of the emerging modern era devoted any time to the doctrine of the just price or had anything to say about the question of justice in exchange more generally. The question had been drained of its philosophical interest if not its normative content, and as more and more economists worked out their theories of value, there seemed to be less and less interesting things to be said about this problem as well. Indeed, one very telling demonstration of the lack of interest in the doctrine of the just price by the time of Adam Smith is the fact that Jeremy Bentham, who was merely twenty when *The Wealth of Nations* was published, would never say anything about the just price or about what would constitute justice in exchange despite the enormous range of issues his works would ultimately address. Of course, he did discuss the related issue of usury, and specifically whether there should be any moral or legal limits on the price charged for the use of money. Not surprisingly, given his commitment to utilitarianism Bentham saw little good and much evil coming from such limits, for he thought that limiting interest rates would only deprive certain less creditworthy projects of much needed capital and thereby limit economic activity.[50] In light of this it is perhaps reasonable to assume that Bentham would also have rejected the imposition of moral or legal limits on the exchange of other goods, at least as long as these took place between equally free and fully informed individuals. So Bentham, it seems fair to say, represents a move away even from Locke, if anything, and therefore a move away from Aristotle, not merely from the Schoolmen, in that like Smith, Bentham seemed to think that even the market price is not something that justice should enforce.

In any event, by the time we get to the middle of the nineteenth century, when J. S. Mill comes to write his *Principles of Political Economy* and discuss the

[49] Robert Skidelsky, *Keynes: The Return of the Master* (New York: Public Affairs, 2009), 147.

[50] See Jeremy Bentham, *Defence of Usury; Shewing the Impolicy of the Present Legal Restraints on the Terms of Pecuniary Bargains in a Series of Letters to a Friend, to which is added, A Letter to Adam Smith*, 2nd edition (London: T. Payne, 1790). As an aside, I must say that Bentham was almost certainly wrong about this—at least at a certain point, the amount of interest charged on many high-risk loans, especially loans to the poor, vastly exceeds what is necessary to compensate the lender for the increased risk, as shown by the unusually high profit margins the businesses that specialize in such loans typically generate. See Gary Rivlin, *Broke USA: From Pawnshops to Poverty, Inc.—How the Working Poor Became Big Business* (New York: Harper Collins, 2010). Which means that at least today, a committed utilitarian would have reason to support usury laws.

concept of value in exchange, the state of value theory seemed sufficiently developed for Mill to say:

> In a state of society, however, in which the industrial system is entirely founded on purchase and sale, each individual, for the most part, living not on things the production of which he himself bears a part, but on things obtained by a double exchange, a sale followed by a purchase—the question of Value is fundamental. Almost every speculation respecting the economical interests of a society thus constituted implies some theory of Value: the smallest error on that subject infects with corresponding error all our other conclusions; and anything vague or misty in our conception of it creates confusion and uncertainty in everything else. Happily, there is nothing in the laws of Value which remains for the present or any future writer to clear up; the theory of the subject is complete.[51]

Of course, Mill was wrong about this—no one had yet articulated a fully satisfying theory of exchange value (that is, price), much less the just price (that is, value), for no one had yet fully appreciated the relation between exchange value and marginal utility (Stanley Jevons, among others, would be one of the first to do that). But Mill was right that further development of the just price version of value theory no longer seemed to be of interest to moral or political philosophers. After Mill, in fact, the only serious philosopher to have anything to say about it was Henry Sidgwick, and he only discussed it briefly, in 1883, and only to address doubts that the common market price, which Sidgwick took without question to be the only candidate for the just price, should be morally enforced.[52] And this is the point this historical discussion is meant to convey. Subject to the few exceptions I have already noted, after the Schoolmen, the doctrine of the just price slipped quietly and almost completely into what can only be described as philosophical oblivion.

Indeed, to the extent the doctrine of the just price survived at all into the modern period, it was only as a kind of vague inspiration for what has come to be known in the twentieth century as the movement for a "living wage," although the movement was and is driven more by its participants' desire to do something about poverty and their belief that receipt of a living wage is an independent human right than by any general conception of justice in exchange.[53] In part this is because most members of the movement seem to

[51] John Stuart Mill, *Principles of Political Economy* (New York: D. Appleton, 1864), bk. 3, ch. 1, sec. 1, p. 536.

[52] See Henry Sidgwick, *The Principles of Political Economy* (London: Macmillan, 1883), bk. 3, ch. 9, sec. 2–3, pp. 584–9.

[53] See, e.g. John A. Ryan, *A Living Wage* (New York: Macmillan, 1906), and John A. Ryan, *Distributive Justice* (New York: Macmillan, 1916, rev. ed. 1927), especially 285–390. For further discussions of the history and beliefs of the movement, see Edd S. Noell, "In Pursuit of the Just Wage: A Comparison of Reformation and Counter-Reformation Economic Thought," *Journal of the*

uncritically accept the revisionist view of the scholastics and therefore take them as having had a market-based rather than a cost-of-production based conception of the just price, which means they cannot get to a living wage by strictly applying what they take to be just price theory.[54] Why this led to an abandonment of the whole concept of the just price rather than simply the market-based conception is less clear—perhaps the cost-of-production conception seemed too closely associated with Marxism for those in the living wage movement to feel that it was politically feasible to advance. One certainly gets the feeling that the revisionists' rejection of the cost-of-production interpretation of Aquinas's view was driven in part by what they saw as the need to "rescue" Catholic economic thought from any possible association with Marxism.[55] But I will discuss the potential relation between the cost-of-production conception of the just price and the idea of the living wage in greater detail later; for now, the only point I want to make is that the contemporary living wage movement is more of a half-relation than a direct descendant of the doctrine of the just price, and does not and never did constitute an attempt to embark on a further and more rigorous philosophical development of it.[56]

This progressively diminishing interest in the doctrine of the just price among philosophers and pretty much everyone else from the medieval to the modern period was also reflected in the way violations of the doctrine were handled by the law. In general, as liberalism rose, the importance of assuring freedom of contract began to seem more and more paramount, and it no longer seemed appropriate to interfere in one-sided bargains merely because they were one-sided, no matter how one-sided they might be.[57] The doctrine of the just price and the remedy of *laesio enormis* largely disappeared from the common law, to be replaced by the far more limited doctrine of unconscionability, which gave courts the power to refuse to enforce a contract that was

History of Economic Thought 23 (2001): 467–89, and Steven A. Epstein, "The Theory and Practice of the Just Wage," *Journal of Medieval History* 17 (1991): 53–69.

[54] See, e.g. Jerold L. Waltman, *The Case for the Living Wage* (New York: Algora Publishing, 2004), 31–8.

[55] It is no coincidence, I think, that the revisionist view of the scholastics burst forth during the 1950s, when a general fear of Marxism, together with a corresponding desire to separate one's intellectual tradition from that of Marxist thought, was at its most intense.

[56] For those wondering about the role of the contemporary fair trade movement in all of this, I consider the fair trade movement an even more distant relation of the concept of the just price. While those in the fair trade movement do advocate living wages for workers in developing countries, they do so mostly because they see this as preferable to aid, and because they see this as a way of encouraging more sustainable farming practices as well as more sustainable development. These environmental and developmental concerns are accordingly the primary drivers behind the movement, not a concern for the overall justice of everyday exchange transactions wherever they may occur.

[57] See K. Zweigert and H. Kotz, *An Introduction to Comparative Law*, trans. Tony Weir, 3rd edition (Oxford: Oxford University Press, 1998), 329.

grossly disproportionate in the respective performances it required. This power was very controversial, however, and remains so even to this day. It is not often exercised, and when it is this is usually because the negotiation process also smacks of fraud, great inequality of bargaining power, critical disparities in information, or duress.[58] In other words, under the common law, extreme price disparity became a necessary but no longer a sufficient condition for relief, or more precisely, it became evidence of some other grounds for relief rather than grounds for relief in and of itself.

While the doctrine of *laesio enormis* did manage to survive in countries that adopted a system of civil rather than common law, a similar weakening of its requirements occurred. During the French Revolution, when prices rose sharply and the value of money dropped, so many actions were brought by sellers for *laesio enormis* that the action had to be suspended in order to protect the currency, and the French Civil Code drafted thereafter allowed it only to minors and to sellers of land, and in the latter case only if the price paid was less than seven-twelfths of the land's market value or became so within two years.[59] Most of the Latin codes followed the French example or rejected the doctrine completely.[60] Other nations mostly followed the German Civil Code, which provided that a contract was void only if there was a "striking disproportion" between the value of what each party exchanged *and* the contract was brought about by the "exploitation of the difficulties, inexperience, lack of judgment or serious indecisiveness" of the other.[61] Even the Austrian Civil Code, one of the few to preserve the doctrine of *laesio enormis* in a somewhat more recognizable form, made it available only to non-merchants and only when what they were promised was worth less than half of what they promised to pay *and they were unaware of this disparity at the time*.[62] Just as under the common law, the nature of the parties involved and the circumstances under which their deal was struck became as important under the civil law as any imbalance in the value of what was being exchanged, and relief became harder and harder to obtain. The concern was no longer over the size of the disparity between price and value in and of itself, but that such a disparity might be indicative of a defect in the bargaining process, for the parties were presumed to have intended to exchange value for equivalent value as long as neither was

[58] See James Gordley, "Contract, Property, and the Will—The Civil Law and Common Law Tradition," in *The State and Freedom of Contract*, ed. Harry N. Scheiber (Stanford: Stanford University Press, 1998), 66–88, at 75 (by the nineteenth century, relief was said to be given not because the transaction was one-sided, but because its one-sidedness was seen as evidence of fraud).

[59] See, e.g. art. 1305, and art. 1674 ff. Code Civil. For a discussion of the evolution of French law on *laesio enormis* or *lésion* as it was called in French, see John P. Dawson, "Economic Duress and the Fair Exchange in French and German Law," *Tulane Law Review* 11 (1937): 345–76, 370–5.

[60] See Hermann Marcuse, "Unbalanced Transactions under Common and Civil Law," *Columbia Law Review* 43 (1943): 1066–79.

[61] See § 138(2) BGB; Zweigert and Kotz, *An Introduction to Comparative Law*, 329–30.

[62] See § 934 ABGB.

intending to make a gift, and it was therefore thought that there could be a disparity between price and value only when an exchange was not truly voluntary or one or both parties were not fully informed.[63] As time went on, then, the focus shifted under both the civil and the common law from what was really a matter of distributive justice to one of corrective justice, from a concern for an aspect of what we might now call positive freedom, or the ability to live a fully realized life, to a concern for what was clearly an element of negative freedom, or the absence of restraint. And while this shift was not complete by the mid-1800s it was well underway, which is perhaps why Marx saw no reason to refer to the doctrine of the just price when he came to develop his theory of exploitation,[64] and why it has so infrequently been connected with any theory of exploitation since.

2.4 What the History of Just Price Theory Has to Tell Us About Exploitation

Of course, in all these discussions of the just price, the word "exploitation" never appears, just as in all Marx's discussions of "exploitation," a reference to the doctrine of the just price never appears. The two concepts are accordingly never directly connected. Aristotle, the Romanists and Canonists who followed him, and the theologians of the twelfth and thirteenth centuries all speak of the just price, but never exploitation. Marx speaks of exploitation, but never of the just price. But the connection between these two concepts should be obvious. When the just price is not paid, the party who receives less than the just price contributes more value to the transaction than he receives in return. The principle of reciprocity is violated, and according to each of these theorists, including (at least according to some) even to Marx, this makes the transaction unjust.[65] One party has unjustly extracted value from another as part of a voluntary exchange transaction that is not otherwise prohibited by law. Under the working definition that I set forth at the beginning of Chapter 1, the party who has not received a just price for what he has contributed to the transaction has accordingly been exploited.

[63] See James Gordley, "Equality in Exchange," *California Law Review* 69 (1981): 1587–1656, 1587–88; James Gordley, "Myths of the French Civil Code," *American Journal of Comparative Law* (1994): 459–505, 469–79; and Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Oxford: Oxford University Press, 1996), 267–70.

[64] See Jon Elster, *Making Sense of Marx* (Cambridge: Cambridge University Press, 1985), 205 (discussing Marx's embrace of a conception of positive freedom).

[65] See Karl Marx, "Critique of the Gotha Program," in *The Marx-Engels Reader*, ed. Robert C. Tucker, 2nd edition (New York: W. W. Norton, 1978), 529–30, where Marx refers to the idea that justice in exchange requires reciprocity, which he takes to mean an exchange of equivalent amounts of labor.

Most importantly, even though the two doctrines were never directly connected, understanding the history of the doctrine of the just price is essential if we are to understand how the doctrine might provide the basis for the development of a new theory of exploitation, for it tells us much about the kinds of limits that might apply to the theory of exploitation we are trying to develop today. First, the historical record nicely illustrates that there are two different possible sources of moral force for the doctrine, depending on whether the just price is determined by the market price or the cost of production, and various consequences flow from this. If the just price is the market price, the doctrine derives its moral force from consent—the idea that an exchange must be just if both parties are willing to agree to it. The intuitive idea behind this theory is that the justness of an outcome depends on the procedures used to produce it. If those procedures are just, the thinking goes, the substantive outcome must also be just.

But as Rawls notes in the course of developing his theory of justice, there are many reasons why people out in the real world might agree to an exchange that was in fact substantively unjust. The parties may start from different positions, making one more anxious to arrive at some sort of agreement than the other and therefore under additional pressure to make concessions, or the parties might have unequal bargaining power for some other reason, or they might have unequal bargaining skill, or asymmetric information about the true utility or value of the what they are bargaining over. In each of these cases, mere agreement would not be enough to convince us the outcome was just because the deck was to some extent "stacked" in favor of one party or the other at the time their respective hands were dealt. In other words, these procedural defects would rob any agreement of the parties of its moral force.

To solve this problem and ensure that agreement does have moral force, Rawls had to construct a hypothetical decision situation. First, he placed his bargainers in "the original position," that is, in a position where principles of justice have not yet been selected, so that everyone is starting from the same place. Second, he put these parties behind a "veil of ignorance" designed to deprive each of knowledge of who they are or their relative place in society, for without such knowledge, they would have no basis on which to seek an agreement that would be biased in their favor. On the contrary, since each party could turn out to be anybody, they would each be motivated to seek an agreement that was as fair to everyone as possible. The idea was that under these conditions, the parties would be both free and equal, and only then would the bargaining process over selection of principles of justice be procedurally fair, and only then, in turn, would the attributes of the bargaining process transfer over and suggest that the outcome of that process must be substantively just.[66]

This same thinking applies if we look to the market price as the signifier of the just price. For it to have this effect, the procedure through which the market determines price must itself be fair, and this would only be the case under conditions of something at least roughly approximating perfect competition. Under these conditions, there would be neither a shortage of sellers nor a shortage of buyers, neither party would have greater bargaining power than the other, and all material information regarding the good for sale would be publically available and widely known. But if one party has monopoly or monopsony power, and therefore the other has little or no choice of alternative trading partners, the party with the greater bargaining power will be able to obtain a much better deal then he would under more competitive conditions. In this case, the fact that the weaker party consents to the transaction gives us no reason to assume that the agreed price is just, because the procedure no longer involves parties who are both free (in the sense of being able to choose their trading partners) and equal (in terms of bargaining power). Similarly, if one party has material non-public information about the goods involved in the transaction, both parties may be free to choose other trading partners, but the parties have unequal access to information, and this robs the consent of the less informed party of its moral force and once again deprives us of reason to believe that the agreement to which that party has consented is substantively just. And this is why those who equate the just price with the market price are willing to make exceptions for market failures—in the presence of such failures, the claim that the market price is just loses its moral force.

In contrast, if one takes the just price to be the cost of production, the source of the doctrine's moral force is completely different. In this case, the doctrine draws its moral force from the principle of reciprocity, and if the source of the doctrine's moral force is reciprocity rather than consent, the conditions under which the exchange is made are irrelevant to determining whether its substantive terms are in compliance with the doctrine. This does not mean, of course, that these conditions (such as inadequate disclosure, for example) cannot make an exchange unjust—they can. It merely means that *if* the exchange is unjust despite compliance with the principle of reciprocity then it is unjust because some separate and independent moral provision has been violated, such as the prohibition against fraud, not because there has been a violation of the doctrine of the just price. If we base the doctrine of the just price on the principle of reciprocity, as Aristotle said we should, then as long as

66 See Rawls, *A Theory of Justice* (rev. ed. 1999), especially chs. 3, 4, and 24.

the value of whatever the parties have exchanged is equivalent, the doctrine of the just price has been satisfied and to that extent at least the exchange is just.

If this is the case, then, why did Aristotle not adopt the cost-of-production measure of the just price, rather than a market-based measure? The answer, I think, is that Aristotle may very well have done so. He never mentions consent as the basis of the doctrine, but makes clear that his claims are based on the principle of reciprocity. And while he does argue that price is determined by use and need, it is not clear that this discussion is meant to explain how the *just* price is determined. In other words, he may have had a supply and demand theory of *price*—of how prices are set by the market, and a cost-of-production theory of the *just* price—of when prices are and are not just, and simply not have distinguished between these two very different theories as clearly as he might have done.[67] In any event, it is going to be very important in the development of our theory that we remember that the moral force of a cost-of-production based just price theory is reciprocity, not consent, for this will explain much of the discussion that is to come. Indeed, much confusion regarding both the doctrine of the just price and the concept of exploitation has been created and persists by the failure to keep this point firmly in mind.

If we understand the doctrine of the just price as based on reciprocity rather than consent, we can also see some of the factors that might serve as limits on the scope of our concept of exploitation more clearly. For example, throughout the history of the development of the doctrine of the just price, the doctrine was designed to apply only to voluntary exchange transactions. If a transaction was coerced or induced by fraud or deceit or intended as a gift, it was always excluded from the reach of the doctrine of the just price.[68] Transactions in which there was fraud or coercion were either void or voidable at the option of the aggrieved party, regardless of whether the price paid was just or unjust, for in these cases, it was the conduct of one of the parties, not the nature of the price, which rendered the transaction unjust. Cases to which the doctrine would apply would accordingly include only those in which neither party knew they were paying more or receiving less than the just price, and more controversially, those in which only one party did not know this and those in which both parties knew but the party aggrieved nevertheless had no independent legal grounds for challenging the conduct of the other. Gifts, in

[67] For an argument that Aristotle did have a cost-of-production theory of the just price, see Hollander, "On the Interpretation of the Just Price."

[68] See Odd Langholm, *The Legacy of Scholasticism in Economic Thought* (Cambridge: Cambridge University Press, 1998), 81.

turn, were excluded because they were not intended to be *exchanges* of value, but rather unidirectional transfers.

The historical development of the doctrine of the just price also illustrates the problems with equating the just price and the market price. Even though this was the predominate method of defining the just price throughout the historical period, concerns that the market price might not always be just were ever-present. As a result of these concerns, various attempts were made to identify situations in which the market price might not be just, and to adopt special rules for determining what price would be just in these situations. Monopolists were not allowed to take advantage of their monopoly power and set market prices at levels above those that would be found in competitive markets, and merchants were not allowed to seek extraordinary profits through market speculation or by deliberately taking advantage of changes in circumstances over time.[69] In essence, the market price was considered the just price only as long as it was relatively stable and unaffected by seasonal shifts or by what we would today call market shocks. Indeed, without stretching the views of those who were writing at the time, we might argue that even those medievalists who officially tied the just price to the market price were really tying it to the cost of production (plus perhaps a modest profit) all along, the market price simply being a useful proxy for this in most situations.[70] After all, given the relatively primitive level of technological achievement at the time, barriers to market entry were typically very low. If a particular good or service was routinely sold at well above its cost of production, new producers would enter the market, and the price would fall. On the other hand, if a good or service could only be sold below its cost of production, no one would be willing to produce it, and its presence in the market would quickly disappear. There is accordingly every reason to think that up through the Middles Ages, there would be a high degree of correlation between the market price and cost

[69] For example, San Bernardino of Siena and Sant' Antonino of Florence, two important scholastics who followed Scotus in time but according to the revisionists rejected the cost-of-production approach to the just price, nevertheless also rejected the market price as the measure of the just price for goods sold by a monopolist. See Raymond de Roover, *San Bernardino of Siena and Sant' Antonino of Florence: Two Great Economic Thinkers of the Middle Ages* (Boston: Harvard Graduate School of Business Administration, 1967), 22–3; Bede Jarrett, *S. Antonino and Mediaeval Economics* (St. Louis: B. Herder, 1914), 69–70. Similarly, Francisco de Vitoria, Domingo de Bañez, Juan de Medina, Francisco García, and Pedro de Aragón, Late Scholastics who also supposedly preferred Aristotle's market-based conception of the just price to Aquinas's cost of production conception, all rejected the market price as the just price for goods sold by a monopolist. See Alejandro A. Chafuen, *Faith and Liberty: The Economic Thought of the Late Scholastics* (Lanham, MD: Lexington Books, 2003), 83. Even medieval Islamic scholars such as Ibn Taimiya who equated the just price with the market price took this to apply only to "a market free from imperfections." If set by a monopolist, the market price was not to be assumed just, and various forms of price manipulation—such as withholding of goods from the market to effect an increase in price—were also prohibited. See Ozay Mehmet, *Islamic Identity and Development* (London: Routledge, 1990), 80–1.

[70] For a similar argument, see Langholm, *The Legacy of Scholasticism in Economic Thought*, 87–8.

of production plus a modest profit no matter what, at least for locally produced goods. Finally, we might think that the market price plus a modest profit was simply a useful proxy for the cost of production because when there was a reason to doubt the coincidence between the two, the market price guideline was usually abandoned. And of course by the time we reach Marx, the idea of using the market price as a guideline was expressly rejected. Even though Marx did not describe what he was doing as finding the just price, within the confines of his own theory he was expressly using the cost of production and not the market to determine whether and if so when exploitation had occurred.

The historical development of the doctrine of the just price also nicely illustrates the tension between insisting that nothing more nor less than the just price should be paid in market transactions and recognizing that the profit motive is the engine that drives people to engage in the kind of specialized production that is only possible in the context of a trading economy. This tension is evident in the fact that while the just price was seen as the market price in both Roman and Canon law, there was no remedy offered for violation as long as the deviation from the just price either up or down did not exceed 50 per cent. Even Aquinas and those of his fellow theologians who argued that any deviation from the just price was prohibited and would be punished in the next life did not advocate the imposition of any sanction beyond moral regret in this one. Until Marx, there was simply no willingness to use a conception of the just price as a way of imposing significant restrictions on what took place in the market. This is a critical feature of how the doctrine of the just price was applied through the Middle Ages, and as we shall see, it shall play an important role in the development of our own liberal theory of exploitation too.

Finally, and this is very much related to the tension between the concept of the just price and the intuition that the profit motive must be given room to operate, there has always been a difference between the moral right against exploitation and the legal right—the point at which the moral right will be enforced using the power of the state. Even when the just price was seen as the market price, and any deviation from that price was considered morally wrong and therefore morally prohibited, only extreme deviations were legally prohibited, and only these extreme deviations could provide a basis for legal relief. In a perfectionist society like the one that Marx envisioned, all departures from perfection are to be strictly prohibited and compliance is to be enforced by the state, at least initially.[71] But in a liberal society, some degree

[71] Although Marx is not clear on this, he probably thought that in the final stages of communism state coercion would no longer be necessary, for everyone would have internalized socialist values and therefore compliance with these values would become something that just

of moral deviation is always tolerated—the question is simply where to draw the line. I will have much more to say about this later, but first I want to discuss my view of the transactions to which the concept of exploitation should apply and how the just price that forms the basis of any determination of exploitation should be calculated.

came naturally. See Elster, *Making Sense of* Marx, 401–2. But even if this would be true in the final stages of a perfectionist society, it is certainly not true of any society that is still struggling to reach some conception of perfection. In those societies, a great deal of coercion by the state will be required both to purge society of its undesirable elements and to keep it pure. See Reiff, "The Attack on Liberalism," in *Law and Philosophy*, ed. Michael Freeman and Ross Harrison (Oxford: Oxford University Press, 2007), 204–10.

3

The Limits of Exploitation

Recall that in the opening chapter, I defined exploitation as the unjust extraction of value from another as part of a voluntary exchange transaction not otherwise prohibited by law. I now want to discuss the meaning of some of these terms and explain how they limit the scope of my theory of exploitation and how these limits are to be understood. In general, all of these limitations can be seen as deriving from a recognition that the subject matter of exploitation is a certain kind of transaction in which value is exchanged. Transactions of some other kind are expressly excluded, for these other kinds of transaction do not trigger the concerns that our theory of exploitation is designed to address. What these transactions are, and why they do not trigger the concerns our theory of exploitation is designed to address, is the topic I take on next.

3.1 Gifts

For an extraction of value to result from an "exchange transaction," the transaction must be one in which each participating party contributes value with the intention of receiving value in return. Transactions in which there is no intent to receive value in return, directly or indirectly, are gifts and are therefore not within the scope of our theory of exploitation, for in such cases there is no exchange transaction for our theory of exploitation to protect. A potential problem arises, however, when we contemplate the possibility that there may be transactions that are partially but not wholly intended to be gifts, in the sense that there is no intent to receive *equivalent* value in return, but there is the intent to receive *some* value. Interestingly, this was a problem for just price theorists too. To end run the doctrine of the just price and head off any danger that one might later find oneself subject to an action for *laesio enormis*, it became common for a party with experience in commercial dealing to attempt to get the other party to waive the right to bring such an action.

These attempts took various forms, but one of these was to obtain a written statement as part of the transaction to the effect that in the case of any overpayment or shortfall with regard to the just price, the difference was intended by the party overpaying or being shorted as a gift.

Initially, such statements were given full force and effect. Later, they began to be eyed with increasing skepticism and were increasingly rejected. But ultimately the general attitude toward them reversed again and they came to be an accepted method for ensuring the finality of exchange transactions.[1] The practical effect of this is that the doctrine came to apply only to those unfamiliar with commercial dealings; merchants and other commercially sophisticated parties would put these clauses in their agreements and thereby avoid the doctrine of the just price in its entirety. Only unsophisticated parties who did not know enough to insist on such clauses were likely to be caught up in an action for *laesio enormis* or otherwise find themselves having to comply with the doctrine's terms.

Whether this is as it should be, for those engaged in repeated commercial transactions are likely to observe the just price anyway out of fear for their reputations, or whether this just gives those who encounter repeated opportunities for sharp dealing and have the strongest motive for doing so free reign to engage in it, is impossible to determine. In either case, however, if the just price is to form the basis of a conception of exploitation and actually regulate a wide variety of exchange transactions in a capitalist economy, its requirements cannot be so easy to evade. The right against exploitation—the moral right that gives each party a moral duty to pay the just price—must accordingly be deemed to be inapplicable only when the circumstances suggesting that the transaction at issue was in part a gift are unambiguous. No statement of intent to make a partial gift can be binding in what are otherwise ordinary commercial arms-length transactions unless one party is the natural object of the other's bounty and the party benefiting from the putative partial gift proves the other's donative intent through persuasive independent means—that is, with evidence other than a self-serving statement contained in what is in all other respects a standard contract for purchase and sale. Indeed, in cases of transactions between employer and employee, merchant and customer, manufacturer and supplier, lender and borrower, professional and client, and the like, there should be a heavy presumption against donative intent, and the burden of proving otherwise should be difficult although not impossible to meet. In non-commercial settings, this presumption may be relaxed

[1] For further discussion of the history of the effectiveness of such statements of intent, see John W. Baldwin, "The Medieval Theories of the Just Price: Romanists, Canonists, and Theologians in the Twelfth and Thirteenth Centuries," *Transactions of the American Philosophical Society* 49 (1959), at 24–7.

somewhat, but the party claiming that there was partial donative intent still must bear the burden of proving it in any subsequent dispute.

This may seem cumbersome, but it really adds nothing additional to the rules under which most liberal capitalist systems currently operate. Many rights designed to protect parties from being taken advantage of in various ways, such as those that stem from occupational health and safety laws, environment laws, minimum wage and hour laws, and the like, are inalienable. In contrast, I am making a more limited claim: I am merely suggesting that in circumstances where donative intent is alleged, it has to be proved by clear and convincing evidence. Donative intent has long had to be proved to such a standard in other contexts, and there is no reason to believe that actual cases of partial donative intent will be impossible to identify.[2] Nothing more will be required of those not actually trying to avoid the requirement of the just price than what has been required of those claiming to be beneficiaries of partial gifts for centuries. So while partial gifts are excluded from the reach of our theory of exploitation, and the theory does recognize that partial gifts can take place, these are to be treated with suspicion and allowed only when the requisite evidence of donative intent is clear.

3.2 Commodification

The next important limit on the scope of our theory of exploitation is also derived from examining the subject matter of the transaction. This is a limit that arises from what are commonly called objections to commodification. Most liberal capitalist societies do not permit people to sell their right not to be maimed or murdered or enslaved, or to sell their body parts, or their reproductive capacities, sexual favors, or children.[3] Allowing such aspects of human bodies, rights, or capabilities to become commodities and therefore a proper subject of an exchange transaction is seen as an affront to human dignity, and a violation of the respect to which all human beings are entitled no matter what the circumstances. Whether any particular item should be on this list—indeed, whether there should be any items on this list at all—is a controversial and important question, but it is not a question that our concept of exploitation can help us answer.[4] While one sometimes sees a concern for the price

[2] For some examples, see Restatement (Third) of Property: Wills & Other Donative Transfers § 6.1 (2003).

[3] See, e.g. *Matter of Baby M.*, 527 A.2d 1227 (N.J. 1988).

[4] Much of the literature discussing slavery and other forms of commodification of the person, including the commodification of child labor, human organs, sexual activities, and reproductive capacities, is listed and discussed in depth in Debra Satz, *Why Some Things Should Not Be for Sale: The Moral Limits of the Market* (Oxford: Oxford University Press, 2010), 115–205. For a helpful summary

paid lurking beneath the judgment that a certain kind of transaction should be prohibited (are sales of kidneys prohibited because they involve kidneys or because the price paid usually strikes us as shockingly low or both?), the question of whether the price is just is entirely separate from the question of whether there is something about the intrinsic nature of what the parties are attempting to exchange that gives us reason to prohibit it, which is the question triggered by commodification concerns. If this latter kind of concerns leads us to conclude that certain kinds of transactions should be unlawful, then there is no reason for the doctrine of the just price to even come into play. Of course, if a particular kind of lawful transaction seems to always or almost always violate the doctrine of the just price as an empirical matter, then this might also be grounds to ban this kind of transaction in its entirety even in the absence of any concerns about commodification, but this will usually not be the case—lawful transactions will usually have to be evaluated under the doctrine of the just price on a case by case basis.

Issues relating to the intrinsic nature of the goods being exchanged and the question of the just price are, however, related to each other in one way. When certain kinds of transactions are prohibited as a result of commodification concerns, it is usually the case that the goods or services or rights at issue are seen as partially if not wholly incommensurable with money.[5] It would therefore be impossible for the just price to have been paid, simply because no amount of money could effectively accomplish this. But even in these cases, our just price concerns are derivative of the concerns arising from the intrinsic nature of the subject matter of the transaction. It is the latter, not the former, which is driving the prohibition here, and therefore it makes sense to exclude such transactions from the reach of our concept of exploitation altogether.

3.3 Contraband

Closely related to the issue of commodification is the issue of contraband. By contraband, I mean carriers of value that are not necessarily incommensurable with money and which can be exchanged without necessarily undermining human dignity or capacities but in which trade is banned because of concerns for the common good. For example, controlled drugs, pornography, many kinds of weapons, certain kinds of information, are all goods for which a

discussion, however, see Michael J. Trebilcock, *The Limits of Freedom of Contract* (Cambridge, MA: Harvard University Press, 1993), 23–57.

[5] For further discussion of the issue of incommensurability, see Joseph Raz, *The Morality of Freedom* (Oxford: Oxford University Press, 1986), 320–66.

certain kind of market exists. Despite the fact that we could actually calculate a just price for such items, trade in these items is banned because such trade is nevertheless seen as harmful to society in some way. Exchanges involving these items are therefore excluded from the reach of our concept of exploitation through the "and not otherwise prohibited by law" provision. If such an exchange takes place, the underlying agreement that produced it is void and both the goods and the payment involved are subject to seizure regardless of the price paid.

3.4 Capacity

There are other kinds of transactions, however, that are not void but merely voidable under existing law. In these cases, the concern is not the nature of the goods exchanged, but the capacity of one or more of the parties involved to engage in transactions of any sort or the relationship between one party and the other, for certain kinds of relationships create a special risk of overreaching. An example would be a transaction entered into by a minor, or between a party and his fiduciary. The law does not prohibit such transactions; it merely gives the party that is the focus of the law's concern the option in some cases of avoiding or affirming the transaction.[6] Such transactions *are* within the scope of our concept of exploitation *if they are affirmed*, because in this case the law provides that they are to be treated like any other permissible transaction. Once affirmed, they can be analyzed under our theory of exploitation, and if they are found to be exploitative, the usual remedies for exploitation can be made available to whichever party has been injured. If the exploited party is the buyer, he may seek a refund of the amount overpaid. If he is the seller, he may seek additional monies from the buyer. These kinds of transactions accordingly cannot escape the reach of the right against exploitation.

3.5 Voluntariness

In addition to not applying to transfers of value intended as a gift or prohibited by law, the reach of our concept of exploitation is limited in another important way. Our concept of exploitation applies only to transactions that are *voluntary* or, to put it differently, it applies only to transactions that are not coerced or induced by some form of duress or any otherwise legally cognizable form of uninformed consent, such as that produced by fraud or deceit. The

[6] See E. Allen Farnsworth, *Contracts*, 4th edition (New York: Aspen, 2004), §§ 4.4–4.5, 4.20, pp. 222–7, 264–7.

classic example of such an involuntary transaction, of course, is highway robbery, where value is extracted by one party (the gunman) from another (the traveler) through the threat or use of force and violence. In this case it would be silly to compare the value of what was given (a life) to the value of what was received (some money) in order to determine whether the transaction was just. The life was not something the gunman had a right to take, so he had no right to receive anything in exchange for not taking it, and his "offer" is best characterized not as an offer at all but as a threat, and therefore improperly coercive. When a transaction is not legally voluntary—and by that I mean when it is induced by something that renders one party's consent to the transaction and therefore the transaction itself legally void—the relative value of the goods exchanged is irrelevant. We simply set the transaction aside on these grounds and move on.

But what about forms of coercion or duress or other defects in consent that do not rise to this level and therefore do not in and of themselves provide legally cognizable grounds for relief? Many transactions are ostensibly voluntary but on some deeper, moral level may nevertheless be seen as coerced. For example, I must work in order to have money to buy food if I have no land to cultivate myself, for the existing rules of property law provide that I cannot take what is not mine or plant crops on land I do not have the right to farm, and the state will use its coercive power to prevent me from violating these rules. Thus, even though I am technically free to choose not to work if I prefer, the existing rules of property law provide a coercive set of background conditions that in a very meaningful sense force me to labor for others at whatever wages are offered to me if I do not wish to starve.[7] So even though such wage agreements are not generally viewed as unlawfully coerced in liberal capitalist societies—we might even say that an unwillingness to find actionable coercion in these cases is in large part what makes a society capitalist—the argument that these wage agreements should be seen as *morally* coerced is powerful indeed.[8]

Something akin to this sensibility clearly informs Marx's theory of exploitation.[9] But more importantly (at least for our purposes), a finding of coercion

[7] For an argument that such agreements should be seen as coerced, see Robert Hale, "Coercion and Distribution in a Supposedly Non-Coercive State," *Political Science Quarterly* 38 (1923): 470–94. For an extended discussion of Hale's ideas and arguments, see Barbara H. Fried, *The Progressive Assault on Laissez Faire* (Cambridge, MA: Harvard University Press, 1998).

[8] There is nothing inherent in liberalism, however, which requires that such wage agreements be treated as non-coercive. A liberal society could find the relevant background conditions of certain wage agreements sufficiently coercive to constitute an interference with negative liberty, thereby requiring that this interference be justified before such agreements would be enforced. See Isaiah Berlin, "Two Concepts of Liberty," in *Liberty*, ed. Henry Hardy (Oxford: Oxford University Press, 2002), at 169–70.

[9] See Allen W. Wood, "Marx on Right and Justice: A Reply to Husami," *Philosophy and Public Affairs* 8 (1979): 267–95, 279–80 ("one essential feature of all economic exploitation for Marx is

(or at least some suspicion that there is reason to question the true voluntariness of the transaction) also often finds its way into a determination that the modern version of the just price doctrine has been violated in liberal capitalist countries. As we have already seen, such a finding is often expressly required by statute in civil law countries,[10] and a similar finding is often made by the courts in common law countries too.[11] In the United States, for example, there are a series of cases in which installment contracts between inner-city retailers and the local poor at what are extremely high interest rates or otherwise subject to onerous financing terms have been found unconscionable, and to support their judgments in these cases the courts invariably emphasize that the customers at issue had no real alternative to these agreements open to them if they were to obtain the basic necessities of life.[12] Similarly, there are another series of cases in which contracts to rescue ships foundering at sea have been found unconscionable, and to support their judgments in these cases the courts invariably note that the choice faced by the owners of these troubled ships and their endangered cargo was a stark one: agree to pay the unreasonably exorbitant price demanded for a rescue or allow the ship and all its cargo to be lost.[13] So it is obvious that in cases of unconscionability, the modern common-law equivalent of the doctrine of the just price, the presence of a reason to doubt the true moral even though not legal voluntariness of the transaction is an important factor. The question, then, is whether some form of involuntariness, including but not limited to what we traditionally think of that produced by fraud, coercion, or physical duress, even if not a *sufficient* condition for the granting of relief in its own right, is nevertheless a *necessary* condition for a finding of exploitation. Must there be *some* defect in consent, either resulting from some situational inequality in bargaining power between the parties, an asymmetry in bargaining skill, an asymmetry in information, or some dispositional defect that makes one party

coercion"). For further discussion of the sense in which Marx saw exploitation as the product of coercion and the extent to which he was right, see Jon Elster, "Exploitation, Freedom, and Justice," in *Marxism, Nomos XXVI*, ed. J. Roland Pennock and John W. Chapman (New York: New York University Press, 1983), 277–304 and G. A. Cohen, "Capitalism, Freedom, and the Proletariat," in *On the Currency of Egalitarian Justice and Other Essays in Political Philosophy* (Princeton: Princeton University Press, 2011), 147–65.

[10] See Zweigert and Kotz, *An Introduction to Comparative Law*, trans. Tony Weir, 3rd edition (Oxford: Oxford University Press, 1998), 329–30. See also Article 3.10(1) (a), UNIDROIT Principles of International Commercial Contracts.

[11] See generally A. H. Angelo and E. P. Ellinger, "Unconscionable Contracts: A Comparative Study of the Approaches in England, France, Germany, and the United States," *Loyola of Los Angeles International and Comparative Law Journal* 14 (1992): 455–506.

[12] See, e.g. *Jones v. Star Credit Corp.*, 1159 Misc.2d 189, 298 N.Y.S.2d 264 (Sup. Ct. 1969); *Williams v. Walker-Thomas Furniture Co*, 350 F.2d 445 (D.C. Cir 1965).

[13] See, e.g. *Post v. Jones*, 19 How. (60 U.S.) 150 (1856). For a discussion of these and other cases on duress and unconscionability, see Charles Fried, *Contract as Promise* (Cambridge, MA: Harvard University Press, 1981), 103–11.

especially and perhaps even irrationally receptive to certain kinds of offers before a transaction may be found exploitive?

Once again, the answer that our theory of exploitation provides is no. But this rejection of the relevance of involuntariness is less controversial than it seems. There is some popular association of exploitation and coercion, probably because of the influence of Marx, and certain non-Marxists also insist that exploitation must involve some form of coercion or at least some inequality in bargaining power that would suggest one party's consent lacked its usual moral force even though such defects in consent might not give rise to legal remedies on their own.[14] Many modern theorists, however, reject this view, and do not regard the presence of a defect in consent as a necessary condition for exploitation.[15] Because the argument for this position has already been set forth at length elsewhere, I will not repeat it here—those who are unfamiliar with it can simply refer to that already substantial body of literature for the relevant discussion.[16] For those who nevertheless feel tempted to associate exploitation with coercion or at least with some form of a defect in consent after consulting this material, however, I will point out that as a historical matter, proof of involuntariness was never a necessary element of a violation of the doctrine of the just price—if the just price was not paid, even when the just price was determined by the market price, it did not matter why the deviation from the just price had occurred. And while the contemporary view takes a different position, there is good reason to see the contemporary view as driven by concerns that are exogenous to the doctrine, and which therefore should not be part of any conception of exploitation that is based thereon.

Here's why. It was only after Aquinas that suspicions of involuntariness began to seem important when searching for just price violations and the idea that such violations could provide separate and independent grounds for relief began to weaken.[17] The reason for this historical development, I think, is that tying relief for just price violations to suspicions if not outright findings of

[14] See, e.g. David Miller, "Exploitation in the Market," in *Modern Theories of Exploitation*, ed. Andrew Reeve (Beverley Hills, CA: Sage Publications, 1987), 149–65, at 156, 161–2; and David Miller, "Exploitation," in *Market, State, and Community: Theoretical Foundations of Market Socialism* (Oxford: Oxford University Press, 1989), 175–99, at 186, 189–93.

[15] See, e.g. Wertheimer, *Exploitation* (Princeton: Princeton University Press, 1996), 13, 27, 247–53; Joel Feinberg, "Noncoercive Exploitation," in *Paternalism*, ed. Rolf Sartorious (Minneapolis, MN: University of Minnesota Press, 1983), 201–35; John Lawrence Hill, "Exploitation," *Cornell Law Review* 79 (1993–1994): 631–99. See also Restatement (Second) of Contracts §208, Comment *c* (noting somewhat cryptically that "[i]nadequacy of consideration does not itself invalidate a bargain, but gross disparity in values exchanged . . . may be sufficient ground, without more, for denying specific performance").

[16] See Wertheimer, *Exploitation*, 13, 27, 247–53.

[17] For a discussion of Aquinas's view that involuntariness is not an element of the doctrine of the just price, see Baldwin, "The Medieval Theories of the Just Price," 62.

involuntariness provided a way of resolving the tension or "cognitive dissonance" that always seemed to exist between the concept of freedom of contract, the idea that people should be free to strike whatever bargains they can manage, and the concept of exploitation, the idea that some bargains are inherently wrong no matter what the parties may agree. The pressure to find some way of reconciling these two views simply became impossible to resist as we moved from a predominately agrarian economy to a more mercantile one given the proliferation of contracts this entailed. By treating coercion or some defect in consent as an element of the doctrine of the just price rather than as antithetical to it, those seeking to relieve what had seemed like an irreconcilable tension between the two doctrines could effectively turn one doctrine into the other—they could interpret exploitation in a way that made the concerns underlying it the same as those underlying freedom of contract.

But the supposed tension between freedom of contract and the regulation of otherwise voluntary transactions is an illusion. There is no such thing as freedom of contract—only freedom. In a liberal as opposed to a perfectionist society, this is mostly understood in its negative form, as freedom from restraint, and it is true that any attempt to regulate the agreements we might otherwise enter into is a form of restraint. But even a liberal society's conception of freedom is not *purely* negative—it has some positive elements too. We have to be able to do *something* with our freedom for it to be meaningful, and the more we can do the more meaningful it gets. Indeed, the entire concept of negative freedom refers to the extent to which restraints are placed upon us by other human agents, so it assumes that freedom is a measure of what we can do within the context of the continuous necessity of social interaction.[18] And if our interaction with others is to offer opportunities for social cooperation and not just social conflict—in short, if we are going to be able to live in cooperation with others—some forms of restraint are going to be necessary to create the background conditions that will enable us to reap the benefits that social cooperation can provide.

This is why we regulate that to which we can agree in all sorts of ways. We cannot enter into certain kinds of agreements, we cannot enter into agreements for certain kinds of goods, we cannot induce agreement by fraud or misrepresentation, and we cannot enter into agreements with certain kinds of people or with people who lack certain capacities or with people who are intentionally or negligently or perhaps even innocently deprived of certain kinds of information even though our (negative) freedom would be greater if we could do any of these things. We can strike any deal we want, but not any way we want, and not over every thing we want, and not with every one we

[18] See Berlin, "Two Concepts of Liberty," 169–70.

want because there are important benefits to be had from not being able to do so. Why should the price to which the parties agree be uniquely protected from interference? Why should we be unconcerned about our freedom to contract in each of the former cases, but think our freedom is being impermissibly infringed in the latter? The question is never whether a particular form of regulation interferes with our freedom to contract in the negative sense—all regulation does that—but whether such interference is justified all things considered.[19]

The justification for interference in this case is that enforcing the doctrine of the just price as I have reconceived it would not actually reduce the sum total of negative freedom (in terms of freedom from restraint) and positive freedom (in the sense of the number of meaningful opportunities for exercise of our freedom) otherwise available to us—on the contrary, enforcing this doctrine would actually *increase* it. Indeed, such enforcement would operate in the same paradoxical way that enforcing promises operates. The latter may limit our freedom in one way, but ultimately it *increases* the overall number of options open to us by providing a mechanism through which we can credibly commit ourselves to certain modes of behavior and thereby obtain goods in exchange for such commitments that we could not otherwise obtain. The fact that we are *not* free to break our promises means that we *are* free to obtain goods in exchange for them.[20] Similarly, ensuring that goods exchange only at a just price generates some interference with negative freedom, but it also greases the wheels of social cooperation and interaction, *increasing* the attractiveness of trade and therefore *increasing* the opportunities available to us and the scope of our freedom overall. If one lives in a society of werewolves, where every potential trading partner has a hidden predatory monster inside of them that is willing to do almost anything to gain even a slight advantage, one must proceed with caution. But if one lives in a society where most people embrace and generally respect the doctrine of the just price, one has some reason to believe that a potential counterparty will act fairly, and one is accordingly going to be much more receptive to proposals to trade than one would otherwise be. Indeed, as the recent economic crisis has made all too clear, trust is an essential element of economic activity,[21] and trust is much easier to

[19] See Berlin, "Two Concepts of Liberty," 172–3, 214–16.

[20] See Mark R. Reiff, *Punishment, Compensation, and Law: A Theory of Enforceability* (Cambridge: Cambridge University Press, 2005), 49–50. Note, however, that I am not the first to make this observation: the paradox that restricting our freedom to break our promises leads to an *increase* in the overall number of options available to us has been noted and commented upon for quite some time. See, e.g. Thomas C. Schelling, *The Strategy of Conflict* (Cambridge, MA: Harvard University Press, 1960), 21–52, especially 43; Charles Fried, *Contract as Promise*, 13–14; Jon Elster, *The Cement of Society* (Cambridge: Cambridge University Press, 1989), 272–3.

[21] See Kenneth J. Arrow, "Gifts and Exchanges," *Philosophy & Public Affairs* 1 (1972) 343–62, 357 ("virtually every commercial transaction has within itself an element of trust"); David Leonhardt, "Lesson from a Crisis: When Trust Vanishes, Worry," *The New York Times* (September 20, 2008);

come by in a trading climate in which participants have internalized and generally respect the doctrine of the just price than one in which everyone feels free to take one another for as much as he can manage.[22]

But one need not take my word on this. The principle at work here is a familiar one, recognized by those at both ends of the economic and political spectrum. To paraphrase Joseph Schumpeter, for example, just as a motorcar that is equipped with breaks and other safety equipment can go faster than one that is not, economic activity can go faster and spread more widely in the presence of regulation protecting each party from abuse.[23] This is why firms offer low price guarantees and thirty-day money-back refunds—these increase trust, and trust increases economic activity.[24] Markets that are constructed so as to encourage participants to internalize and observe the just price restraint are accordingly likely to generate more social capital in the form of trust than markets that do not, and the presence of this extra social capital cuts down on the need to obtain information about one's trading partners and the risks of trading when one does not (what Ben Bernanke calls the need for "informational capital").[25] And this, in turn, makes many more opportunities for exchange available to everyone.[26]

While the notion that limitations on some specific forms of freedom can actually increase overall freedom is nothing new—both Kant and Hayek, for example, subscribed to it,[27] we can get to the same place even if we reject the idea that negative and positive freedom can be considered together and summed in the way I have suggested. Any infringement of negative freedom can also be justified if that particular aspect of negative freedom is not one that we have a right to enjoy, or conversely, if people have a duty not to act against us in this way and we have a right to enforce this duty. Given that the conception of exploitation I have been positing does indeed treat exploitation

James Surowiecki, "The Trust Crunch," *The New Yorker* (October 20, 2008); David Brooks, "An Economy of Faith and Trust," *The New York Times* (January 16, 2009).

[22] See generally Martin Hollis, *Trust within Reason* (Cambridge: Cambridge University Press, 1998) (emphasizing the importance of shared notions of the common good if social cooperation is to be successful); Russell Hardin, *Trust and Trustworthiness* (New York: Russell Sage, 2002); Jocelyn Pixley, *Emotions in Finance: Booms, Busts and Uncertainty*, 2nd edition (Cambridge: Cambridge University Press, 2012).

[23] See Joseph Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper Perennial Modern Thought Edition, 2008), 88.

[24] See Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (New York: Free Press, 1995), 152.

[25] Ben S. Bernanke, "Speech at the Credit Channel of Monetary Policy in the Twenty-First Century Conference," *Federal Reserve Bank of Atlanta* (June 15, 2007), 2.

[26] See, e.g. John Meadowcroft and Mark Pennington, *Rescuing Social Capital from Social Democracy* (London: Institute for Economic Affairs, 2007), especially 41–2.

[27] For discussions of Kant's and Hayek's views on this matter, see Jeffrie G. Murphy, *Kant: The Philosophy of Right* (London: Macmillan, 1970), 92, and Chandran Kukathas, *Hayek and Modern Liberalism* (Oxford: Oxford University Press, 1989), 142–3.

as a violation of right, a right that arises out of the principle of reciprocity, the fact that enforcement of this right would constitute an infringement of negative freedom is not an argument against it. We also, for example, prohibit the sale of various weapons, drugs, and other contraband even though the parties involved may both be fully informed and willing, and the fact that this is an infringement of their negative freedom does not mean such sales cannot be regulated. The question is not whether enforcement of a right against exploitation along the lines I have outlined would constitute an infringement of negative freedom, but whether some defect in consent or other form of involuntariness must be an element of such a right to justify this.

Frankly, I do not see how the enforcement of a right against exploitation could require a defect in consent. To see why, remember that I have no reason to engage in an exchange (that is, a transaction that is not intended as a whole or partial gift) unless I believe the utility (to me) of what is being offered exceeds the utility (to me) of what is being asked of me in return. Defects in consent therefore refer to the circumstances surrounding judgments of comparative utility—if I am offered a choice between my money and my life, for example, I have been coerced, but only because I am making this comparative utility judgment under conditions that no one has a right to impose. The concept of coercion only has meaning because the choice foisted upon me is a violation of our moral baseline, a baseline that can only be identified by reference to a pre-existing theory of rights.[28] And if coercion can only exist once we have already settled on a background system of rights, it is hard to see how it could be a factor in determining what rights that background system actually includes.

At least, it is hard to see how this could be a factor in constructing a theory of exploitation that is designed to be compatible with rather than a critique of this background system of rights, which is the objective of the project in which we are currently engaged. A defect in consent that is not otherwise recognized as being a violation of law and therefore as providing independent grounds for relief accordingly *cannot* be a requirement for a finding of the kind of exploitation we are looking for. If we are concerned about the voluntariness of a particular transaction, we must focus on this question until we have determined whether that transaction is voluntary or not. That determination, in turn, is not controlled by our theory of exploitation, but by whatever background theory our legal system uses to determine what causes what, or rather what effects should be deemed to be caused by the impermissible interference of other human agents and not sufficiently the product of our

[28] See Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), 262–5; Fried, *Contact as Promise*, 96–9.

own free will.[29] The fact that the price paid seems unjust may be evidence that there was coercion, since this suggests some kind of overreaching, but there is no reason to think this works the other way around. If we find a transaction was coerced, then we have all the reason we need to set it aside at the request of the aggrieved party—there is no need to consider the question of exploitation further. If we find that the transaction was not coerced, then this might give us reason to consider whether our theory of involuntariness really does reflect the moral values we think our society should embrace. But it does not justify smuggling concerns for involuntariness into our theory of exploitation once we have already decided they do not provide a sufficient basis to invalidate the relevant transaction on their own.

Indeed, if we did allow concerns for voluntariness to influence our determination of whether a just price had been paid, we would simply be muddying the waters, making it impossible to develop a determinate principle for deciding when a violation of the doctrine of the just price has occurred. What we would end up with is a principle that required us to balance the degree of deviation from the just price and the degree of economic coercion together to find a violation, for the more we had of one the less we would need of the other, but it is difficult to imagine that we could conduct such balancing any other way than intuitively.[30] What we want is a theory that will allow us to decide when a transaction is exploitive in a more determinate, principled fashion. And if we are to find such a principle, the degree of involuntariness attached to a transaction must be of no relevance in determining whether the transaction is exploitive.

But I recognize that no matter what I say in support of rejecting involuntariness as an element of exploitation, the idea of doing so will continue to rub some people's moral intuitions the wrong way. The reason why, I think, is that if we abandon involuntariness as an element of exploitation, it seems like we will be unable to explain how an exploitive transaction could occur. If the just price is the market price the only reason someone would agree to pay more or receive less than this is that there was some sort of defect either in their consent or their reasoning—they were deprived of important information, pressured in some way, or were the victim of an appeal to an irrational disposition. As we shall see, however, if we do not equate the just price and the market price this problem melts away. There is no need to explain why there is a deviation from the market price, for even if there is no deviation, the

[29] For a similar argument, see Anthony T. Kronman, "Contract Law and Distributive Justice," *Yale Law Journal* 89 (1980): 472–511.

[30] For an example of the need for this kind of balancing, see *Dean Witter Reynolds v. Superior Court*, 259 Cal. Rptr. 789, 795 (Ct. App. 1989) (noting that both procedural unfairness and substantive unfairness are elements of the doctrine of unconscionability, and the more one kind of unfairness is present, the less will be required of the other).

transaction can be exploitive. I will explain my concept of the just price in great detail in a moment, but for now I merely want to point out that given a concept of the just price that does not equate the just price with the market price, the usual motivation to look for some defect in consent does not arise. The circumstances under which the parties agreed to the transaction simply become irrelevant to whether a just price has been paid.

Of course, there is one sense in which the presence of consent always negates the implications of the doctrine of the just price. Transactions in which the seemingly exploited party was actually intending to make a full or partial gift, as I have already explained, are not subject to the doctrine. When this is alleged, consent will accordingly always be an issue—but not with regard to whether the parties had equal bargaining power, information, equivalent starting positions, or the like. In this case, the issue will simply be whether there is clear and convincing proof presented by the privileged party of the other party's donative intent. If there is, the doctrine of the just price does not apply, and if there is not, the presence of circumstances that suggest the seemingly exploited party's agreement to pay the price was truly free and voluntary is irrelevant unless they add up to a grounds for relief all on their own.

Let me emphasize one final point regarding the above for those who still find the disassociation of coercion or involuntariness and exploitation in all other cases hard to swallow. While an element of coercion is not a necessary condition for a finding of exploitation under the conception I am developing here, this does not prohibit us from treating coercion as a necessary condition for a finding of exploitation under some other conception. What I am developing here is a conception of exploitation that is based on the justness of the price charged alone. But as I have said before, this theory of exploitation is not intended to be comprehensive—in other words, I am not trying to articulate a theory that captures every kind of conduct we might want to call exploitive. Rather, I am simply trying to come up with a theory that covers a certain kind of exploitation, a kind that would have determinate and important redistributive implications and effects. There may indeed be a coherent and defensible conception of exploitation that takes an interest in the conditions surrounding the transaction as well as the question of the price—nothing I say here is intended to preclude this. Those who feel that it is important to keep the possibility of such a theory alive and to distinguish it from the theory being developed here can accordingly feel free to acknowledge this by adding an appropriate modifier to the term "exploitation" wherever it hereinafter appears (just as the conception of exploitation articulated by Marx is often referred to as "Marxian exploitation") without fear of undermining any of the arguments I am going to present or any of the conclusions I am going to base thereon.

3.6 Value

The final but most important limitation on the conception of exploitation I am advancing is that it applies only when there has been an exchange of value for value. What this means is that our theory of exploitation, like the doctrine of the just price, requires a pre-existing theory of value. Many people assume that for Marx, this pre-existing theory is the labor theory of value, which says that the value of a commodity is the socially necessary labor time required to recreate it at the time its value is to be determined. But a growing number of contemporary theorists—most prominently among them G. A. Cohen—have convincingly argued that this represents a misreading of Marx—Marx's theory of exploitation does not depend on the labor theory of value being true. On the contrary, that theory is either irrelevant to Marx's claims regarding exploitation, or these claims actually depend on the labor theory of value being false, which one, in turn, depending on how the labor theory of value is understood.

For example, if the labor theory of value is understood as entailing the claim that labor and labor alone creates value, then the labor theory of value must be false, for what matters under Marx's theory of exploitation is not how much value a commodity has at the time of its creation but how much it has at the time it is exchanged, and the latter can be more or less than the former. Indeed, in extreme cases, a commodity might have no value at all at the time it is created yet have substantial value at the time it is exchanged. If, on the other hand, the labor theory of value is understood as *not* entailing the proposition that labor and labor alone creates value, and there can be other sources of value as well, then the fact that there is a difference between the socially necessary labor time required to create a good at the time of its exchange and the socially necessary labor time required to create the goods that the worker can purchase with his wages (in other words, the fact that the worker creates surplus value and that this is appropriated by the employer) gives us no reason to think that the worker is being exploited—some other theory is required to account for this. So in this case, the labor theory of value simply has no bearing on whether Marx's theory of exploitation is true.[31]

Despite all this, the labor theory of value is still widely assumed to undergird Marx's theory of exploitation, and therefore is widely believed by many Marxists (and some non-Marxists as well) to be true. No doubt, these people

[31] See G. A. Cohen, "The Labor Theory of Value and the Concept of Exploitation," *Philosophy and Public Affairs* 8 (1979): 338–60, especially 345–6; Ian Steedman, "Ricardo, Marx, Sraffa," in *The Value Controversy*, ed. Ian Steedman (London: New Left Books, 1981), 11–19; John E. Roemer, *Free to Lose: An Introduction to Marxist Economic Philosophy* (Cambridge, MA: Harvard University Press, 1988), 47–51; John Rawls, *Lectures on the History of Political Philosophy* (Cambridge, MA: Harvard University Press, 2007), 331.

will want to know how our theory of exploitation can proceed if it relies on a different pre-existing theory of value. So some further comment on this is required in order to make clear that the pre-existing theory of value on which our theory of exploitation relies is actually designed to play a completely different role in our theory of exploitation than the role the labor theory of value is (supposedly) designed to play in Marx's theory. As a result, it simply makes no difference to our theory how the labor theory is to be understood or whether it is true.

The labor theory of value is an attempt to develop a universal way of measuring value. A universal way of measuring value would apply across societies, no matter what economic system each society happened to have in place, and even if those economic systems happened to be different. It would also apply no matter what economic conditions happened to obtain, and at all times. It would accordingly provide an invariable and irreducible standard for explaining how commodities come to have value and how much value they actually have. In other words, as a universal measure of value, the labor theory purports to provide a theory of both the *origin* and the *extent* of value.[32] If there were differences between the values the labor theory reveals and the prices that necessarily obtained under a particular economic system, this difference can then be used to explain why that economic system—such as capitalism—is exploitive while another economic system—such as socialism—is not. It can thus be used to critique economic systems as well as to determine the value of commodities no matter what economic system happens to be in place.

But whether the labor theory of value succeeds or fails at this task is of no consequence to us here. We are not trying to explain what might be (necessarily) unjust *about* capitalism, but rather what might be (contingently) unjust *within* capitalism given the presuppositions that its acceptance and implementation necessarily require. In other words, our theory of exploitation is not designed to tell us whether capitalism as a system is just, but only whether any particular capitalist system is operating justly within the presuppositions that allow that system to exist, regardless of whether these presuppositions can or perhaps should be challenged. So even if Cohen and those who like him reject the labor theory of value are wrong and the value of any good can be

[32] Clearly, even if the labor theory explains the extent of value, it is not by itself sufficient to explain the origin of value, for why should the fact that all commodities can be reduced to the labor required to create or recreate them explain why they have value? To explain this, we need an additional theory to explain what the connection between labor and value is. This is usually provided by something like Locke's theory of property, which says that mixing one's labor with unowned resources is how one comes to own things. A further theory is then needed to explain why owning things gives them value—something, for example, that says owning things is like owning ourselves, and that the autonomy that owning ourselves reflects is the ultimate source of value.

reduced to the socially necessary labor time required to recreate it, this is not a problem for our theory. As we shall see, our theory does not distinguish between value at the time of production and value at the time of exchange, and therefore does not encounter the same problem that Marx's theory of exploitation would if labor and labor alone did create value. And as we shall also see, if labor and labor alone does not create value, this does not leave the judgment that exploitation is wrong under our theory of exploitation unmotivated, for under our theory this does not depend on how value is originally created. Indeed, if the labor theory of value were true, all this would mean is that a particular transaction could be exploitive for reasons *other* than our theory of exploitation provides—it would not mean that a transaction which *is* exploitive under our theory is not exploitive for the reasons our theory does provide. In any event, because the theory of value on which our theory of exploitation relies is intended to play a more limited role than the role (supposedly) played by the labor theory of value, we can simply take the justness of a capitalist society's pre-existing theory of value as given, and focus exclusively on what has value within the confines of that system.

What then, is the theory of value on which capitalism relies? Labor certainly does have value within capitalism, since many transactions involve the exchange of labor for other carriers of value. These other carriers of value, however, could be many other types of goods, tangible and intangible, including rights, liberties, and opportunities, land, plant and equipment, money, financing, and insurance services, transportation, consolidation, storage, and coordination services, the assumption of risk and liabilities, the waiver or forbearance on execution of a previously existing obligation, and promises to deliver any one or combination of the above. It seems clear that while some of these goods could be reduced to the labor that was required to create them, or to create the means of their production, it is generally thought that land cannot be so reduced, for land (or at least most land) is not created by labor.[33] It is hard to see how rights, liberties, opportunities, or the assumption of risk could be reduced to some amount of labor either. And while a promise may indeed be a promise to perform labor, it seems to be somewhat of a stretch to interpret such a promise as labor itself, at least at the time the promise is made rather than performed. Yet an executory promise can be very valuable—indeed, it is often the most valuable asset that many people have, at least once a method for the enforcement of promises has been put in place.[34] In any event, regardless of whether these various carriers of value can be wholly

[33] Indeed, this is why some theorists have attempted to articulate a theory of value that relies on both labor and land. See, e.g. Richard Cantillon, *Essay on the Nature of Commerce in General*, trans. Henry Higgs (New Brunswick, NJ: Transaction Publishers, 2001), ch. 10.

[34] For more on the available methods of enforcement, see Reiff, *Punishment, Compensation and Law*, 17–44.

reduced to labor, it is not labor that people are necessarily seeking to obtain when they engage in trade, but rather the form that these carriers of value actually take, even if at some point in their past this form was the result of the interaction between labor and the world. What we need, then, is not a theory of how goods that have value (and again, I am using the word goods here in its broadest possible sense) come to be produced, but a theory that tells us what goods have value and therefore what goods can be the basis of an enforceable exchange in the society in which the exchange takes place. And this, of course, includes but is not limited to labor.

Where, then, do we look for this theory of value? Well, the first thing we should note is that the theory of value on which our theory of exploitation relies is not to be found in the concept of property—the theory that explains how people come to own things—despite the fact that the labor theory of value and the labor theory of property have long been associated. At least it is not to be found exclusively in the concept of property. On the contrary, in capitalist societies, the relevant theory of value is to be found in the concept of contract. Exploitation is a concept that regulates transactions, and transactions are contracts, not property. It is our theory of contract, not property, which determines whether something is intended as a gift. It is our theory of contract, not property, which determines what can be exchanged and what cannot. It is our theory of contract, not property, which determines whether an exchange is voluntary. And if we want to know what a society considers to be of value, it is within contract law and its foundations that we must look. It is accordingly our theory of contract, not property, which defines the realm within which our concept of exploitation is to operate, and it is our theory of contract, not property, which determines what has value and what does not.

Conveniently, there is already a word in use in common law countries to describe the particular types of goods that have value under contract law. That word is "consideration." In short, consideration is anything that is bargained for—whether it be the transfer of money or property, or an affirmative act or forbearance, or the acceptance of risk or liability, or a promise to do any of these things.[35] In common law countries, the exchange of consideration is evidence of the parties' intent to enter into a binding contract, to create rights in one another that did not exist before and which they each may subsequently enforce. A mere statement of intent to make a gift, for example, is not supported by consideration because nothing is bargained for in exchange—that is what makes it a gift. For a contract to arise, in contrast, for each party to

[35] See American Law Institute, *Restatement (Second) of Contracts* (1981) § 71. For a general discussion of what constitutes consideration, see Joseph M. Perillo, *Calamari and Perillo on Contracts*, 5th edition (St. Paul, MN: Thomson West, 2003), chs 4–6.

have the right to enforce the performance of the other, some form of consideration must have passed between the parties—each party must have bargained for something from the other. Not that the value of what is bargained for by each party must be equivalent—the purpose of the consideration requirement under common law is not to ensure that the transaction is just, although I will be using the concept for that purpose. The purpose of the consideration requirement is merely to ensure that the parties intended their respective performances to be enforceable.[36] Consideration is accordingly the term used to describe anything that has legal value under the system currently in force. If no consideration passes between the parties, no contract can arise, and if there is no contract, there can be no possibility of exploitation under our theory, for there has been no exchange of value for value.

There is one qualification, however, I must make to this last remark. In some common law systems, detrimental reliance on a promise can substitute for consideration, even if it is not directly bargained for and even if the benefit of such reliance (if there is any benefit at all) does not flow directly to the promisor.[37] In other words, reliance that is intentionally induced or even just foreseeable in these jurisdictions can turn what would otherwise have been a one-way unenforceable promise into an enforceable exchange. Where reliance has this power, it accordingly has a value that it would not have in other circumstances. For purposes of the argument I am making in this chapter, then, when I refer to consideration, I mean to include detrimental reliance among the type of goods to which this terms refers, at least as long as this is accepted as a substitute for consideration under the relevant legal system, and all other recognized substitutes for consideration as well.[38]

Consideration, of course, is primarily an Anglo-American legal concept, and consideration is not required for the formation of a contract under civil law. But while the presence of consideration is not required for there to be a contract under civil law, the concept of consideration is not mysterious to

[36] The thinking behind this is that the parties would not have this intent unless each gave up something of value to the other. In fact, this may or may not be true, but for historical reasons that are not important to us here, in common law countries it is conclusively presumed to be the case.

[37] See, e.g. American Law Institute, *Restatement (Second) of Contracts* (1981) § 90. Detrimental reliance is accordingly said to give rise to what is called "promissory estoppel." For further discussion of the history and effect of the doctrine of promissory estoppel, see Robert A. Hillman, "Questioning the 'New Consensus' on Promissory Estoppel: An Empirical Theoretical Study," *Columbia Law Review* 98 (1998): 580–619; Charles L. Knapp, "Rescuing Reliance: The Perils of Promissory Estoppel," *Hastings Law Journal* 49 (1998): 1191–335.

[38] Depending on the legal system, there may also be other substitutes for consideration. And in every common law system, there will be countless cases discussing exactly what constitutes consideration or one of its substitutes and what does not. While all systems agree on what consideration is in the central case, exactly what constitutes consideration at the fringes will vary from one system to another. But this is not a problem for our theory—indeed, the whole idea is that what has value is to be determined from within each system, not from outside it, so some degree of variation is both expected and appropriate.

those living in civil law countries. The concept of consideration may not be an element of civil contract law, but it is an element of civil tax law, where it is used to calculate the amount of value added for purposes of the value added tax.[39] So the concept should provide a handy way of describing the theory of value on which our theory of exploitation is based no matter what legal tradition is followed in the particular capitalist society at issue.

Note that saying that consideration must pass between the parties for the transaction to be subject to our theory of exploitation does not mean that there must be a contract between the parties in the legal sense. In many cases, consideration may pass between the parties but a contract nevertheless does not arise because of non-compliance with some formal requirement, such as the absence of a writing reflecting the contract's essential terms signed by the party to be charged, a requirement that is a part of contract law and referred to as "the statute of frauds."[40] Under common law, when an exchange is not properly documented according to the statute of frauds, the exchange takes place in what is called "quasi-contract," and the aggrieved party may be allowed to recover the reasonable price for the goods or services provided even though he will be unable to recover the contract price.[41] For our purposes, however, as long as consideration has passed between the parties, the transaction is an exchange of value for value and is therefore one to which our theory of exploitation will apply.

But that still leaves us having to decide how units of this kind of value will be expressed, for we have rejected the idea that they should be expressed in terms of the social necessary labor time. Once again, then, we must return to the idea that our theory sits inside the capitalist system to which it applies rather than stands outside it. The value to which our theory of value necessarily refers must accordingly be expressed in the terms this capitalist system is already set up to recognize: that is, money. No further reduction of the concept of value is required because money is already the established capitalist means of exchange. In some cases, of course, translating certain kinds of valuable consideration into its equivalent in money may pose problems, for some goods are not so easily valued in monetary terms. Merely stating that the value of consideration is to be expressed in units of money does not tell us how that value is to be calculated, for as we have seen we must still choose between a market-price based conception of value and a cost-of-production based conception. There are many sub-conceptions within these two general categories from which to choose as well. I shall get to the latter problem in just

[39] See Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge: Cambridge University Press, 2007), 246–51.

[40] On the statute of frauds generally, see E. Allan Farnsworth, *Contracts*, ch. 6.

[41] See Joseph M. Perillo, "Restitution in a Contractual Context," *Columbia Law Review* 73 (1973): 1208–26.

a moment. The former problem, I am afraid, we shall just have to live with. Any theory of value is going to face translation problems. All I can say about this is that the problems to be faced in translating an endless variety of forms of consideration into sums of money are no more difficult than the problems we would face translating these into anything else.

We are now in a position to summarize the qualifications that apply to our original definition. We started with the idea that exploitation is the unjust extraction of value from another as part of a voluntary exchange transaction not otherwise prohibited by law. We now know that "value" means consideration in its broadest sense, and that this is to be translated into and expressed in terms of units of money, that a "voluntary" exchange is one that is defined as voluntary under existing law, that a voluntary "exchange" is a sales transaction rather than a whole or partial gift, and that a transaction cannot be exploitive if it is void but may be exploitive if it is merely voidable and is affirmed. And we know that some sort of not legally-cognizable involuntariness or other defect in consent is not a necessary condition for a finding that the transaction is "unjust." This, of course, still leaves that last term to be cashed out—we still need to know when an extraction of consideration *is* unjust. To answer that question, we have to go back to the doctrine of the just price.

4

What Price is Just?

We now come to the critical question for any conception of exploitation based on the doctrine of the just price—how are we to determine what price is just? Shall we use the market price, as (almost) everyone has for more than two thousand years, or shall we, as Marx and perhaps Aquinas did, use the cost of production? And if we do use the cost of production, how is the cost of production to be determined? We have already rejected socially necessary labor time as the sole measure of the cost of production, but merely replacing the labor theory of value with a broader theory of consideration does not alone tell us how the cost of production is to be calculated. Are we to use marginal cost—the cost of producing one additional unit of the good? Or should we use fully allocated cost—the average total cost of producing the good, calculated by dividing the total cost of production, including both fixed and variable costs, by the total number of units produced? Do we use private cost—the cost that the producer actually incurs, or do we use social cost, which includes the cost of any externalities (such as pollution costs) imposed on non-parties to the transaction? Do we use the accountant's approach to calculating cost, or do we use the economist's? And how do we account for time? Is the justness of the price to be determined at the time the transaction takes place, or are we to take into account subsequent discoveries or events, and if so, in what way? And finally, while we are not attempting to express all costs in terms of labor, are there nevertheless any special concerns when it comes to calculating the just price of labor, and if so, what might these be? These are the thorny questions to which we now turn.

4.1 Market Price vs Cost of Production

The argument for using market price as the referent for our doctrine of the just price goes like this. The idea that something is worth whatever someone will pay for it has a powerful intuitive appeal. How can we deny that this is indicative of a good's value? Each man is the judge of his own utility, and if a man finds that whatever is on offer has greater utility than whatever is being demanded in return, who are we to go behind these judgments and second guess the parties directly involved? If Jack is convinced that three magic beans have greater utility than his prize dairy cow, and there has been no fraud or other violation that would give us reason to prevent or avoid such a transaction, who are we to intervene?

The answer is that for our purposes, value and utility are not the same thing. Value is something that is intrinsic to whatever is being valued, determined by whatever properties it has and how these were created, preserved, and transferred. Utility, in contrast, is a function of the nature of these properties, their level of scarcity under current conditions, the needs, wants, and desires they can satisfy (what economists call their "use value"), and the needs, wants, and desires of particular persons. Taken together, these considerations determine what economists call a good's "exchange value," which is what that good can command in terms of other goods and services in the marketplace at the time. Use value is accordingly part of what goes into calculating exchange value, which is equivalent to a good's market price, but it is critically important to remember that value does not merely have *two* forms. On the contrary, it has *three*, the third being value itself (a more helpful label here would be "just exchange value," although no theorist actually uses this term when they are speaking of the just price). Unfortunately, many theorists (especially economists) seem to forget this and speak as though use value and exchange value are the only kinds of value that exist.[1]

Utility, in contrast, is a different standard of measure altogether. Utility is forward-looking, focusing on use value, supply, and demand; whereas value (meaning just exchange value) is inherently backward-looking, focusing on what something is and on how it came to be. Used in this sense, then, value is an historical, objective measure, whereas utility is a subjective, predictive one. So while a good's utility may be an excellent measure of its value to a particular person, and its utility in general may be an important factor in the calculation of its exchange value, there is no reason to think that either kind of utility provides an accurate way of measuring *just* exchange value. That kind of value is what the doctrine of the just price is designed to measure. Indeed, only that kind of value can be equal for both parties to a transaction. Utility, by definition, must be unequal, at least from the point of view of each party to the transaction, otherwise the transaction would not occur. Indeed, it is precisely

[1] See, e.g. the various theorists discussed in Knut Wicksell, *Value, Capital, and Rent* (London: George Allen & Unwin, 1954), 32–41. Wicksell himself seems to have made this mistake. Ibid. at 47–96. Marx, however, did not. For a discussion of Marx's use of the terms "value," "use value," and "exchange value," see G. A. Cohen, *Karl Marx's Theory of History: A Defence* (Princeton: Princeton University Press, exp. ed. 2001), app. 2.

because the utility of goods offered for exchange is different for each party from their own idiosyncratic points of view that both have a reason to engage in the transaction, for each can secure utility gains even though the value of the goods exchanged may be equivalent.

Now some of those to whom I have made the above argument have been inclined to resist it, arguing that at the very least value cannot be determined without consideration of demand—the higher the demand for a good the greater its value, and therefore its just price, and not merely its utility. But I do not see why this should be the case. Why should justice allow much less require one party to pay more for a good than it cost to produce simply because that party has some special need for it? As Aquinas said, one cannot own the need or want of another man. And if one cannot own the need or want of another man, one cannot sell it. But this is exactly what one does if one raises his price to reflect not increased costs but increased demand. And while those who think that this is just and proper will often point to transactions where our intuitions seem to support this kind of thinking, once those transactions are placed in their proper context we can see that our intuitions actually flow in the opposite direction. Indeed, as R. H. Tawney noted many years ago,

> The idea that there is some mysterious difference between making munitions and firing them, between building schools and teaching in them when built, between providing food and providing health, which makes it at once inevitable and laudable that the former should be carried on with a single eye to pecuniary gain, while the latter are conducted by professional men, who expect to be paid for their services, but who neither watch for windfalls nor raise their fees merely because there are more sick to be cured, more children to be taught, or more enemies to be resisted is an illusion only less astonishing than that the leaders of industry should welcome the insult as an honour and wear their humiliation as a kind of halo.[2]

Tawney's point is that there is simply no relevant difference between these pairs of situations. If we do not think that demand should determine price in the latter cases, it should not determine price in the former cases either. Of course, the converse is also true, but I find it hard to believe that many people would be willing to say that munitions makers ought to be able to charge more for their wares in times of war than in times of peace, that doctors should be able to bump up what they charge for their services in times of plague, that a private fire department should be able to charge more for putting out a fire in a city school even after it has been evacuated than it can charge for putting

[2] R. H. Tawney, *The Acquisitive Society* (New York: Harcourt Brace, 1921), 96.

out a fire in an abandoned warehouse when the costs and risks involved are otherwise the same, and so on.

There are also a number of other reasons why our unconsidered intuition that a price cannot be unjust if someone is willing to pay it (at least in certain situations) is less powerful on closer examination than it initially seems. First of all, it is clear that this intuition does not hold unless the price has been set in the context of a genuinely competitive market. Even though some potential purchasers are prepared to pay the higher prices that a monopolist can demand, for example, few think this is alone sufficient to make the price charged just. Indeed, there is a long history of challenging prices that reflect monopolistic practices, not only because monopoly pricing is viewed as inefficient, but also because it is viewed as unfair. This concern for fairness holds not only for pricing decisions that represent the exercise of established monopoly power, but also for attempts to cash in on what may be fleeting or isolated shortages or other brief or intermittent sources of such power, and also for pricing decisions that are attempts to acquire monopoly power by (for example) selling below cost and driving out the competition.[3]

For example, most people do not think it fair for a local hardware store to raise the price of a snow shovel from $15 to $20 after it snows even though there is increased demand and no greater supply, or that it is fair for a landlord to raise the rent on an apartment $40 more than he was going to raise it after he finds out that his tenant has just taken a job nearby and therefore is unlikely to move.[4] Similarly, most people think that a ticket broker is doing something

[3] Some people, of course, believe that fairness is a part of justice but not coextensive with it. In other words, they believe that something may be unfair but not unjust, because there may be other all-things-considered moral considerations, which they view as part of justice, that come into play. For these people, justice is accordingly the name for an all-things-considered conclusion about what morality requires us to do. But I do not think that this is how most people use these terms, and in any event, this is not how I will be using them here. When I say that people tend to see certain pricing practices as "unfair," I mean they see them as unjust, and by "unjust" I simply mean that they think of themselves as having a *pro tanto* justice-based reason to consider these practices morally objectionable. I do not mean that people necessarily conclude that morality prohibits these pricing practices, all-things-considered, and I certainly do not mean that they necessarily think that these practices should be legally prohibited. Whether such practices are unjust all-things-considered, and whether and if so when they should be legally prohibited, are questions that I shall address at length later.

[4] 82 per cent of people surveyed thought the price increase unfair in the first example, 91 per cent thought the increase unfair in the second. See Daniel Kahneman, Jack L. Knetsch, and Richard Thaler, "Fairness as a Constraint on Profit Seeking Entitlements in the Market," *American Economic Review* 76 (1986): 728–41. These survey results are now more than twenty-five years old, so the equivalent increases in current dollars would be higher, but the same survey also reveals that popular reaction is remarkably insensitive to the amount of the increase. Rather, it seems that people focus on the reason for the increase, and that they overwhelmingly perceive price hikes based on a simple increase in demand or an increase in bargaining power as unfair. Similar reactions have also been found in other free market cultures. See Bruno S. Frey and Werner W. Pommerehne, "On the Fairness of Pricing—An Empirical Survey Among the General Population," *Journal of Economic Behavior and Organization* 20 (1993): 295–307 (Germany); Robert J. Shiller, Maxim Boycko, and Vladimir Korobov, "Popular Attitudes Toward Free Markets: The

unfair when he charges a premium for seats to otherwise sold-out events that includes more than compensation for the cost of the services he provides—this is why ticket brokers are often derogatorily referred to as ticket "scalpers."[5] And similar examples abound.[6] Thirty-four US states even have laws against various types of "price gouging," which is typically defined as raising prices on essential goods more than 10 per cent above the existing price during a state of emergency, excluding, of course, prices increases that are necessary to compensate the seller for any actual additional costs he may have been forced to incur.[7] Indeed, people generally react to price increases based on increased demand rather than increased costs as unfair, which is why sellers often go to great lengths to disguise price increases rather than have to explain them.[8] And if this is what we think with regard to price *increases*, why would we think something different when it comes to judging existing market prices?

The answer, of course, is we do not. The proposition that a price cannot be unjust if someone is willing to pay it under the relevant circumstances does not in fact coincide with our considered intuitions. On the contrary, people know and indeed expect that the same product purchased from a big box store will cost less than if purchased at a corner market because the big box store benefits from economies of scale and therefore enjoys lower costs, and customers will think that prices at the big box store are unfair if they do not reflect a cost-based discount. People generally view the "flipping" of real property with disdain, even though the price ultimately charged is what the market will bear, because the profits generated often greatly exceed the costs the "flipper" has incurred. People see bank overdraft and credit card late fees as

Soviet Union and the United States Compared," *American Economic Review* 81 (1991): 385–400 (Russia).

5 See Walter Block, *Defending the Undefendable* (New York: Fleet Press, 1976), 94–6.

6 See, e.g. Kahneman, Knetsch, and Thaler, supra.

7 For a list of these states and some of the various conditions and restrictions that apply to the relevant statutes, see Matt Zwolinski, "The Ethics of Price Gouging," *Business Ethics Quarterly* 18 (2008): 347–78, at Appendix A. For a discussion of these conditions and restrictions, see Jeremy Snyder, "What's Wrong with Price Gouging?" *Business Ethics Quarterly* (2009): 275–93. Note that the fact that these statutes only apply in emergency situations does not imply that there is no moral objection to be made to similar price increases in non-emergency situations or with regard to non-emergency goods. It is simply that formal prohibition of such price increases in non-emergency situations is generally unnecessary because competition should ordinarily keep prices from rising more than this unless, as the examples I have given in the text demonstrate, there are reasons for an idiosyncratic or localized increase in demand.

8 This, for example, is what Skippy recently did when it raised the price of its peanut butter without seeming to—it switched from a smooth bottomed jar to a jar with a concave bottom. To the unwary consumer, the new jar appeared to be the same size as the previous jar, but it actually contained significantly less peanut butter for the same price. See William Poundstone, *Priceless: The Myth of Fair Value (and How to Take Advantage of It)* (New York: Hill and Wang, 2010), 4–5. Whether this effective price increase was justified by increased costs is unclear, but even if it was, the fact that Skippy chose to disguise the rise rather than try to justify it is telling. For examples of similar attempts to disguise price increases, see Stephanie Clifford and Catherine Rampell, "Food Inflation Kept Hidden in Tinier Bags," *The New York Times* (March 28, 2011).

unfair because it defies credibility to imagine that the fees charged are even a rough approximation of the costs incurred as a result of the customer's behavior.[9] And people expect to pay much less than market price when purchasing goods from someone who does not ordinarily deal in goods of that kind, for such a person has not incurred the costs typically incurred by dealers. This is why, for example, everyone expects to pay less for a used car purchased from a private party rather than a dealer, but thinks it unfair that the dealer will pay less for a used car than a private party. People do think that cost matters, and are prepared to insist that when costs are lower for the seller, at least a portion of these savings be passed on to them.

Moreover, even perfectly competitive market prices are not always seen as fair. For example, people are often willing to pay more than the market price to producers whose costs are higher (and even substantially higher) than the market leaders, or at least they are prepared to accept that the higher prices of these less efficient producers are not *unjust*. For example, in a market for milk dominated by giant mechanized producers, we do not think that a small family farm is acting unjustly when it sells the hand-drawn milk from its dairy cows for more than the market price. Of course, we may or may not choose to buy the small dairy farmer's more expensive product, especially if it is otherwise indistinguishable from that on offer by the big producers, and the farmer may accordingly be forced to lower his price to that set by the big producers. But whether we think the small farmer's higher price is unjust and whether we are prepared to pay it are entirely different questions—it is hard to see how the farmer is acting *unjustly* if he prices his milk above the market price given the higher costs of his smaller operation. Similarly, not all workers are equally productive. Some will take longer to complete a particular job—let us say painting a house—than others under the same conditions. Whether they price their services by the hour or the job, those for whom the job will take longer will want to charge a higher total price for the project than the market price set by their more efficient competitors. And while we may prefer to hire the more efficient and therefore cheaper worker if we can find him, I do not see how we could say that the less efficient worker is acting *unjustly* by charging (or attempting to charge) more than the market price when this merely reflects the greater labor time he must devote to completing the project.[10]

[9] See, for example, the criticism levied against such fees in Seana Valentine Shiffrin, "Are Credit Card Late Fees Constitutional?" *William & Mary Bill of Rights Journal* 15 (2006): 457–500, 477–9.

[10] I therefore disagree with Alan Wertheimer, who thinks that as long as a competitive market price is paid neither party can have "taken advantage" of the other, even though he concedes that such a price does not "correspond to any deep principle of desert or value." See Wertheimer, *Exploitation* (Princeton: Princeton University Press, 1996), 230–3.

Finally, and I shall discuss this in much greater detail in a moment, a competitive market price is not necessarily fair if it imposes costs (called negative externalities) on non-parties to the transaction, as would be the case, for example, when the price paid for a good does not include the cost of cleaning up the pollution that the production of the good creates. In this case, it is neither the buyer nor the seller who has been taken advantage of—the parties involved have gotten a bargain—it is those who suffer at their hands who have cause to complain. I shall discuss the degree to which such complaints are justified in a moment; for now, however, the only point I want to make is that we have strong reason to doubt that the market price necessarily tells us anything conclusive about fairness no matter how competitive that market price might be.

What these examples show is that market price is not *dispositive* when it comes to determining the just price, it is merely *suggestive* of the just price, and how suggestive it is depends very much on the surrounding circumstances. When these circumstances indicate that the market price does not accurately reflect costs the seller has actually incurred, we are unwilling to pay it. And when circumstances indicate that the price charged by a particular producer *does* reflect costs he has actually incurred, we are unwilling to prohibit him from charging this even though the prevailing market price may be much lower. Market price is really just a proxy for the cost of production, and when we have reason to believe the relation between these two measures has broken down, it is the cost of production, not the market price, that we find most important. And if cost can be such an important factor in these cases, it is hard to see why it should not be just as important in all cases. Despite the fact that many people purport to rely on the market forces of supply and demand to determine the just price, the true measure of the just price is and really always has been the cost of production.

Indeed, if we believe in the principle of reciprocity, we *must* reject demand as the measure of value, because no matter what goods are the subject of an exchange, only the cost of production of these goods can always be equal. While it is true that both parties may and usually will profit from the transaction in terms of utility *gains*, and these gains could be equal, this is likely to happen only rarely, for the degree of gain will depend on each party's individual wealth, needs, intensity of desire, and other personal circumstances, and these will often vary widely. To determine whether utility gains were equivalent, it would also be necessary to measure each party's gain against a single cardinal scale, and most people think such interpersonal comparisons of utility are impossible. So if the just price doctrine required that each party realize an equivalent utility gain, this would effectively mean that all or at least almost all exchange transactions would be prohibited. If we are to give effect to the principle of reciprocity, and we reject the idea that demand can be a factor here, then the only way to do this is by ensuring equality in terms of the cost of production. Reciprocity in terms of the cost of production is what would happen naturally anyway if we lived in a world where all goods were exchanged under conditions of perfect competition. It is only because such conditions are rare that profit in terms of value is even possible. I will have more to say later about how such profits come about and the extent to which we may want to allow or even encourage producers to pursue profit given the imperfect state of the world in which we actually live, but the reasons for doing so are all-things-considered reasons, reasons that relate to economic growth and efficiency, not reasons of justice.

There is, however, one argument in favor of the justness of market-based pricing not based on the principle of reciprocity that I also want to mention. This is that pricing goods according to demand is the fairest way of allocating them between multiple claimants when there are insufficient amounts of the good to go around. Those who have the greatest need or want for the good will be prepared to pay the most, and thus allowing the price to float according to market demand ensures that goods are distributed in the fairest as well as the most efficient manner possible. This would be true, however, only if wealth were equally distributed among the competing claimants, and this is not always or even often going to be the case. Demand pricing is subject to wealth effects—because of the declining marginal utility of money, the fact that A is willing to pay more for a good does not necessarily mean that the good satisfies a greater need or want for him than it does for B if A is significantly wealthier. Indeed, if A is significantly wealthier, A's need or want may be trivial in comparison to B's even though A is willing to pay substantially more. In light of this, allocating scarce goods to the highest bidder is not necessarily fair. Indeed, we have no reason to believe it is any fairer than allocating scarce goods based on the principle of first in time, at least in most cases. More importantly, however, even if it were true that demand pricing is the fairest way to allocate scarce goods in particular circumstances, this would not explain why it is just for the *seller* to profit from this. At least it is not clear why *all* the amount over the cost of production should go to the seller in such cases rather than be taxed by the government or be shared out among various members of the community in some other manner. So even if there is something to be said for using market-based pricing as an allocation method in certain circumstances, this does not mean that allowing the seller to charge and to retain whatever price the market will bear is just. If we want to determine what price is just for the seller to receive, we have to refer to the cost of production.

Opting for the cost of production as the measure of the just price, however, does not in itself tell us how the just price is to be calculated, for there are various ways of interpreting what the cost of production entails. While we have already rejected reliance on Marx's reductionist theory of the cost of production, which (supposedly) claims that the cost of production is equivalent to socially necessary labor time alone and have instead opted for a much broader definition of cost of production that includes labor, the use of land, plant, and equipment, goods, money, financing, assumption of risk, and promises to provide any of the above—in short, anything that constitutes consideration under the common law, there are still issues of definition that remain. To resolve these issues, I propose that we take the choice of the cost of production as our referent for the doctrine of the just price to mean this: a price is just only when it is equivalent to the average total social cost of the good at issue, and by average total social cost, I mean the average total cost of producing whatever good is at issue, plus the cost of externalities.

4.2 Accounting vs Economic Cost

Besides including the cost of externalities, there are further adjustments that must be made to what would otherwise be considered the average total cost of production. Accountants and economists have long had different views as to what counts as a "cost" of production and therefore what the profit (or loss) generated by an act of production might be. For example, accountants typically do not include the opportunity cost of capital (what could be earned if the capital required for production were instead employed in some other equally risky investment); accountants treat actual cost as the basis for depreciation, whereas economists use anticipated replacement cost; accountants are often reluctant to write up or write down the book value of a capital asset until a capital gain or loss is actually realized, while economists tend to want to recognize these as soon as it is reasonably clear that changes in the market value of an asset have occurred; and so on.[11] In other words, accountants are generally more concerned about historical cost—what is the sum total of out-of-pocket expenses and income actually generated by an activity, whereas

[11] Ironically, this last difference in approach has become a political battleground in recent years. In response to extreme pressure to present a more economically accurate picture of a firm's financial position, accountants recently changed their position on the valuation of assets and required firms to "mark to market," that is, they required firms to show market value rather than book value of certain assets in their financial statements. In light of the recent collapse of the market for mortgage-backed securities, however, accountants are under enormous pressure to reverse themselves yet again, and to allow a much more generous approach to the valuation of certain assets, for in the current circumstances this is claimed to be more economically realistic. See Floyd Norris, "Banks Get New Leeway in Valuing Their Assets," *The New York Times* (April 9, 2009). See also Floyd Norris, "Accountants Misled Us Into Crisis," *The New York Times* (September 11, 2009).

economists have a much more prospective outlook.[12] Which view are we to take here?

It might seem that it is the economist's approach we would want to follow, for the accountant's approach is often criticized as overstating the amount of profit earned from an activity. I have no doubt that this criticism is correct in the context in which it is raised, but for our purposes, it is the accountant's approach that is most suitable. Remember, at this point, all we are trying to do is establish a formula for calculating the just price; we are not trying to develop a principle for telling us what we should do, assuming, of course, that what we want to do is maximize our profit opportunities. Were we trying to do the latter—to develop a principle that was designed to help us to determine which of two mutually exclusive activities was likely to be most profitable, then of course we would want to consider factors like the opportunity cost of capital and other factors accountants generally do not consider, for otherwise we might choose the activity that generated the lower expected profit given the risk involved. But we are not trying to develop such a principle of choice. We are simply trying to develop a way of measuring when the consideration given by one party to another is equivalent to the consideration received in return. Besides, if we considered the opportunity cost of capital now, and then made some allowance for charging a reasonable profit over and above the just price later, we would essentially be counting the opportunity cost of capital twice. Because an allowance for the opportunity cost of capital will come into the calculation of whether a transaction is exploitive later, we do not need to make that a part of our calculation of the just price now. Accordingly, at least for now, whenever I refer to the average total social cost of production this should be understood to mean average total *accounting* cost, plus the cost of externalities.

Note that one of the things this tells us is how to handle determining the cost basis of a partial or total gift. In these cases, rather than assign the relevant good a cost of production of zero in the hands of the beneficiary, we carry over its cost basis from the donor to the beneficiary, for this is what making a gift of a good rather than its current fair market value actually means. If the donor does want to give the beneficiary the fair market value of the good rather than the equivalent of its cost of production, he has a way of accomplishing this—he can simply sell the good and give the beneficiary the proceeds. If the donor chooses not to do this, then our theory of exploitation requires that the good have the same value in the hands of the beneficiary as it had in the hands of

[12] For a classic and still relevant discussion of the differences between these two approaches to cost accounting and their effect on the calculation of profit, see Joel Dean, *Managerial Economics* (New York: Prentice-Hall, 1951), 3–43. For a more recent discussion, see George J. Benston, "Accounting Doesn't Need Much Fixing (Just Some Reinterpreting)," *Journal of Applied Corporate Finance* 15 (2003): 83–96.

the donor. Of course, there might be reasons why we might want to do otherwise for tax purposes—we might want to assign the good its fair market value at the time of the gift, either in all cases or only when this is higher or lower than the cost of production (remember, either figure could be higher depending upon the circumstances). Or we may only want to do this in certain circumstances, such as when the good has been transferred as a testamentary rather than an *inter vivos* gift. But this is a matter of tax policy, not exploitation.[13] For purposes of our theory of exploitation, the good is to be valued as if it were still in the hands of the donor, for making a gift of a good does not change its actual cost of production.

There is, however, one further actual adjustment to accounting cost we may need to make in a certain number of cases. When goods are produced by a sole proprietorship, and sometimes even by a small business, there may be labor costs that are not fully taken into account on the business's books and records. A great deal of the success of such enterprises is due to the labor of the proprietor or principal owner, and sometimes this labor is performed without compensation, or at least without the level of compensation the business would have to pay if it actually had to pay for it, the idea being that the owner's labor will instead be compensated out of the business's profits. Indeed, as we have seen, this was one of the principal reasons that the Schoolmen used to justify the pursuit of profit, which they distinguished from the pursuit of profit for its own sake. But compensation for labor is a *cost* under our theory, not a justification for profit. And it is an *actual* cost, not an *opportunity* cost, for we are not asking what level of compensation this labor would have generated had it been provided to someone else. We are merely asking what amount of labor is actually needed for the sole proprietorship or other small business to produce the goods it actually does. So when the average total cost of providing this labor is not fully reflected on a business's books and records, it needs to be added in. Only then is it possible to determine the true cost of production of the good involved, and only then is it possible to calculate the average total cost of each individual unit of that good.

4.3 Marginal vs Average Total Cost

But why average total rather than marginal cost? Of course, in long-term equilibrium, average total cost will equal marginal cost will equal price, so there is no need to choose between anything here, but prices are rarely in long-term equilibrium. In the real world, we may occasionally be approaching

[13] For a discussion of the currently effective relevant US tax rules, see generally Publication 551, *Internal Revenue Service* (2011).

long-term equilibrium in certain industries, but we will most likely never get there. There will accordingly almost always be a difference between marginal cost and average total cost. If we are interested in defining the just price, a choice between these two possibilities will accordingly be required. And over the years, many economists have argued for marginal cost pricing. Indeed, there was a time when a majority of economists advocated marginal cost pricing for all goods, arguing that switching to marginal cost pricing from average cost pricing would increase the general welfare, in capitalist as well as socialist economies.[14] Note that if marginal cost pricing were adopted, producers who operated under conditions of increasing marginal costs would receive a windfall, for total revenue would in this case exceed total costs. But this surplus would be taxed and end up in the general fund. Producers who operated under conditions of decreasing marginal costs (this would include natural monopolies like power companies and railroads), in contrast, would suffer a loss, for total revenues would not be sufficient to cover total costs. But this would be made up by government subsidies and ultimately borne by everyone through general taxation or, under some proposals, funded in whole or in part from the surplus recovered from producers in industries with increasing costs. All products would then exchange for their marginal cost, and after the relevant taxes and subsidies were paid, each producer would recover all but no more than all of its total costs.[15]

The argument for why this would increase the general welfare is twofold. First, and most importantly, if consumers are not able to buy additional units at marginal cost, and there is a demand for such units, there will be a maldistribution of the factors of production. With marginal cost pricing, however, the same factors of production would be redeployed in a way that was Pareto superior—that is, we would make at least one person (and in fact many people) better off and no one worse off. Second, even if the demand curve for a certain good lies at all points below the average cost curve, it might nevertheless be possible to raise average revenue sufficiently to bring it up to

[14] For a comprehensive discussion of the history of the arguments for and against the marginal cost pricing principle and a discussion of the principle's several variants, see two articles by Nancy Ruggles, "The Welfare Basis of the Marginal Cost Pricing Principle," *The Review of Economic Studies* 17:1 (1949): 29–46, and "Recent Developments in the Theory of Marginal Cost Pricing," *The Review of Economic Studies* 17:2 (1949): 107–26.

[15] The roots of this argument go back to the French engineer and economist Jules Dupuit, see Karl Pribram, *A History of Economic Reasoning* (Baltimore: Johns Hopkins University Press, 1983), 279, and to Alfred Marshall, see Alfred Marshall, *Principles of Economics*, 8th edition (London: Macmillan, 1936), 467–70. But perhaps its most influential early advocate was Harold Hotelling, who developed and defended it in a series of articles in the late 1930s. See, e.g. Harold Hotelling, "The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates," *Econometrica* 6 (1938): 242–69; Harold Hotelling, "The Relation of Prices to Marginal Costs in an Optimum System," *Econometrica* 7 (1939): 151–5; and Harold Hotelling, "A Final Note," *Econometrica* 7 (1939): 158–60.

average cost by means of price discrimination.[16] If a firm is not permitted to sell below average cost in this situation, however, it cannot take full advantage of the opportunities that price discrimination would allow, and therefore would not be able to recover its total costs regardless of output, so no units of the good will actually be produced. If the firm could charge various prices between marginal cost and average total cost, in contrast, it could take advantage of whatever demand meets or exceeds marginal cost. If this would allow the recovery of total cost at some level of output, then some units of the good would indeed be produced, and this again would be Pareto superior.

Now the argument against marginal cost pricing depends on whether the shortfall in total costs is to be made up by government subsidies or through price discrimination. With regard to the argument for government subsidies,

[16] To see this, consider Figure 2 below.

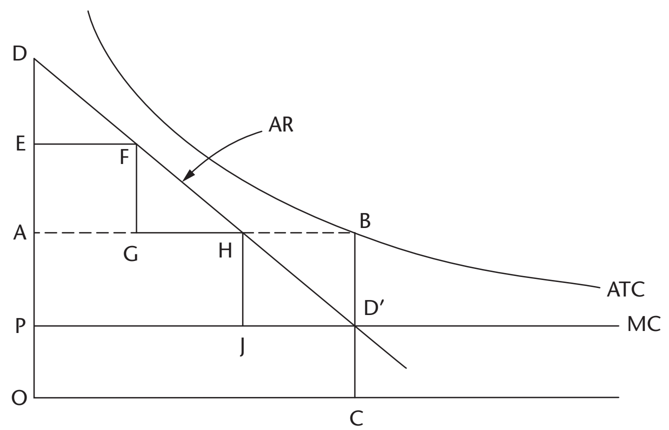

Figure 2. Figure on the relation between marginal and average total costs

The vertical axis OD is price. The horizontal axis OC is output. At all times, both marginal cost MC and demand DD′ are less than average total cost ATC. At no single price would average revenue AR be sufficient to cover total costs. The socially optimum price would be OP, output OC, because this is where average revenue AR meets marginal cost MC. At this output, however, the resulting revenue OPD′C would fall short of total costs. But a lot of dollars are being left on the table at price OP, for a good number of consumers would be prepared to pay more than this for the good, and some substantially more, as the figure shows. So if perfect price discrimination were possible, the producer could capture all the potential revenue under demand curve ODD′C at the same level of output. If this revenue exceeded total costs OABC, production of this good would be economically justified, not only privately but also socially as long as there are no externalities here that have not been counted. In other words, as long as the area of triangle ADH were to exceed the area of triangle HBD′, a producer could recover its total costs at this level of production because some units would sell for more than average total cost at this level, and this would generate enough revenue to make up for the fact that some would sell for less. And even if perfect price discrimination were not possible, in the right circumstances, block pricing at EFGHJD′ might accomplish the same thing. See Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions: Volume I* (Cambridge: MIT Press, 1988), 132 n. 17. See also Robert W. Harbeson, “A Critique of Marginal Cost Pricing,” *Land Economics* 31 (1955): 54–74, at 64–5.

the problem here is that promoters of this position fail to take into account the welfare loss suffered by those who would have to pay additional taxes to fund the subsidies given producers in industries with decreasing marginal costs. With marginal cost pricing, there are both winners and losers. Consumers are winners, because they are able to fully satisfy their demand for goods at marginal cost. But taxpayers are losers, or at least some taxpayers are losers, for the burden of financing the fixed cost of production would be shifted from consumers to taxpayers. Some taxpayers would accordingly be paying the fixed costs of producing goods they do not consume.[17] Thus, it is not true that marginal cost pricing produces welfare gains that are Pareto superior, for some people are made worse off, and winners do not compensate losers. At best, marginal cost pricing produces welfare gains that are superior only in the Kaldor-Hicks sense, and it does not even do this unless we can make interpersonal comparisons of utility and determine that the welfare gains of the winners exceed the welfare losses of the losers, comparisons that many people believe are impossible to make.

Indeed, even if we could make such comparisons, it is unlikely that there would be positive gains to be had here. The more one consumed, the more one would benefit from the redistribution of income that marginal cost pricing with government subsidies would produce. Since those with greater incomes tend to consume more, marginal cost pricing effectively redistributes income from the poor to the rich. Although this effect could be ameliorated by progressive taxation, and perhaps even reversed if the rate of taxation were progressive enough, the fact that marginal cost pricing would have redistributive effects makes it a poor candidate for the just price, since the whole point of the just price as we have conceived it is to ensure there is reciprocity in exchange.

Perhaps because of this, the idea that any shortfall incurred through marginal cost pricing should be made up through government subsides, while popular during the 1930s, 1940s, and 1950s, began to decline in influence in the 1960s, and few economists today would advocate this approach as a solution to the problem of marginal cost pricing even for natural monopolies. What many economists do continue to recommend, however, is marginal cost pricing where it is possible to couple this with a certain kind of price discrimination—the kind that would allow the producer to recover his fixed costs from consumers with high demand curves, while everyone else was permitted to purchase the good at prices just above marginal cost. In this case, of course, the principle of reciprocity is violated twice—once when those customers with high demand curves are charged too much, and again when those with

[17] See R. H. Coase, "The Marginal Cost Controversy," in *The Firm, the Market, and the Law* (Chicago: University of Chicago Press, 1988), 75–93, at 85.

demand curves below average total cost are charged too little. But even if we were to ignore the injustice of this, there would still be numerous problems with relying on alleged welfare gains to establish marginal cost pricing as universally just.

First, it will often be impossible to engage in this kind of price discrimination, so in most cases this solution to the subsidy problem would not be available. Second, even when it is available, there is no guarantee that it will solve the problem—the demand curve of those who are willing to pay more than average total cost may not be high enough or cover a sufficient number of customers to allow the full recovery of fixed costs, in which case even perfect price discrimination will still produce an operating loss. Third, there would once again be a redistribution of income here, except this time it would go from those with higher demand curves to those with lower, and from all consumers to the producer overall, and it is not clear that absent interpersonal comparisons of utility it would be possible to say that the net effect on social welfare in this case would be positive. Finally, to the extent there are some net welfare gains to be had here, some of these could still be captured even if we set average total cost rather than marginal cost as the just price, for price discrimination within certain limits would still be possible. I will explain how this would work in some detail later, but for now, we need merely note that these very special circumstances are likely to arise only rarely, and when they do, they operate as an excuse, not a justification, for violating the principle of reciprocity, and therefore do not warrant setting marginal rather than average total cost as the just price.

Indeed, even if the welfare gains occasioned by marginal cost pricing were to *always* exceed welfare losses, this would not make the argument for marginal cost pricing an argument for treating the just price as marginal cost. No advocate of marginal cost pricing has ever contended that the *value* of a good in the sense we have been using that term here was its marginal cost. Indeed, those advocating marginal cost pricing took it for granted that the losses such a pricing policy would generate under conditions of decreasing marginal cost would have to be made up somehow. The question was simply whether an equal share of fixed costs should be recovered from all consumers, as would be the case with average total cost pricing, or recovered through government subsidies financed by the taxpayer, as required under the original conception of marginal cost pricing, or recovered from consumers with high demand curves, as required under the more modern conception. In any case, the value of the good was assumed to be its average total cost; the only issue was how payment of that price should be allocated between consumers or between the consumer and the taxpayer.

There are also serious practical problems that would arise if we were to attempt to implement marginal cost pricing. Marginal costs are themselves extremely difficult to estimate, for a variety of reasons. All costs are marginal in the long term—even a factory does not last forever—and it may be unclear exactly where the cut-off for determining marginal cost should lie. There may also be problems in defining what constitutes the smallest possible incremental unit of sale, or in determining which costs should be assigned to which product when they are common to more than one. As a result, while marginal cost pricing is (or was for a time) a favorite of economists, it never caught on among businessmen. On the contrary, there was always and still is a strong tendency for producers in most industries to use average total cost pricing.[18] This does not make average cost pricing just, of course, or marginal cost pricing unjust, but it does suggest that as a practical matter employing marginal cost pricing would be a risky endeavor no matter what its theoretical benefits might be, and that as a real world solution we are more likely to generate the highest achievable level of social welfare by employing average cost pricing than by opting for any of the available alternatives.

Nor is there is any reason to believe that marginal cost pricing might otherwise be just because it more closely tracks the value each consumer receives from a good. As a generally accepted accounting principle, all fixed costs are equally allocable to all units produced. A company can increase its profits by adopting marginal cost pricing, for as long as it can recover its fixed costs from early purchasers and it earns more for each additional unit sold to later purchasers than that unit costs to produce it has added to its profit. But this allows later purchasers, at least those who would have been willing to pay average total cost, to free ride on the higher prices paid and fixed costs recovered from earlier purchasers. And while this might be good for the firm, it forces early purchasers to subsidize later ones. In some cases, this might be justified on the grounds that early purchasers receive additional value from the producer in the form of status and therefore should pay more for the good, but this is not true for all goods, and in any event, the fixed costs recovered from early purchasers often exceed the value of any additional benefit received, leaving early purchasers to resent later price cuts and perceive their treatment as unfair. Indeed, in extreme cases, marginal cost pricing may be seen as so unfair that the potential blowback in early purchaser ill will may force the firm to refund much of those early subsidies, as Apple was forced to do when it dramatically dropped the price of the iPhone just two months after it was introduced.[19] As between marginal cost and average total cost pricing, it

[18] See Kahn, *The Economics of Regulation: Volume I*, p. 84; Richard B. Heflebower, "Full Costs, Cost Changes, and Prices," in National Bureau of Economic Research, *Business Concentration and Price Policy* (Princeton: Princeton University Press, 1955), 361–92; Ben B. Seligman, *Main Currents in Modern Economics* (New York: Free Press, 1962), 364.

[19] See Katie Hafner and Brad Stone, "IPhone Owners Crying Foul Over Price Cut," *The New York Times* (September 7, 2007).

is accordingly the latter that not only is but also is most likely to be perceived as fair.

4.4 Private vs Social Cost

But why average total social cost rather than average total private cost? The answer is that in some cases, and perhaps even in many, there will be externalities to the transaction. Negative externalities arise when the parties are able to impose what are actually costs of production on non-parties to the transaction. If, for example, production creates waste products that are released into the air, water, or surrounding soil, and these cause or can cause injury to crops, animals, property, or people who are exposed to them, these waste products will need to be disposed of properly. The cost of this is therefore a cost of production, and should be incorporated into the price of the product, either directly or through the imposition of taxes, in order to ensure that only the socially optimal amount of the product is produced and that there is no misallocation of the factors of production. If this is not done, then not only is our allocation of productive resources economically inefficient, the price charged for these particular goods is unjust, because the clean-up costs of production will ultimately have to be borne by someone, and it is unjust for anyone other than those who enjoy the benefit of consuming the good to have to bear these costs against their will. Indeed, to the extent that a product is sold below average total social costs, *both* the seller and the buyer of the product are guilty of exploitation, because they have together forced those who have not received any benefit from the transaction but who are subject to its externalities to bear a portion of its cost. The cost of negative externalities, then, must be part of the calculation of the just price even though neither party to the transaction has actually had to bear them.

This is not to say, of course, that the identification of all negative externalities and the calculation of their extent is always going to be easy. But a great deal of work is now being done in this area, and we are beginning to have a pretty firm grip on how such calculations should be made.[20] Which is not to say that further problems do not remain. For example, even when we have a good understanding of what future effects a particular transaction may have, there may be issues with regard to whether certain costs experienced by others are "caused" by the transaction in the relevant sense. Determining this requires a theory of causation. Do we, for example, consider the cost of dealing

[20] See, e.g. Nicholas Z. Muller, Robert Mendelsohn, and William Nordhaus, "Environmental Accounting for Pollution in the United States Economy," *American Economic Review* 101 (2011): 1649–75.

with the social disruption caused by a factory closure and relocation a cost of production of the goods produced by the new factory, as some contend we should?[21] Or do we treat this as an "uncaused" expense, or at least as one for which no party to the relevant exchange transaction is responsible? No matter what, remember, we have to have a theory to deal with such matters for otherwise we are going to be unable to decide whether and if so who may be sued for these injuries and what kind of damages may be recovered when someone has violated another's acknowledged rights. And because we have to have such a theory anyway, there is no "extra work" to be done here in order to actualize our theory of exploitation. Thus, everything we need to determine what is an externality of what is something that is already on hand.

While we do need to take into account negative externalities in calculating the social cost of production, however, the same is not true for positive externalities. In contrast to *costs* that are imposed on non-parties to the transaction but not included in the private cost of production, positive externalities are *benefits* that are enjoyed by non-parties to the transaction but not paid for by them. The cost of producing these benefits has presumably already been included in the cost of production, however, for if these costs could be separated out and the good produced without these positive externalities, it most likely would be and the factor that causes these positive externalities packaged and sold separately. In any event, even if this is not the case, the fact that there are positive externalities in no way increases or decreases the cost of production. So as long as the beneficiaries of positive externalities do not pay for the benefits they receive, there is no basis for arguing that some sort of credit should be awarded against what would be the just price paid by the immediate buyer. In short, there is an asymmetry between how positive and negative externalities are handled—the existence of positive externalities in no way enters into our calculation of the just price.

But this does not mean that the existence of positive externalities must be entirely ignored. While positive externalities are not to be taken into account in the calculation of the just price, these nevertheless may be taken into account when deciding who should pay the just price, what portion they should pay, and how that payment should be collected. If there are positive externalities, nothing in the principle of reciprocity prevents making the beneficiaries of such externalities pay an amount equivalent to the average total cost of producing the value they received, perhaps collected through general taxation and then paid over to the producer in the form of a

[21] See, e.g. Barry Bluestone and Bennett Harrison, *The Deindustrialization of America: Plant Closings, Community Abandonment, and the Dismantling of Basic Industry* (New York: Basic Books, 1982).

government subsidy, as we currently do with a variety of what we often call public goods. The principle of reciprocity does not *require* this, however, because even if non-parties to the transaction who are the beneficiaries of positive externalities do not contribute to the cost of production of the good, the buyer who pays all of that cost will have received a good of equivalent value and therefore will have no cause to complain. And because the existence of these positive externalities has not increased the cost of production, the seller has no cause to complain either, for he has been paid in full by the buyer. Indeed, the mere fact that one has received a benefit does not mean that one has to pay for it, at least if that benefit was foisted upon one and given the choice one would rather have saved the cost of producing it.[22] Of course, if the benefits enjoyed by non-parties are substantial enough and the transaction that produced them important enough, we may want to require non-parties who benefit from the transaction to pay a portion of the just price, and if the ratio of benefits received by non-parties to parties is large enough, maybe even a substantial portion if this is necessary to ensure a good that might not be produced in appropriate quantities does gets produced in those quantities when direct purchasers are unwilling or unable to subsidize the benefits that these would-be free-riders receive. But the purpose of the doctrine of the just price is merely to determine what costs are to be taken into account in determining what price the seller may receive in total from all sources, and to ensure the seller receives no more than what it cost him to produce whatever he has transferred, regardless of how payment of this cost is divided between those who have benefited from the transaction. How responsibility for payment of the just price should be allocated between these direct and indirect beneficiaries is simply another matter, to be determined by some other principle, not by the doctrine of the just price.[23]

[22] Nozick, of course, is the most prominent contemporary advocate of this view, see Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), 93–5, but others maintain it as well. See, e.g. Gijs van Donselaar, *The Right to Exploit* (Oxford: Oxford University Press, 2009), 21; A. John Simmons, "The Anarchist Position: A Reply to Klosko and Senor," *Philosophy and Public Affairs* 16 (1987): 269–79. Even Kant supposedly held it. See Arthur Ripstein, *Force and Freedom: Kant's Legal and Political Philosophy* (Cambridge: Harvard University Press, 2009), 102. Note, however, that it is not always clear whether an externality is positive or negative: what one man experiences as pleasant background music coming out of his neighbor's speakers another may consider annoying noise. In the latter case, no payment is due, not because one does not have to pay for benefits that one did not ask to receive, but because what the latter neighbor has received is not of "benefit" to him at all. See Michael Davis, "Nozick's Argument for the Legitimacy of the Welfare State," *Ethics* 97 (1987): 576–94, 586–90.

[23] One such theory would be the principle of proportionality, under which each person who received a substantial benefit would pay a share of the just price that is proportional to the degree of benefit received. See Reiff, "Proportionality, Winner-Take-All, and Distributive Justice," *Politics, Philosophy, and Economics* 8 (2009): 5–42.

4.5 Accounting for Time

Once we have decided that the just price of a good is its average total social cost, it would seem that the application of this test would be relatively straightforward. Indeed, all but the most ephemeral firms calculate the average total *private* cost of the goods they produce every quarter, if not more frequently, and while the records maintained by individuals are sometimes less complete, no one who maintains inadequate records is likely to stay in business very long. There may be some accounting issues to be resolved along the way in either case, but we already have detailed and generally accepted accounting principles to resolve them. And while calculating average total *social* cost may be somewhat more complicated, for this involves correcting for externalities, even the difficulties to be encountered here are nothing new—indeed, a great deal of government time is spent searching for such externalities and then determining how best to prevent them from arising or, if this is not possible, how best to force producers to internalize these costs of production. If we assume that all relevant externalities are known or determinable at the time of production, calculating average total social cost may accordingly present some investigatory and accounting problems, but none of these problems are insurmountable. Anticipated future costs would simply have to be discounted to present value using the appropriate discount rate (the rate of interest that a risk-free or relatively risk-free investment can be expected to earn over the relevant period), and the present cost of generating an income stream sufficient to pay these costs when they come due can be added to the cost of production now.

But of course not all externalities *are* known or determinable at the time of production. The damage a particular good may cause to human health or the environment and therefore the true social cost of producing this good may become apparent or even discoverable only years after the transaction in which the good is sold, as at least arguably was the case with lead paint, asbestos, and various pharmaceuticals. How are we to account for such latent externalities? Are we to retroactively treat the price at which these products were sold as unjust simply because it did not include the cost of these externalities, or are we to test whether a price is just by including only those costs that were known or reasonably discoverable at the time? There seems to be ought-implies-can problems in doing the former, at least if we take a very broad view of the ought-implies-can principle and interpret it as imposing epistemic as well as logical and physical limitations on moral responsibility. But there are problems in doing the latter too. If we include only those costs that were known or reasonably discoverable at the time, we are effectively allowing parties from the past to extract value from parties in the future, and there is at least an intuitive sense in which this seems to be unjust.

A full discussion of the intricacies of the ought-implies-can principle would take a chapter in itself, so I will not attempt this here. I will merely point out that we are not talking about epistemic *impossibility* here, but rather epistemic *feasibility*. It will always (or at least almost always) have been possible to have not entered into the transaction that ultimately caused the unaccounted for cost, and thereby to have avoided the externality. It will also always (and here I do mean always) have been possible to discover the relevant information about the externality, as this is in fact what ultimately happened, and therefore the externality could have been included in the cost. So epistemic feasibility is the only issue left. But as various authors have persuasively shown, the argument that epistemic feasibility is a necessary condition for moral responsibility is not correct—in some cases, even "impeccable precautions are no excuse" for committing a moral wrong.[24] Those who have doubts about this, however, should refer to this work for the relevant argument and discussion.

But there are a few additional arguments for the consideration of future costs that I do want to specifically mention. First, even at the height of the influence of the market-price based conception of the just price, the market price at the time of the transaction was never controlling. If there were fluctuations in the market price over varying periods, sometimes as long as thirty years, a transaction that was initially just could become unjust. So there is a long history of taking future discoveries into account in connection with the application of the doctrine.

Second, finding that a transaction is retroactively unjust does not necessarily mean we are going to have to go back and track down the original parties and impose these newly discovered costs on them. Indeed, in most cases, as long as there was relevant historical data available to the parties at the time (the kind of data that actuaries use to figure probable loss rates and insurance companies use to figure premiums), it should not only have been feasible but also relatively easy for them to have calculated the probable total loss from future contingent externalities over a particular class of transactions and have included a proportionate share of the cost of that loss in each. Most manufacturers, of course, do something like this already with regard to standard and extended warranties by assigning certain future costs to product classes even though they do not know exactly which product within the class will generate the future cost or what the precise failure rate will be. But this is not just sensible business practice—any business that keeps its books in accordance

[24] See, e.g. Matthew H. Kramer, "Moral Rights and the Limits of the Ought-Implies-Can Principle: Why Impeccable Precautions are No Excuse," *Inquiry* 48 (2005): 307–55, especially 328–31.

with generally accepted accounting principles is already required to accrue contingent future losses now if these are probable and can be reasonably ascertained, and at least disclose all loss contingencies that are reasonably possible, so imposing an obligation to make these kinds of calculations would merely be requiring them to do something they are largely doing voluntarily already.[25] And for those sellers that do not currently make these calculations anyway, or do not make them carefully and in good faith, there are two ways to encourage them to do so. Government agencies can make the required calculations for them, and then force recalcitrant parties to internalize the present value of the discounted cost of these externalities through taxation. Or we can simply rely on the law of product liability, suitably expanded wherever necessary to cover a wider range of goods, to force internalization of these costs. Indeed, this form of tort law already provides manufacturers with powerful incentives to make these calculations and price them in to what they charge for their products, and imposes substantial penalties upon them when they do not.[26] So including the cost of subsequently discovered externalities in the average total social cost calculation may make that calculation somewhat more difficult, but it does not make this cost impossible to fix.

Is there another problem, however, that accounting for time in this way creates? If our theory of exploitation requires firms (and individuals too, although individuals are probably much less likely to produce goods that cause externalities) to include the estimated cost of future externalities in the price of their goods but does not require them to actually reimburse others for these externalities until they become manifest, what happens if these externalities only actually become manifest after the producer has died, dissolved, or disappeared? Who will be responsible for bearing the cost of these externalities then? If we insist that prices include the cost of externalities—in other words, if we force producers to internalize these costs—our theory of exploitation will have effectively worked to provide these sellers with a windfall—they will have received reimbursement for costs they ultimately imposed on others but never actually incurred. In this case, it seems that our theory of exploitation will have had a counterproductive effect, increasing rather than

[25] See FASB Accounting Standards Codification ("ASC") topic 450-20-25 (2009).

[26] Perhaps the most famous example of this is *Grimshaw v. Ford Motor Company*, 119 Cal. App. 3d 757, 174 Cal. Rptr. 348 (1981), in which Ford's failure to take sufficient precautions to prevent postcollision fires in the Ford Pinto resulted in a 1978 jury verdict of $2.5 million in compensatory damages and $125 million in punitive damages (later reduced to $3.5 million by the judge). For a discussion of the Ford Pinto case and how it requires manufacturers to figure the cost of future injuries into the price of current goods, see Mark Geistfeld, "Reconciling Cost-Benefit Analysis with the Principle That Safety Matters More Than Money," *New York University Law Review* 76 (2001): 114–89; Gary T. Schwartz, "The Myth of the Ford Pinto Case," *Rutgers Law Review* 43 (1991): 1013–68.

reducing the degree of injustice that the relevant transaction happened to create.

The remedy for this concern is simply to remember that our theory of exploitation is not meant to function in a vacuum. On the contrary, it is to apply only to a capitalist economy that has already adopted some form of political liberalism, one of the tenets of which is that those who unjustly cause harm (or impose costs) on others have to compensate those who suffer these harms (or bear these costs). To ensure that the firms or individuals that charge these costs do not fritter away the funds received before the costs come due, we simply have to require them to segregate the funds collected for this purpose into some sort of trust account that is not accessible to creditors and that will survive even if the firm itself or the individual ceases to exist. In contrast, if we force the producers of such goods to internalize these costs through taxation rather than through the tort system, then we would relieve the producer of any tort liability, or at least any liability up to the present value of the taxes paid, and provide that the government and not the producer will be responsible for providing reimbursement and compensation when the actual victims of these externalities are finally indentified and the costs incurred come due. Finally, because of the risk of tort liability, many of these anticipated future costs can and will be internalized through the purchase of insurance. In these cases, it is not the party that causes the externalities to arise that must survive in order for these costs ultimately to be paid, but its insurer. The possibility that the insurer may fail, however, is a concern whenever insurance is involved, so it is not a special problem for our theory. The normal precautions regarding the maintenance of reserves and the regulation of investments made by companies that provide insurance would simply have to be applied.

There is one other issue with regard to accounting for time under our theory of exploitation, and it has ramifications with regard to efficiency as well. Under Marx's theory, socially necessary labor time is to be measured in the present—that is, it does not matter how much labor time it actually took to produce a good, but how much labor time it would take to *re*produce that good at the time it is being valued, using the methods currently available, and these amounts could be quite different. If technological improvements have been made since the good was originally produced, it might take far less labor time to produce the good now than it did originally. On the other hand, if there have been regulatory, environmental, demographic, or perhaps even cultural changes in the society in which the good was originally produced, it might take far more labor time to produce that good now than it did when conditions were more favorable (say there is a drought and crop yields per acre dramatically decline).[27] Similarly, under Marx, socially necessary labor time is to be measured against reasonable standards of efficiency. A good that is made inefficiently by hand has no more value than what it would cost in labor time to reproduce an identical version by machine, and a good that is produced super-efficiently has the same value as one that was produced with the usual degree of efficiency, even if this requires more labor than was actually expended. In other words, under Marx, goods do not *embody* the labor time that was required to create them, but rather represent a description of what currently available reasonably efficient methods of production would have to reproduce.[28]

But neither kind of adjustment is required under our theory of exploitation. If the costs of production have dropped, this may mean a good that was produced when costs were high can now be sold only at an unjust price, but this does not make that price any less unjust. Similarly, a good produced largely by hand may embody much greater costs than one that can be made now largely by machine, and if the two goods are otherwise indistinguishable, the market price for each may be equivalent. Nevertheless, the *just* price for each will differ. The fact that the producer of the hand-made good is inefficient does not change his actual costs of production, and it is these costs, not the costs of his more efficient competitor, which determine the just price. While actual labor time is *not* embodied in a good under Marx's theory of exploitation, a good *does* embody the actual costs incurred to produce it under our theory. No one may be willing to pay more for a good produced by hand if it has no greater utility than one produced more efficiently by machine, and nothing in our doctrine of the just price requires anyone to buy the hand-made good instead of the cheaper but otherwise identical machine-produced one. But if one does choose to buy the hand-made good, the fact that an identical good can be produced more cheaply by machine has no impact on what the just price of the hand-made version of the good would be. Under our theory of exploitation, unlike Marx's, the value of a good is what it actually cost to produce, not what it would cost to replace using the most reasonably efficient means of production available at the time.

Indeed, the only adjustment to the actual cost of production resulting from the passage of time required under our theory of exploitation other than discounting anticipated future costs to present value is an adjustment for inflation, for all past costs must be expressed in current dollars to ensure that when value is measured it is measured in equivalent units. For example, a car that has never been used may have cost $500 to produce in 1923, but its

[27] See Ian Steedman, *Marx after Sraffa* (London: New Left Books, 1977), at 70 n. 3.

[28] See generally G. A. Cohen, "The Labor Theory of Value and the Concept of Exploitation," *Philosophy and Public Affairs* 8 (1979): 338–60, 344–9.

inflation-adjusted just price would of course now be much more than this. But no adjustment would be made to reflect how much it would cost to reproduce that same car now, since it would have to be built by hand, given that many of the tools and machines used to produce it presumably no longer exist, or to reflect the scarcity of an unused 1923 model in today's market, or the fact that it is probably now too dangerous to drive but very desirable for a collector to possess, or the fact that production methods have become vastly more efficient since that time and thus if the requisite tools and machinery were available the car could be produced for less today than when it was originally made. The need to take account of these potential complications is simply not required under our theory of exploitation.

Aside from avoiding what would be difficult and sometimes even insoluble calculations, precluding such adjustments has other benefits too—it protects buyers and sellers from being the victims of market fluctuations, and prevents them from profiting from their own acts of exploitation. If I pay below cost for a good and therefore exploit another, then justice requires that I charge no more than this when I resell it, even if the market would allow me to charge much more. And if I paid more for a good in the past than the market currently allows, our theory recognizes that if I were to receive only the current market price when I sell the good, this would be unjust. Whatever the cost of production, that cost is *embodied* in its product, and only if that product is exchanged for something that embodies a similar cost is there the requisite reciprocity in exchange. The market may offer all sorts of opportunities for injustice, but this does not make the acts of those who take advantage of these opportunities any less unjust.

The mere fact that a price is unjust, however, does not mean that the appropriate remedy is to insist that the parties to the exchange pay the just price or eschew the transaction altogether. Indeed, there are certain goods that we believe should be made available but which we know no one would be able to afford if they were actually required to pay the good's average total social cost. Take, for example, orphan drugs—drugs that treat diseases that few people have and therefore are not cost-effective to produce but which are essential if these unfortunate few are to have a chance at a reasonable quality of life. These drugs are extremely expensive to develop, but it seems strange to claim that the prices at which they are sold, which are well below their development costs, are somehow unjust. The answer, I think, is that the prices at which these drugs are sold are indeed unjust, or rather they would be unjust if the pharmaceutical companies did not receive subsidies to cover what would otherwise be their unreimbursed development costs. Because they do receive such subsidies, however, the actual price of these drugs is just as long as it does not exceed the average total of the unreimbursed costs remaining. And as long as the actual consumers of the drug pay no more than this price either, they also have no basis for complaint. The only issue is whether and if so how much subsidy is justified by the positive externalities that producing orphan drugs creates.

A similar issue is also raised by government subsidies to the performing arts. Most performing arts institutions would not exist if their costs of production had to be fully recovered through ticket sales and associated merchandising alone. But while people may disagree about whether the positive externalities generated by the arts are substantial enough to justify spreading some of their cost over what are in effect non-parties to the individual transactions through which the production is consumed, this is not relevant to the point I am making. For now, I am simply pointing out that the mere fact the end-user pays a price that would by itself be unjust does not mean that the appropriate remedy is to force the parties involved to charge and pay the just price or prohibit the sale of the good altogether. This is only one possible remedy, and in many cases there may be reasons for thinking that some other remedy is preferable all-things-considered. In cases where a good can only be provided below cost, we simply have to decide whether the shortfall is something that should be borne by the community at large or not. If everyone or almost everyone suffers a risk of contracting a rare disease *ex ante*, it is at least arguably fair to divide the cost of producing medicines to treat such diseases equally, even if only a few will actually contract the disease *ex post*.[29] Similarly, if the benefit the good provides is one that is not enjoyed only by direct purchasers, but trickles down throughout society, as those who support government subsidies for the arts often claim the arts do, then it is not unfair to spread at least some of the cost of producing these benefits across the community at large.

But we are getting ahead of ourselves here. There may be various cases in which we wish to provide government subsidies to lower what would otherwise be the just price of a good, and even cases in which we are willing to simply tolerate deviations from the just price. At this point, however, we are only interested in determining whether there has been a violation of the doctrine of just price. What remedies justice permits or perhaps even requires is a matter we will take up later.

4.6 Calculating the Cost of Labor

In contrast to the task of calculating the average total social cost of selling most goods, the task of calculating the average total social cost of labor is

[29] See Reiff, "Proportionality, Winner-Take-All, and Distributive Justice."

rather more complicated. Firms typically maintain accurate and detailed records of all their costs of production, and individuals selling goods other than their own labor usually do so as well, so once we have added in any negative externalities, the calculation of average total social costs should be relatively straightforward. Most individuals, however, sell only their own labor, and various often unaccounted for costs go into producing this. Gathering the information necessary to make the requisite calculation on an individual basis accordingly requires more effort than it does for firms. But there is no reason to think that the required information is not obtainable. Indeed, these kinds of calculations are made every day for individuals in the context of wrongful death actions, where the damages recoverable by those left behind are the expected income of the now deceased individual less the cost this individual would have been expected to incur in generating that income. This kind of information has also been collected on an average basis for all sorts of classes of individuals for many years now by those working in the field of labor economics. The cost of education is well known, as is the cost of on-the-job training. The cost of food, housing, child care, and health care have all been exhaustively studied and are continuously monitored. Even the cost of acquiring a reputation and other social networking costs and the costs of engaging in various kinds of "signaling" behavior are known or at least determinable. In short, all the issues we would encounter in trying to determine the cost of acquisition of the requisite skill set for a wide range of occupations have been exhaustively explored, categorized, and quantified over the last thirty years.[30]

4.6.1 *Subsistence and Contextual Basic Needs*

The most important cost to include in this calculation of the average total social cost of production of individual labor is of course the cost of subsistence, for if the worker did not exist his labor would not exist either. But the cost of subsistence under our theory of exploitation is not simply the absolute minimum necessary to keep the worker alive.[31] *This* amount is merely what a slave-owning society that embraced the most minimal humanitarian concerns would require its citizens to provide their slaves, and what all politically liberal societies already require their citizens to provide their work animals

[30] See, e.g. Gary S. Becker, *Human Capital*, 3rd edition (Chicago: University of Chicago Press, 1993).

[31] The cost of mere survival for the worker would include the cost of food containing about 1600 kilocalories per day, see Garrett Hardin, "The Tragedy of the Commons," *Science* 162:3859 (1968): 1243–8, at 1243, plus the cost of food containing whatever additional calories are to be expended on work, plus the cost of work clothing and basic shelter.

and pets.[32] Indeed, it is difficult to see what the difference would be between a slave and a worker who merely earned just enough to keep himself alive. Rather than bare physical subsistence, then, what is required of a society that embraces the presuppositions of modern capitalism is that workers be paid an amount that will enable them to be both physically and psychologically capable of working to the best of their abilities, for that is what a capitalist economy wants and needs from its workers if it is to be maximally productive.[33] To perform at this level, in turn, the worker must not merely be able to sustain himself, he must feel that he is a valued part of the society surrounding him and be willing to endorse its fundamental precepts and to generally obey its fundamental rules. He must not view these rules as oppressive, or feel distant and alienated from the social structure in which he finds himself, or be contemplating revolt. All socially beneficial work has dignity, but to confer dignity on the worker, the wages such work provides must not merely enable the worker to keep himself *alive*—to satisfy what we might call his *primary* basic needs, the need for food, clothing, and shelter. To confer dignity on the worker, and to put him in a position to be as productive as he can be, the wages generated by even the most unskilled work must enable the worker to satisfy his *contextual* basic needs as well.

What these are will vary, of course, according to the level of welfare in the society in which the worker lives. A television and a car (and perhaps soon even a smart phone and a personal computer) may be perceived as basic needs in more affluent societies; in other societies these may be considered luxuries, and it may be far more important to own a two-way radio, a gasoline-powered generator, and an ox. In all cases, however, a worker's contextual basic needs will include the cost of necessary medical care, if this is not already made available to them as part of the government's provision for every citizen's primary basic needs, and the cost of raising a family. Capitalism can only succeed when there is a steady supply of able and willing workers, and such a supply can exist only if workers are able to maintain their health and

[32] Once, back when I was working in the San Francisco financial district, I passed a homeless man on the street on the way into my office. Two officers from animal control were there inspecting the man's cats, which he kept on a leash with him on the sidewalk. The officers were checking to be sure the cats were being properly fed and cared for. The cats were fine. Homeless people take very good care of their pets. Whether the man's own subsistence needs were being met, of course, was another matter. But no one was checking up on him.

[33] As Joseph Schumpeter says, capitalism is all about incentives: "[t]he capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within the reach of factory girls in return for steadily increasing amounts of effort." Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper Perennial Modern Thought Edition, 2008), 67. See also L. T. Hobhouse, *Liberalism* (London: Williams and Norgate, 1911), 192: "Economic justice is to render what is due not only to each individual but to each function, social or personal, that is engaged in the performance of useful service, and this due is measured by the amount necessary to stimulate and maintain the efficient exercise of that function."

reproduce. The cost of healthcare for the worker and his or her family is therefore one of the social costs of making the labor of the worker available. If it is not provided to everyone by the government, then it must be subsidized by wages, and the same would be true with regard to the costs of reproduction and child rearing.

How large a family the worker must be able to support depends on the particular society at issue. In most fully industrialized capitalist economies—in other words, in societies that have already gone through what is called the demographic transition (the transition from high death, high birth rates to low death, low birth rates)—maintaining the current population is all that will be required.[34] But in some societies, even those well into the demographic transition, an increase or decrease in the population may be necessary, and the cost of making the worker's labor available may have to be adjusted accordingly. At an absolute minimum, however, it seems that each worker would have to have sufficient resources to support one child to maturity, at least in societies where women have become fully integrated into the relevant marketplace for workers and appropriate child care can be provided in large part by others.[35] If this is not the case, however, then each worker would have to be able to support at least two children to maturity, as well as himself and his spouse, as the Irish-born eighteenth-century French banker and economist Richard Cantillon and many others since have expressly claimed.[36] In any event, regardless of their personal desire for children, being in a *position* to support a family is an important part of what allows workers to maintain their sense of self-respect, whether they then go on to raise a family or not. If a worker feels that society does not make the wherewithal necessary to do this available to him, it is unlikely that he will be inclined to provide truly productive labor absent a significant degree of economic or physical coercion.

Note, importantly, that our commitment to putting each worker in a position to satisfy his contextual basic needs does *not* commit us to subsidizing workers who have expensive tastes, and therefore does *not* require that some receive more support in order to avoid social alienation than the rest of us, a

[34] For further discussion of the demographic transition, see, e.g. Jean-Claude Chesnais, *The Demographic Transition* (Oxford: Oxford University Press, 1992); John C. Caldwell, "Toward a Restatement of Demographic Transition Theory," *Population and Development Review* 2 (1976): 321–66.

[35] For an historical discussion of the lowering of barriers for women who want to pursue careers outside the home and the corresponding transition from mostly one to mostly two-earner households, see Gary S. Becker, *A Treatise on the Family* (Cambridge, MA: Harvard University Press, enlarged ed. 1991), 30–79.

[36] See Richard Cantillon, *Essay on the Nature of Commerce in General* (New Brunswick, NJ: Transaction Publishers, 2001), ch. 11, pp. 17–18. Adam Smith, although he did not endorse Cantillon's precise calculations, subsequently made a similar claim. See Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Oxford: Oxford University Press, 1976), vol. 1, ch. 8, pp. 85–6.

criticism that is often leveled at theories advocating the establishment of some sort of equality of welfare.[37] While we are using the *actual* cost of basic needs as the relevant measure, determining actual cost requires reference to more than any one particular individual, for the needs at issue are *contextual*. Because they are contextual, a reasonable, objective element is introduced, and this ensures that the cost of satisfying contextual basic needs cannot vary widely from individual to individual. The worker who is perfectly happy to live by himself in a tent eating only bread and water in the midst of an otherwise modern industrialized culture is still entitled to be given the wherewithal to live like other members of society should he choose to, while the worker who requires a lunch of plovers' eggs and pre-phylloxera claret to reach the level of welfare that others reach on beer and sandwiches has no right to have his expensive tastes subsidized, for these needs are idiosyncratic not contextual. In either case, what we are doing is ensuring that the compensation each individual receives is sufficient to express the dignity of the work provided, no more no less, regardless of what the worker chooses to do with the compensation he receives. Wages must *support* a certain level of welfare, for this is the cost of conferring dignity on the worker, but if we are to confer dignity on the worker we must not ignore his moral agency and paternalistically *guarantee* that the worker will achieve a specified level of welfare. Whether a particular worker is an atypically efficient or inefficient converter of resources into welfare is accordingly of no consequence in determining whether the contextual basic needs test has been met.

In any event, the importance of wages in establishing the dignity and therefore the value of labor is the key lesson, in my view, that Martin Luther King, Jr. was trying to impart in his address to striking sanitation workers in Memphis on March 18, 1968, just a few weeks before he was assassinated. In this speech, King refers several times to the idea that all socially beneficial labor must generate wages that enable the worker to satisfy his basic needs, and he expressly mentions food, clothing, and shelter and "the basic necessities of life." The failure of American society to ensure that all work does this, a failure that unfortunately continues, is outrageous and shameful. But King does not, I think, believe that this is all American society must do. The obligation to provide people with resources sufficient to allow them to satisfy their *primary* basic needs is an obligation that a nation owes to *all* its citizens, not merely those engaged in full-time labor. The latter group is owed something more than this. King argues that if we are to show the requisite "respect"

[37] See, e.g. John Rawls, "Social Unity and Primary Goods," in *Utilitarianism and Beyond*, ed. Amartya Sen and Bernard Williams (Cambridge: Cambridge University Press, 1982), 159–85, at 168–9; Ronald Dworkin, *Sovereign Virtue* (Cambridge, MA: Harvard University Press, 2000), 48–59; G. A. Cohen, "On the Currency of Egalitarian Justice," *Ethics* 99 (1989): 906–44 and "Expensive Taste Rides Again," in *Dworkin and His Critics*, ed. Justine Burley (Oxford: Blackwell, 2004), 3–29.

for "the dignity of labor," we must ensure that the wages generated by even the most unskilled forms of full-time labor allow the worker to participate "in the mainstream of economic life," that his wages be sufficient to provide "economic security" for him and his family, that they enable him to escape the "air-tight cage of poverty," to spend the kind of time with his children that every parent should, to send them to schools that are neither overcrowded, dilapidated, nor ill equipped, and to occasionally take his family on vacation and his wife out to dinner as indeed more skilled workers often do. King says:

> If you will judge anything here in this struggle, you're commanding that this city will respect the dignity of labor. So often we overlook the worth and significance of those who are not in professional jobs, or those who are not in the so-called big jobs. But let me say to you tonight, that whenever you are engaged in work that serves humanity, and is for the building of humanity, it has dignity, and it has worth. One day our society must come to see this. One day our society will come to respect the sanitation worker if it is to survive. For the person who picks up our garbage, in the final analysis, is as significant as the physician. All labor has worth.[38]

In other words, if America is to fulfill its potential, it must live up to its own capitalist aspirations. Capitalism presupposes that we accept the goal of maximizing productivity, and if we do accept this then we must be true to this goal all the way down. We must ensure that our unskilled workers are not mere instruments for facilitating the productive labor of others, for a society is only maximally productive if all the necessary components of the chain of production, even those not requiring special skills, are maximally productive. A capitalist society must ensure that each of its workers feel that they are an integral and respected part of the project in which all members of society are in fact jointly engaged.[39]

To do this, one other element of cost must be added to the minimum mix. This is the cost of supporting the worker's contextual basic needs after his retirement. Whether these cost are included in the wages actually paid to the worker or simply go into a government investment fund and are then disbursed to the worker upon his retirement as government-sponsored social

[38] See Martin Luther King, Jr., "Address to Striking Sanitation Workers in Memphis, Tennessee," (March 18, 1968). Throughout this speech, King assumes that the male is the primary breadwinner, but there is no reason to believe that in another context King would not have rephrased his message in a way that was gender neutral.

[39] Economists call this the "fair wage-effort hypothesis." For a discussion of the various arguments supporting this hypothesis and the empirical evidence suggesting that workers do indeed increase their productivity when they feel they are fairly treated and, conversely, decrease their effort when they feel they are not, see, e.g. George A. Akerlof and Janet L. Yellen, "The Fair Wage-Effort Hypothesis and Unemployment," *Quarterly Journal of Economics* 105 (1990): 255–83; George A. Akerlof, "Labor Contracts as Partial Gift Exchange," *Quarterly Journal of Economics* 97 (1982): 543–69.

security systems are supposed to ensure is irrelevant, at least for purposes of our theory of the just price, although we might reasonably favor the latter approach as a way of lowering the overall cost of providing such benefits to large numbers of people.[40] What is important is that the worker not feel he is simply a microchip in a big machine, to be discarded and replaced whenever his useful productive life is over, as a piece of silicon, glass, or steel would be. Providing for a dignified retirement is accordingly something that every liberal capitalist economy must do in order to ensure the maximal productivity of its workers. Indeed, those who oppose such a provision for all workers are simply not taking the presuppositions of capitalism that they already profess to accept seriously enough.

Of course, King was not the first to insist that the "natural" or "just" minimum wage for unskilled work not only differs from the "market" wage but also is socially constructed, established by contextual rather than primary basic needs. Indeed, a long line of prominent figures have actually made such claims. Among them, for example, are the Schoolmen, although for them "context" was arguably determined by social class rather than by the standard of living maintained in the economy as a whole.[41] Some even argue that a similar sentiment can be found in Adam Smith.[42] But many important theorists made their support for the contextual view unambiguous. In 1817, for example, in his *Principles of Political Economy and Taxation*, the English political economist David Ricardo said:

> It is not to be understood that the natural price of labor, estimated even in food and necessaries, is absolutely fixed and constant. It varies at different times in the same country, and very materially differs in different countries. It essentially depends on the habits and customs of the people. An English laborer would consider his wages under the natural rate, and too scanty to support a family, if they enabled him to purchase no other food than potatoes, and to live in no better habitation than a mud cabin; yet these moderate demands of nature are often

[40] See Hobhouse, *Liberalism*, 177.

[41] Joannis Duns Scoti, *Opera Omnia* (Paris, 1894), vol. 18, "Quaestiones in Quartum Librum Sententiarum," dist. 15, quaestio 2, no. 22, p. 117 (as translated in Bernard W. Dempsey, "Just Price in a Functional Economy," *American Economic Review* 25 (1935): 471–86, at 482). For further discussion of what Scotus and his fellow Schoolmen meant when they expressed such sentiments, see Dempsey, "Just Price in a Functional Economy," 477–82; Hamouda and Price, "The Justice of the Just Price," *European Journal of the History of Economic Thought* 4 (1997): 191–216, at 200; E. A. Johnson, "Just Price in an Unjust World," *International Journal of Ethics* 48 (1938): 165–81, at 166–71.

[42] See Edd S. Noell, "Smith and the Living Wage: Competition, Economic Compulsion, and the Scholastic Legacy," *History of Political Economy* 38 (2006): 151–74. While I have serious doubts that Smith did indeed harbor the beliefs that Noell attributes to him, Noell does not stand alone. See Donald R. Stabile, "Adam Smith and the Natural Wage: Sympathy, Subsistence, and Social Distance," *Review of Social Economy* 55 (1997): 292–311.

> deemed sufficient in countries where "man's life is cheap" and his wants easily satisfied. Many of the conveniences enjoyed in an English cottage would have been thought luxuries at an earlier period of our history.[43]

A similar view was expressed by Ricardo's friend and fellow political economist Robert Malthus in 1820,[44] and later of course by Karl Marx. In *Capital*, for example, Marx notes that the value of labor power under capitalism is not merely the amount necessary to keep the worker physically alive, but also includes a social or historical element. Marx says:

> The number and extent of [the worker's] so-called necessary wants, as also the modes of satisfying them, are themselves the product of historical development, and depend therefore to a great extent on the degree of civilization of the country, more particularly on the conditions under which, and consequently on the habits and degree of comfort in which, the class of free laborers has been formed.[45]

And in *Value, Price, and Profit,* Marx tells us:

> Besides [the] mere physical element, the value of labor is in every country determined by a *traditional standard of life*. It is not mere physical life, but it is the satisfaction of certain wants springing from the social conditions in which people are placed and reared up. The English standard of life may be reduced to the Irish standard; the standard of life of a German peasant to that of a Livonian peasant.[46]

And while it is probable that neither Marx nor Ricardo nor Malthus had as generous a standard in mind as that which would be equivalent to my and King's conception of contextual basic needs, they clearly recognized that merely satisfying primary basic needs was not enough, and that some higher wage would be required under capitalism's own terms depending on the context in which those claims for wages arose.

I should also note that the idea that basic needs are to some extent socially constructed comes up in Marx only in the context of Marx's criticism of the so-called "Iron Law of Wages," which the romantic socialist Ferdinand Lassalle had first articulated in the mid-nineteenth century (although Lassalle claimed to be drawing on the work of Malthus and Ricardo). Lassalle claimed that wages will naturally trend toward the amount necessary for workers to subsist and replace themselves and maintain a constant population, and may only rise above this for the shortest time. Marx despised Lassalle, probably because he thought that if the assumptions underlying Lassalle's claim were true the

[43] David Ricardo, *The Principles of Political Economy and Taxation* (Mineola, NY: Dover, 2004), ch. 5, pp. 54–5.

[44] See T. R. Malthus, *Principles of Political Economy* (Cambridge: Cambridge University Press, variorum ed. 1989), vol. 1, ch. 4, sec. 2, pp. 247–57.

[45] Karl Marx, *Capital, Volume I* (Chicago: Charles H. Kerr & Co., 1921), ch. 6, p. 190.

[46] Karl Marx, *Value, Price, and Profit* (Moscow: Foreign Languages Publishing House, 1947), ch. 14, p. 66 (emphasis in original).

"Iron Law" would apply to socialism as well as capitalism, and because he wanted to encourage the activities of trade unions whose efforts to bring about increased wages would otherwise be pointless. But in any event, in his *Critique of the Gotha Program* Marx argued vociferously against Lassalle's view, claiming that because wages were in part socially constructed wage minimums were flexible rather than rigid and that they could trend up as easily as down even under capitalism.[47]

Curiously, however, when it comes to his theory of exploitation, Marx's view of the minimum wage as socially constructed seems to play no role. Indeed, Marx defines exploitation as the appropriation of surplus value, which is itself defined as the difference between the socially necessary labor time required for worker's subsistence and the socially necessary labor time required to produce the goods the worker actually produces. If the socially necessary labor time required for the worker's subsistence were to be measured by contextual basic needs rather than primary basic needs, however, it would be possible for the capitalist to appropriate *more* than surplus value from the worker (the socially necessary labor time required to satisfy the worker's contextual basic needs after his primary basic needs were satisfied), yet this would not be within the Marxian definition of exploitation. It seems odd to think that this is what Marx intended—or at least if this is indeed what Marx intended one would have expected that he would discuss this possibility in greater detail and explain how we are to think about the appropriation of this additional amount by the capitalist. Because he did not, the only way to prevent this anomaly from arising is to treat this amount as included in the concept of surplus value, at least for purposes of measuring Marxian exploitation. In other words, under Marx's theory of exploitation, subsistence must be treated as the amount required to support the worker's primary basic needs, not his contextual ones. Under our theory, in contrast, the concept of contextual basic needs has a specific role to play in determining whether there has been exploitation, for that is the minimum set for the just price of labor.

This does not mean, however, that we must actually make a comprehensive list of what would constitute a contemporary individual's contextual basic needs, resolve all the quibbles making such a list would probably create, and calculate a precise figure for the just price of unskilled labor in current dollars. Making such a precise calculation would be both unnecessary and unhelpful. As I shall argue at length later, the point of our theory of exploitation and the doctrine of the just price on which it is based is not to set forth a picture of

[47] See Samuel Hollander, *The Economics of Karl Marx: Analysis and Application* (Cambridge: Cambridge University Press, 2008), 90–4; William Baumol, "Marx and the Iron Law of Wages," *American Economic Review* 73:2 (1983): 303–8, 304; Marx, "Critique of the Gotha Program," in, *The Marx-Engels Reader*, ed. Robert C. Tucker, 2nd ed. (New York: W. W. Norton, 1978), 534–5.

what the world would look like were we to eliminate injustice all at once, for this is not an achievable objective and probably not even desirable given the economic shock an attempt at such an abrupt transition would certainly create. Rather, it is to provide a basis for guiding us toward justice in the present day. What the minimum wage should be depends on the economic and social conditions obtaining at the time, and these will change, and since we cannot and should not attempt to bring the minimum up to the required level all at once, what the precise just minimum wage should be right now is not important. All we need to do is recognize that the minimum wage should be a great deal higher under the economic and social conditions in which we currently find ourselves and we will know all we need to know to begin shaping a more just and enlightened minimum wage policy.

In any event, with reference to the current standard of living in the United States, a report recently issued by the non-profit group Wider Opportunities for Women together with the Center for Social Development at Washington University in St. Louis gives us some idea of how far we have yet to go.[48] What this report (called the Basic Economic Security Table for the United States) shows is that many low-wage jobs today are drastically failing to provide for a worker's contextual basic needs. To do this, the minimum wage would have to be something more than twice the current federal minimum wage,[49] a figure that is also what those in the living wage movement typically advocate. Indeed, over 100 city and local governments in the US[50] and in various non-US communities as well[51] have already adopted living wage ordinances that require firms doing business with the community to pay what usually works out to be twice the federal minimum, although this varies to some extent because it is calculated individually for each particular locality.[52] Even if this does not prove the matter conclusively, this is at least some evidence that the minimum wage can be increased and even increased substantially without

[48] See Wider Opportunities for Women, *The Basic Economic Security Tables for the United States* (2010), available at <http://www.wowonline.org/documents/BESTIndexforTheUnitedStates2010.pdf>.

[49] See Motoko Rich, "Many Low-Wage Jobs Seen as Failing to Meet Basic Needs," *The New York Times* (March 31, 2011). For a more personal description of how difficult it is to get by on what a full-time low-wage job currently pays, see Barbara Ehrenreich, *Nickel and Dimed: On (Not) Getting by in America* (New York: Henry Holt, 2001).

[50] See Mark Brenner, Jeannette Wicks-Lim, and Robert Pollin, "Detecting the Effects of Minimum Wage Laws," in Robert Pollin et al., *A Measure of Fairness: The Economics of Living Wages and Minimum Wages in the United States* (Ithaca, NY: Cornell University Press, 2008), 233–53, at 233.

[51] See *Living Wage Movements: Global Perspectives*, ed. Deborah M. Figart (London: Routledge, 2004).

[52] See Noell, "Smith and the Living Wage," at 151, and Robert Pollin and Stephanie Luce, *The Living Wage* (New York: The New Press, 1998), 204–14 (listing localities).

any of the disastrous results that are typically predicted by those who oppose such measures.[53] But I will have much more to say about this later. For now, the only point I want to make is that the concept of calculating the minimum wage by reference to contextual basic needs is by no means as difficult as some critics of the concept have and no doubt will continue to vociferously claim.

Of course, in many cases workers are entitled to more than a mere living wage, for in many cases the cost of maintaining a worker's contextual basic needs will not be the only cost of producing the worker's labor. For anything other than purely unskilled labor, there is also the cost of education and training that goes into the acquisition of skills and the development of natural talents and abilities; there is the cost of acquiring and developing a reputation, which is what makes one's labor saleable; there is the cost of acquiring and developing contacts, if trading on such contacts is of value in connection with the particular endeavor under examination (let us call these networking costs); there is the cost of acquiring and maintaining a marketable image, if the individual is trading on this in lieu of or in addition to his labor as, for example, movie stars and models do; and of course there are certain costs such as the assumption of liability or risk that are unconnected with the sale of labor and which a firm can incur too. While economists typically treat these costs as costs of consumption rather than of production when they are incurred by individuals, it is important that we not do so here. Labor is not fungible. At least it is not always fungible. The more specialized and developed the skills and talents required, the more it generally costs the individual to produce them. And those who have incurred additional costs in producing their labor are entitled to wages that exceed the minimum.

Indeed, this allows us to explain why we feel that many lower- and middle-income workers are underpaid. Take, for example, secondary school teachers. The wages many such individuals receive are often not even sufficient to cover their contextual basic needs, much less the true cost of producing the kind of skilled labor required of them, especially since secondary school teachers have often incurred high education costs in order to be in a position to perform this labor. If the amount these individuals are being paid for their labor is less than its average total social cost, including these educational and other relevant expenses, then the price paid for their labor is unjust, and we have at least a *pro tanto* reason for trying to do something about this, such as enacting minimum wage and maximum hour laws governing such professions.

[53] As a result, pressure is already building at the state and federal level to follow what has been done at the local level and raise the minimum wage. See Steven Greenhouse, "Raising the Floor on Pay," *The New York Times* (April 9, 2012).

4.6.2 *When Compensation is Excessive*

But there is an even more important ramification of including what are usually unaccounted for costs of production in calculating the just price for labor—it gives us a way of testing whether certain highly compensated individuals, such as the Chief Executive Officers of Fortune 500 companies and other high-ranking corporate executives and, in the financial industry, various proprietary traders and those in charge of such departments, are being overpaid for their services. This is a critical calculation to make, for land owners and industrialists are no longer the primary source of new entrants into the top of the income distribution. Rather than those who *own* the means of production, the biggest source of new entrants into the elite 0.01 per cent of the income distribution are those who *manage* the means of production and, even more recently, those who manage the capital of others. It is the growing compensation packages paid to such managers, not only the profits earned by, say, venture capitalists and entrepreneurs, that is driving the dramatic increases in economic inequality in the US and other wealthy nations in recent years.[54] In such advanced capitalist societies, the appropriation of surplus value is simply no longer the exclusive privilege of owners of the means of production—it is now the privilege of managers too, and in ever-increasing proportions. So while we normally think of exploitation as something that capitalists do to workers, it can also be something that highly-compensated managers do to capitalists, and ultimately to the rest of us, who have to pay higher prices for the products the firms managed by these individuals produce.

Indeed, there is reason to believe that there is a natural tendency for the compensation of highly-compensated individuals to rise as a capitalist economy matures and the organic composition of its key productive enterprises begins to change.[55] Such a change would be a natural consequence of technological advance, which causes a reduction in the amount of labor time required to produce the same goods and a corresponding reduction in the ratio of variable capital to total capital for the involved industries. As technological advance makes labor more efficient, less of it is needed to produce the

[54] See Thomas Piketty and Emmanuel Saez, "Income and Wage Inequality in the United States, 1913–2002," in *Top Incomes over the Twentieth Century*, ed. A. B. Atkinson and T. Piketty (Oxford: Oxford University Press, 2006), 141–225, at 150–2, 163; and Eric Dash, "Executive Pay: A Special Report: Off to the Races Again, Leaving Many Behind," *The New York Times* (April 9, 2006); and most recently, Jon Bakija, Adam Cole, and Bradley T. Helm, "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data," (April 2012) (available at <https://web.williams.edu/Economics/wp/BakijaColeHeimJobsIncomeGrowthTopEarners.pdf>).

[55] See Simon Mohun, "The Rate of Profit in the US Economy, A Class Perspective," in *Social Fairness and Economics*, ed. Lance Taylor, et al. (London: Routledge, 2012), 171–98, figure 3 (showing production worker wage share falling and supervisory worker wage share rising correspondingly since 1949); Simon Mohun and Roberto Veneziani, "Goodwin Cycles and the U.S. Economy, 1948–2004" (December 30, 2005), at 19–20, figure 6 (available at <http://ideas.repec.org/p/pra/mprapa/30444.html>) (same).

same amount and quality of goods. But labor is not a monolithic factor of production, although it is often treated as if it were. There is L, the general amount of labor time required to produce a good, and HCL, highly-compensated labor. Assuming all other factors are held constant, as technology makes production more efficient and reduces the amount of general labor time required for production, there will be pressure on the price of HCL to rise. First, increases in efficiency and the corresponding reduction in the cost of L will often be seen as a reason to reward HCL, regardless of supply and demand. Second, while technology tends to reduce overall labor time and therefore the demand for L, it tends to increase the average skill level required and especially the skill level required from HCL and upper management personnel. And while it is relatively easy to tell who has the ability to carry around 100-pound sacks of concrete, it is not so easy to tell who has the ability to effectively manage a highly-sophisticated and complex corporate entity. There is accordingly a great deal of uncertainty associated with deciding what criteria should apply when it comes to hiring HCL. Whatever criteria are ultimately selected, these are likely to be highly imprecise and subjective. So there will also be a great deal of uncertainty associated with deciding who has the necessary skills according to these criteria and who does not. As a result, even when the supply of those who could perform HCL is actually increasing, outpacing any increased demand, there may appear to be an increasing shortage of such individuals, again putting pressure on the price of HCL to rise.

In light of all this, serious questions have begun to be raised in various quarters in a number of nations about whether the seemingly ever-increasing compensation packages being awarded to select corporate managers and executives are economically and morally just.[56] For even if an increase in the price of HCL is a natural tendency, there is nothing in capitalism which says it is a necessary one if we are to maximize economic growth. Quite the contrary, in fact—because this increase in the price of HCL increases inequality, it redistributes income from those who have the highest marginal propensity to consume to those who have the lowest, and from those who would spend their income locally to those more likely to spend it internationally, if they choose to spend it at all, fuelling someone else's economy.[57] The rising

[56] According to a recent *New York Times*/CBS News poll, two-thirds of Americans now say that wealth should be distributed more evenly. See Editorial, "Flat Tax and Angry Voters," *The New York Times* (October 30, 2011). Such sentiments are also now beginning to be expressed on the street. See, e.g. Jennifer Preston, "Protest Spurs Online Dialogue on Inequality," *The New York Times* (October 8, 2011); George Packer, "All the Angry People," *The New Yorker* (December 5, 2011). For a discussion of the rising outrage about executive pay in Britain, see Julia Werdigier, "In Britain, Rising Outcry Over Executive Pay that Makes 'People's Blood Boil'," *The New York Times* (January 22, 2012).

[57] See Robert B. Reich, "How to End the Great Recession," *The New York Times* (September 2, 2010). For a more extended discussion of this point, see Robert B. Reich *Aftershock: The Next Economy and America's Future* (New York: Knopf, 2010), especially 32–8.

real cost of HCL also seems to be associated with a recent decline in the rate of corporate profit, leaving less money available for investment in new plant and equipment and research and development.[58] And it may also put inflationary pressure on regular wages; at least it is plausible to assume that seeing those at the top receiving astronomical salaries does not encourage line workers to moderate their wage demands or make compromises, even when wage or benefit roll-backs may be necessary if the firm is to effectively compete. So there is accordingly good economic reason to try to identify the effects of this natural tendency and control it. For a long time, however, it seemed difficult to find a principled way of doing so. Determining the value of HCL seemed too subjective an enterprise to determine with any certainty that it was being overpriced. But if we use average total social cost to calculate the cost of producing this labor, we finally have a way of assessing the value of HCL that is objectively verifiable, or at least more objectively verifiable than the self-serving claims such managers make when they try to defend the compensation packages they receive.

These claims, it seems, typically fall into one of two categories. First, highly-compensated individuals claim that they are merely receiving the market price for their services, achieved after arms-length bargaining, and therefore their compensation packages cannot be unjust. As we have already seen, however, even competitive market prices are not *necessarily* just—something more than the mere existence of even robust competition among senior officers and executives for the available positions is accordingly required to establish that the market price for their services should be considered just. More importantly, however, we have good reason to question whether the market for HCL really is competitive, for there are built-in defects in the way such market prices have been set. The bargaining between executives and the corporate committees that set their compensation is rarely arms-length—indeed, opportunities to bring improper influence to bear on the members of the relevant committee abound, and the interlocking nature of corporate directorships and the compensation committees they create provide an opportunity for informal *quid pro quo* agreements as to the level of compensation they receive from each other that is often too tempting to resist.[59] And even if we assume away the problem of systemic corruption and lack of arms-length dealing, there are still problems with the way the price of HCL is set. In deciding the amount of compensation to be awarded to the individuals occupying these management positions, the relevant committee will survey the amount of compensation

[58] See Mohun, "Rate of Profit and Crisis in the US Economy, A Class Perspective," especially sec. 2.6 and 3.1.

[59] For an extensive discussion of this problem, see Lucian Bebchuck and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004), especially 23–44.

other corporations are paying similar managers. They will not be able to attract the best executive candidate, however, if they merely offer that candidate what their survey reveals to be the current average amount of compensation. After all, who would accept (and who would want a manager who would accept) anything other than something more than the current average? The board does not want to hire an *average* manager; it wants the best. As a result, the average compensation package for such highly compensated individuals keeps ratcheting up, not because of any increase in the value of what these individuals are offering the firm, but simply because of the way the market price for the services of these executives happens to be calculated.[60]

Regardless of any market failures involved in how the compensation levels for HCL are set, however, those who occupy these positions also claim that their compensation is justified by the value they are adding to their firms. But while this claim is often made, it is not so often true. It is certainly not true for the *average* CEO, who delivered only half of the earnings growth projected over the past twenty-four years and less than the nominal growth enjoyed by the economy as a whole.[61] Of course, the average CEO is just a mathematical construct, not a real person, but when we look at the real people involved there still seems to be little correlation between executive compensation and company performance.[62] And even where there has been an increase in the value of the firm, this does not necessarily prove anything, for this increase may be only short term and therefore may not reflect the kind of sustainable achievement that warrants increased reward. For example, given the way these compensation packages are structured, executives often have incentives to take actions that increase short-term profitability, such as cutting research

[60] For further discussion of this "ratcheting-up" process, see Charles M. Yablon, "Is the Market for CEOs Rational?," *New York University Journal of Law and Business* 4 (2007): 89–141, at 112–13; Kevin J. Murphy, "Executive Compensation" (April 1998), available at SSRN: <http://ssrn.com/abstract=163914 or DOI: 10.2139/ssrn.163914>, especially 9 and 25. For a recent example of this process at work, see Nicole Perlroth, "Lavish Pay Helped Lure Yahoo Chief," *The New York Times* (July 19, 2012) ($129 million pay package offered new Yahoo Chief is "larger than the pay package of the average chief executive in Silicon Valley, but not largest among chiefs of publicly held technology companies").

[61] See John C. Bogle, *The Clash of Cultures: Investment vs. Speculation* (Hoboken, NJ: John Wiley, 2012), 90.

[62] See Lisa Waananen, Seth Feaster, and Ian McLean, "200 Slices of Wealth," *The New York Times* (June 16, 2012) (listing the 2011 compensation of the 200 most highly paid chief executives with US public companies and comparing how changes in their compensation relate to changes in their company's profitability). The correlation coefficient for changes in profitability and changes in CEO compensation shown in this survey is only a little above zero, and this is only after outliers are eliminated (before that there is actually a slight negative correlation), and it is not clear that eliminating outliers would be justified. Only technology and finance show a positive correlation including outliers, and that correlation is very weak, although it becomes stronger once again if we assume that outliers should be eliminated. Of course, these calculations reflect only one year of data, so I do not want to make too much of this, but they do not seem to support the assertion that the current high rates of compensation these individuals are receiving is largely or even substantially a reflection of the amount of value they have been adding to their firms.

and development costs, even when these cuts will ultimately produce negative effects in the longer term. They also have incentives to take large risks that will produce immediate paper profits even if these will or at least may produce large losses in the longer term. What capitalism tells us is that if you give people incentives to take unreasonable risks they will take unreasonable risks. It should accordingly come as no surprise that the Financial Crisis Inquiry Commission found that the excessive compensation packages which have proved so popular in the financial industry in recent years actually provided inappropriate incentives to traders and other executives to engage in irresponsible risk-taking and thereby contributed substantially to the recent financial collapse.[63] Indeed, even in relatively good times, there is some evidence that a rising level of pay for HCL is an independent predictor if not a contributing cause of an inevitable decline in a company's rate of profit.[64] In any event, limiting the amount of compensation on offer for HCL is not anti-capitalist; it is exactly what capitalism recommends we do. It is no coincidence that the last time wages in the financial sector were so high relative to other sectors of the economy was around 1930, the time of the last equivalently serious worldwide financial collapse. During the interim period, when banking was relatively boring and bankers behaved much more responsibly, creating real rather than largely fictitious wealth, wages in the financial and the non-farm private sector were approximately the same.[65]

Notwithstanding this connection between excessive compensation and unreasonable risk-taking, many corporations are reluctant to leave their overly-generous compensation policies behind. Take the financial industry as an example once again. Despite the financial debacle that ensued from taking undue risks on subprime mortgages, the trend seems to be to rely *even more* on short-term rather than long-term outcomes in calculating incentive pay.[66] While various consumer watchdogs and even a few government officials and agencies are beginning to recommend that companies insert "claw back" provisions in their bonus agreements requiring executives to return

[63] See Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (New York: Public Affairs, 2011), xix, 61–4. Many of the failings outlined in the Report, of course, were brought to our attention well before the crisis by various individuals who had been examining how the financial industry was changing in response to deregulation. See, e.g. also Raghuram G. Rajan, "Has Financial Development Made the World Riskier," NBER Working Paper 11728 (Cambridge, MA: National Bureau of Economic Research, 2005).

[64] See Gretchen Morgenson, "Enriching the Few at the Expense of the Many," *The New York Times* (April 9, 2011).

[65] See Thomas Philippon and Ariell Reshef, "Wages and Human Capital in the U.S. Financial Industry: 1909–2006: Working Paper 14644," *National Bureau of Economic Research Working Paper Series* (Cambridge, MA: January 2009); Paul Krugman, "Making Banking Boring," *The New York Times* (April 10, 2009); Louise Story, "On Wall Street, Bonuses, Not Profits, Were Real," *The New York Times* (December 18, 2008).

[66] See Gretchen Morgenson, "Fair Game: The Quick Buck Just Got Quicker," *The New York Times* (August 16, 2009).

bonuses and other compensation if the loans or other transactions on which these were based go bad within a specified period of time, this practice is not yet mandatory,[67] and the willingness and ability of companies to actually exercise such claw back rights even when they have them is largely untested.[68] Indeed, rather than inserting claw back provisions in their compensation agreements with top executives, some companies are actually buying insurance to *protect* their executives from loss if their bonuses are clawed back as a matter of law.[69] Some companies are even paying their executives huge bonuses up front, eliminating all pretense that this represents pay for performance.[70] And banks are also being allowed to compensate their executives in other ways—such as by buying back stock or paying large dividends even though the overall financial position of the bank remains precarious.[71] So if

[67] See Julia Werdigier, "British Government Looks to Rein in Executive Pay," *The New York Times* (January 23, 2012); Louise Story, "Bonus Season Afoot, Wall Street Tries for a Little Restraint," *The New York Times* (December 9, 2008).

[68] Only a few major financial institutions have exercised such rights so far. One is Lloyds Bank in the UK, which recently clawed back between 5 per cent and 40 per cent of the bonuses awarded to certain executives and directors in 2011. The amount of the claw back was approximately £2 million; the reason for the claw back was that after the bonuses were awarded, the bank suffered a £3.2 billion loss in settlement of claims that it had improperly sold many of its customers mortgage protection insurance during the relevant period. Despite the huge difference between the amount of this loss and the amount of the claw back, however, these individuals were allowed to keep the remainder of their bonuses. See Jill Treanor, "Lloyds Bank Claws Back £1.5m in Bonuses from Directors" and "Lloyds to Seize Back Bonuses from 10 Senior Bankers," *The Guardian* (February 20, 2012). HSBC has also announced it will claw back some portion of 2011 bonuses for the same reasons, although it has not yet done so and the amount to be clawed back is not yet clear. See Jill Treanor, "HSBC Poised to Claw Back Bonuses after Fine for Misselling," *The Guardian* (February 26, 2012). And JPMorgan clawed back the equivalent of two years' compensation from four individuals in light of their responsibility for a "hedging" fiasco (more on this later) that cost the firm a staggering $5.8 billion, and could cost the firm as much as $1.7 billion more. See Floyd Norris "Trading Loss at JPMorgan Will Result in Millions in Pay Givebacks," *The New York Times* (July 13, 2012). How much of their total compensation these individuals will nevertheless be allowed to keep for the period of their misconduct is not clear.

[69] See Reynolds Holding and Una Galani, "Pushing Back on Clawbacks," *The New York Times* (December 19, 2011).

[70] See Michael J. De La Merced, "Big Payday for Yahoo's New C.E.O.," *The New York Times* (January 6, 2012) (noting that Yahoo's new CEO received a signing bonus of $4.5 million in cash and $22.5 million in stock). Timothy D. Cook, the new CEO of Apple, received an upfront award of Apple stock that was initially worth the staggering sum of $376.2 million, but has since increased in value to the even more staggering sum of $634 million. While the shares do not fully vest for another 10 years, it is not clear whether there are specific performance targets that Mr. Cook must meet, and if so, how difficult this might be. See Natasha Singer, "In Executive Pay, a Rich Game of Thrones," *The New York Times* (April 7, 2012). Even if we ignore the present value of these shares and focus exclusively on their worth at the time they were granted, however, the value of this award is enough to cover 12 years of pay for the CEO of Walt Disney. 25.4 years of pay for the CEO of Citigroup, and 33.5 years of pay for the CEO of General Electric, based on their 2011 compensation, figures that are not insubstantial in their own right. See "The $378 Million Man," *The New York Times* (April 8, 2012).

[71] See Jesse Eisinger, "Fed Shrugged Off Warnings, Let Banks Pay Shareholders Billions," *ProPublica* (March 2, 2012), available at <http://www.propublica.org/article/fed-shrugged-off-warning-let-banks-pay-shareholders-billions>. During the first nine months of 2011, the top nineteen financial institutions paid out $33 billion to shareholders, including many of their own

we are to make progress on ensuring that top executives are not rewarded for unreasonable risk-taking, we are going to have to regulate compensation agreements much more carefully than what current law provides.

In addition to incentivizing unreasonable risk-taking, there is also reason to be concerned that excessively high compensation packages tied to corporate performance may sometimes have the effect of *lowering* profitability even in the near term. Performance targets tend to operate as maximums as well as minimums. In other words, when performance targets are too easily met, this may encourage executives to *defer* pursuing certain profit-generating activities open to their companies until the following year, or to engage in various other kinds of earnings or stock price manipulation.[72] Despite this danger, however, most corporate employers seem to be inclined to do nothing about this. Once again, if we are going to make progress here, more careful regulation is going to be required.

Finally, and most frustratingly, even when a firm suffers losses, even quite severe losses, highly compensated individuals often remain highly compensated, as the ongoing revelations from the most recent financial crisis reveal. In the UK, "a fifth of the FTSE 100 companies paid out 90 per cent of maximum possible bonuses in a year when the earnings of 90 per cent of [these companies] suffered share price falls."[73] And in 2009, after being bailed out by the British taxpayer, the Royal Bank of Scotland ("RBS") paid out £1.3 billion in bonuses despite posting a £6.5 billion loss.[74] In the US, the story is

top executives, despite concerns raised about the banks' ability to survive another downturn in the economy.

[72] For an alleged example of the latter kind of manipulation, see Robert J. McCartney, "A Most Unusual Bonus Plan: At General Dynamics, Top Managers Receive a Windfall after Talking Up the Stock," *Washington Post* (October 21, 1991), A1. Even when bonuses are paid in stock, rather than cash, they may provide an incentive to reduce profitability in the near term. See Susanne Craig, "Modest Bonus Year on Wall St., but Stock Could Yield Fortunes," *The New York Times* (December 3, 2011), quoting one senior financial industry executive as saying that he comes in every day "praying" the stock price of his firm doesn't go up before bonuses are handed out early next year, because the upside potential for the stock options granted him will then be greater.

[73] Kate Burgess, "Directors' Bonuses Set to Cause New Outcry," *Financial Times* (August 17, 2009).

[74] See George Parker, Sharlene Goff, and Patrick Jenkins, "Chancellor Poised for Backlash after Approving £1.3bn in RBS Bonuses," *Financial Times* (February 25, 2010). And these bonuses just keep on coming. For 2010, RBS paid out bonuses of £950 million, and for 2011, despite suffering a loss for a *fourth* consecutive year—this time in the amount of £2 billion, the 82 percent taxpayer-owned RBS paid out bonuses of almost £400 million. See Jill Treanor, "RBS Prepares to Pay Out £400m in Bonuses Despite Expected £2bn Loss," *The Guardian* (February 22, 2012). But the RBS action is even more outrageous than it seems: while RBS did cut its bonus pool by more than half this year, this cut was largely offset by increases in the fixed salaries it paid to its investment bankers. See Sharlene Goff, Megan Murphy, and George Parker, "RBS Bonus Cuts Offset by Salary Increases," *The Guardian* (February 23, 2012). Barclays in turn recently announced it had paid its chief executive Bob Diamond £17 million for 2011, plus another £5.7 million to cover Diamond's tax bill, even though the Bank's profits had fallen 3 percent last year under his leadership. See Jill Treanor, "Barclays Chief Bob Diamond Takes Home £17m in Pay, Shares, and Perks," *The Guardian*

much the same. According to a report prepared by Andrew Cuomo, then Attorney General (and now Governor) of the State of New York:

> When the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well. And when the banks did very poorly, they were bailed out by the taxpayers and their employees were still paid well. Bonuses and overall compensation did not vary significantly as profits diminished.
>
> An analysis of the 2008 bonuses and earnings of the original TARP ["Troubled Asset Relief Program"] recipients illustrates the point. Two firms, Citigroup and Merrill Lynch suffered massive losses of more the $27 billion at each firm. Nevertheless, Citigroup paid out $5.33 billion in bonuses and Merrill paid $3.6 billion in bonuses. Together, they lost $54 billion, paid out nearly $9 billion in bonuses and then received TARP bailouts totaling $55 billion.
>
> For three other firms—Goldman Sachs, Morgan Stanley, and J. P. Morgan Chase—2008 bonus payments were substantially greater than the banks' net income. Goldman earned $2.3 billion, paid out $4.8 billion in bonuses, and received $10 billion in TARP funding. Morgan Stanley earned $1.7 billion, paid $4.475 billion in bonuses, and received $10 billion in TARP funding. J. P. Morgan Chase earned $5.6 billion, paid $8.69 billion in bonuses, and received $5 billion in TARP funding. Combined, these three firms earned $9.6 billion, paid bonuses of nearly $18 billion, and received taxpayer funds worth $45 billion.[75]

In sum, the report shows that while "compensation and bonuses steadily increased during the bull market years between 2003 and 2006 . . . when the sub-prime crisis emerged in 2007, followed by the current recession, compensation and benefits stayed at bull market levels even though bank performance plummeted." Nor was this because those receiving bonuses were in divisions that had performed well but had profits that were overwhelmed by losses generated by other divisions where employees were not so highly compensated. On the contrary, the report states "our investigation has shown numerous instances where large bonuses were paid to individuals in money-losing divisions at firms who saw either substantially reduced profits or losses in 2008."[76] For example, the insurance giant AIG paid (or at least attempted to

(March 9, 2012). For more figures on the growing disconnect between pay and performance in the UK, see High Pay Commission, *Final Report* (November 22, 2011), p. 44 and annex 3.

[75] Andrew Cuomo, "No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture" (released July 30, 2009), 1–2, available at <http://www.cbsnews.com/htdocs/pdf/BonusReportFinal7.30.09.pd>. Note that the bonuses paid by Merrill Lynch went to just 700 of Merrill's 39,000 employees. 149 people received $3 million or more, 53 received more than $8 million each, 20 more than $8 million each, and the top four received a total of $121 million. See Michael J. de la Merced and Louise Story, "Nearly 700 at Merrill in Million-Dollar Club," *The New York Times* (February 11, 2009). Note also that to make up for the "limited" bonuses it could pay to in 2008, Citigroup raised executive salaries in 2009. See Eric Dash, "Citigroup Has a Plan to Fatten Salaries," *The New York Times* (June 24, 2009).

[76] Andrew Cuomo, "No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture," at 2–3. Similar findings are contained in the report prepared by Kenneth Feinberg, the Obama Administration's special master for executive compensation at firms that received funds as

pay) huge bonuses to some of the very executives who wrote trillions of dollars' worth of credit-default swaps and brought the entire company to the brink of collapse in 2008.[77] In 2009, despite experiencing its first annual loss in its seventy-four-year history, Morgan Stanley earmarked a record 62 cents of every dollar of revenue for compensation, bringing the amount of salaries and bonuses it paid to $14.4 billion, even more than in 2008, when despite widespread financial difficulties Morgan Stanley actually managed to make a profit.[78] Lloyd Blankfein, Chairman and CEO of Goldman Sachs, received total pay of $16.2 million in 2011, up from $14.1 million in 2010, despite presiding over a 46.2 per cent decline in the company's stock value.[79] Even executives for companies that paid bonuses in stock options rather than in cash at the height of the recession have done very well, as these stock options have now turned out to be worth more than the bonuses paid in prior, better years in cash.[80] Indeed, despite the economic downturn compensation for financial traders and corporate executives continued to hit record levels in 2010 and 2011, and even executives who did so badly they ended up having to resign or be sacked routinely received eye-popping severance packages and other "rewards for failure."[81] And when bonuses did go down, they still

part of the federal bailout of the financial industry. See Eric Dash, "Federal Report Faults Banks on Huge Bonuses," *The New York Times* (July 22, 2010).

[77] See Edmund L. Andrews and Peter Baker, "A.I.G. Planning Huge Bonuses after $170 Billion Bailout," *The New York Times* (March 15, 2009). For more on the bonus practices of these and other firms, see Gretchen Morgenson, "After Losses, a Move to Reclaim Executive's Pay," *The New York Times* (February 22, 2009); Louise Story, "Cuomo Cites Big Bonuses for Many at Merrill," *The New York Times* (February 12, 2009); Ben White, "What Red Ink? Wall Street Paid Hefty Bonuses," *The New York Times* (January 29, 2009); Eric Dash and Vikas Bajaj, "Few Ways to Recover Bonuses to Bankers," *The New York Times* (January 30, 2009); Claudia H. Deutsch, "A Brighter Spotlight, Yet the Pay Rises," *The New York Times* (April 6, 2008).

[78] See Graham Bowley, "Morgan Stanley's Quarter is Weak, Unlike Its Pay Pool," *The New York Times* (January 21, 2010). In fairness, I should note that Morgan Stanley claimed that its revenue had been artificially depressed by one-off accounting charges, and that adjusting for this, the percentage earmarked for compensation would have been closer to 50 percent, the industry standard. But this, of course, does not change the fact that by basing compensation and especially bonuses on revenue, not earnings, the financial industry weakens its claim that employee compensation is pegged to value added to the firm. Indeed, some firms are paying so much in compensation that this is actually producing an overall loss for shareholders and the firm. See Eric Dash, "Ailing Banks Favor Salaries over Shareholders," *The New York Times* (January 27, 2010).

[79] See Susanne Craig, "Goldman's Blankfein Collects $12 Million," *The New York Times* (April 13, 2012).

[80] See David Kocieniewski, "Tax Benefits from Options as Windfall for Businesses," *The New York Times* (December 29, 2011). The companies that awarded these bonuses benefited handsomely as well, as paying bonuses in stock options rather than in cash gives employers tax benefits they would not otherwise enjoy, essentially forcing taxpayers to subsidize a good deal of this executive pay.

[81] See Jesse Eisinger, "As Banking Titans Reflect on Their Errors, Few Pay Any Price," *New York Times* (August 1, 2012) (noting that disgraced former executives do not even seem to pay a social cost, much less a financial one, as they still sit on corporate and non-profit boards, attend functions and galas, and even serve as regulators); Eric Dash, "Outsize Severance Continues for Executives, Even After Failed Tenures," *The New York Times* (September 29, 2011); Gretchen Morgenson,

increased as a percentage of revenues, meaning that the rate of compensation was going up even as revenues were going down, and going down quite substantially.[82]

Part of the explanation for this phenomenon may be that people tend to care much more about experiencing losses from their current baseline than about not achieving gains. This attitude is called loss aversion, and it has various and sundry effects. One is that people typically assign roughly twice the importance in their decision-making to avoiding losses than to obtaining gains.[83] For example, most people will turn down a risk that offers an equal chance of winning $200 or losing $100. People are also much less willing to part with something they already have than to pay for it if they do not have it already, a phenomenon called the endowment effect.[84] Unfortunately, loss

"Report Criticizes High Pay at Fannie and Freddie," *The New York Times* (March 31, 2011); Julie Creswell, "Even Funds that Lagged Paid Richly," *The New York Times* (March 31, 2011). Consider, for example, the case of Bob Diamond. Despite having to resign as CEO of Barclay's as a result of his involvement in the bank's manipulation of the London Interbank Offered Rate, or LIBOR, to which many floating interest rates are pegged, and even though this had cost the bank $450 million in fines already and could expose it to claims for damages amounting to tens of billions of dollars, Diamond initially looked like he was going to receive an additional £22 million payoff. See Jill Treanor and Larry Elliot, "Bob Diamond Looks Set to Fight for £22m Payoff," *The Guardian* (July 4, 2012); Nathaniel Popper, "Rate Scandal Stirs Scramble for Damages," *The New York Times* (July 10, 2012). While the outrage this caused ultimately forced him to forgo such a payment, it appears that none of the compensation he already received for the period during which the bank manipulated rates will be clawed back (he received approximately £100 million since 2006, about a year before the bank's manipulation of LIBOR began), and he "will still receive severance and pension payments totaling around £2 million, which is twice the amount his contract stipulates in the event of resignation." Dan Cimilluca, Max Colchester, and Sara Schaefer Muñoz, "Diamond to Forgo Deferred Bonuses," *The Wall Street Journal* (July 10, 2012). Yet even so Barclay's treatment of Diamond has been characterized as unusually severe. See Gretchen Morgenson, "The British, At Least, Are Getting Tough," *The New York Times* (July 7, 2012). In many cases, executives who resigned under pressure received (or were allowed to keep) even greater rewards. See, e.g. Ian Austen, "Research in Motion Reveals Multimillion-Dollar Pay for Former Chief Executives," *The New York Times* (June 14, 2012).

[82] See Andrew Ross Sorkin, "A Paradox of Smaller Wall Street Paychecks," *The New York Times* (January 9, 2012); Kevin Rose, "Bonuses Dip on Wall Street, but Far Less than Earnings," *The New York Times* (February 29, 2012) (bonuses drop only 14 per cent for 2011 despite 51 per cent drop in earnings, and that does not include non-cash compensation, which could makes bonuses substantially higher). Patrick Jenkins and Patrick Mathurin, "Bank Staff Costs Take Bigger Share of Pot," *Financial Times* (June 5, 2012) (while bank share prices have slumped almost 60 per cent and dividends are at their lowest level since 2000, staff costs have increased from a pre-crisis level of 58 per cent to more than 81 per cent). Even firms who did better than this in tying compensation to performance did not do much better. For example, Morgan Stanley's stock price dipped 44 per cent in 2011, yet its chief executive still received compensation of $10.5 million for that year, a reduction of only 25 per cent. See Susanne Craig, "Morgan Stanley Chief Collected $10.5 Million for 2011," *The New York Times* (April 6, 2012).

[83] See Amos Tversky and Daniel Kahneman, "Loss Aversion in Riskless Choice," *Quarterly Journal of Economics* 106 (1991): 1039–61.

[84] See Daniel Kahneman, Jack L. Knetsch, and Richard Thaler, "The Endowment Effect, Loss Aversion, and the Status Quo Bias," *Journal of Economic Perspectives* 5 (1991): 193–206.

aversion and its result, the endowment effect, are also subject to framing effects—that is, changes in position can often be perceived as either suffering a loss or failing to obtain a gain, depending on how they are framed.[85] As a result, bonuses once awarded have the potential to become "sticky;" that is, they may tend to be perceived as part of one's endowment, something each employee (at least subconsciously) expects to be repeated even though they know that bonuses are technically discretionary and there are no formal guarantees that the amount of each year's bonus will stay the same much less always go up. And if bonuses do tend to be incorporated into an employee's compensation baseline, reducing an employee's bonus from one year to the next is likely to cause a great deal of resentment and distress. Realizing this, compensation committees are naturally going to be reluctant to reduce bonuses as much as the changes in the company's or even the employee's yearly performance actually warrant.

Of course, even when there are truly gains in overall corporate value, there is no reason to assume that current management or any other specific individual is responsible for this, at least in a rising market.[86] As Paul Volker, who served as Chairman of the Federal Reserve under both Democrat Jimmy Carter and Republican Ronald Reagan, once noted, "stock prices rise for a lot of reasons, including ones that have nothing to do with these people."[87] When a firm's value does increase, it is always possible that the firm's value would have increased even more if someone else had been at the helm. There is simply no way to be sure that increases in the firm's value were due in whole or in part to the labor of any particular employee.

But even if there was a way to be sure that a particular executive or trader really had increased the value or profits of the firm, this would not necessarily mean that this employee would be entitled to a greater amount of compensation. After all, this is what the employee was hired to do—why is the employee entitled to an *additional* reward for performing the very obligation he was already under? The question of how increases in the firm's value are to be distributed is a question of distributive justice, and we cannot simply assume that "degree of causal contribution" is to be taken as the only relevant factor in deciding how this increase should be distributed, for determining what factors are relevant to deciding how this increase is to be justly divided is exactly the question under examination. Instead of dividing this increase wholly or even partially in proportion to causal contribution, for example,

[85] See, e.g. Amos Tversky and Daniel Kahneman, "The Framing of Decisions and the Psychology of Choice," *Science* 211 (1981): 453–8; Richard H. Thaler, "Mental Accounting Matters," *Journal of Behavioral Decision Making* 12 (1999): 183–206.

[86] See Louis Uchitelle, "The Richest of the Rich, Proud of the New Gilded Age," *The New York Times* (July 15, 2007).

[87] See Murphy, "Executive Compensation," 13–18.

we could instead divide it in proportion to the cost allocable to each relevant party's contribution. In other words, we could look at the average total social cost of producing this increase in value, and then determine the share to which each party is entitled according to the proportion of costs attributable to that party, rather than attempting to measure the effort or talent or skill expended by each party and dividing the increase on this basis. The question, as always, is which basis for distribution is most just.

The argument against using effort or talent or skill as the key factor in determining how increases in the firm's value shall be distributed is the argument against viewing these as some sort of criteria of desert. First, these are very difficult factors to measure, and the margin of error associated with any attempt to measure effort or talent or skill makes these criteria less attractive for determining entitlements than they initially appear. If we try to separate one of these criteria out, we often find that they are inextricably intertwined. As Rawls notes,

> [I]t seems clear that the effort a person is willing to make is influenced by his natural abilities and skills and the alternatives open to him. The better endowed are more likely, other things being equal, to strive conscientiously, and there seems to be no way to discount for their greater good fortune. The idea of rewarding desert is impracticable.[88]

And even if we were to view these criteria holistically rather than try to separate one out, the kind of counterfactual reasoning that would be required in order to determine the degree of contribution that one individual's particular holistic package has made would be wracked with uncertainty. How, for example, do we tie a particular outcome to a particular individual's particular combination of effort, talent, and skill? How do we determine the extent to which the outcome would have differed had that individual contributed slightly different *kinds* of effort, talent, or skill, or slightly different *amounts*, or contributed these in slightly different *combinations* than he actually did?

Second, if we do use these factors to determine whether highly compensated individuals are entitled to a distributive share, justice would surely require that we apply the same criteria all the way down. Yet a recent study of publically-listed companies in the UK by the London School of Economics showed that this is not the case: while a 10 per cent increase in firm value was associated with a 3 per cent increase in CEO pay, it was associated with only a

[88] See Rawls, *A Theory of Justice* (Cambridge, MA: Harvard University Press, 1971; rev. ed. 1999), 274. For a discussion of this passage and other similar comments by Rawls, see T. M. Scanlon, "Justice, Responsibility, and the Demands of Equality," in *The Egalitarian Conscience: Essays in Honour of G. A. Cohen*, ed. Christine Sypnowich (Oxford: Oxford University Press, 2006), 70–87, at 80–5.

0.2 per cent increase in worker pay.[89] Indeed, the successful suppression of worker pay is typically viewed as a reason to increase the rewards of upper management. Which means one of two things, both of which are very troubling. One is that while we view senior executives as the kind of beings who respond to incentives, we view line workers and middle management, who will in many cases be the ones most directly responsible for any increase in corporate productivity anyway, as something else, something more like animals or objects, but in any event as beings who are incapable of consciously and deliberately responding to incentives to work harder or smarter or more carefully and therefore as unworthy of reward for improved performance. Or, even more disturbingly, we *do* view line workers and middle management as the kind of beings who respond to incentives, but while we offer incentives in the form of rewards to upper management, the incentives we provide to others are threats of punishment. In either case, this is outrageous: it is not true that only those in upper management have a human nature, and therefore it is not true that only those in upper management are suitable subjects for incentives designed to encourage them to perform better. And whatever incentives we provide, what possible justification could we provide for not offering the same kind of incentives to everybody? If highly compensated individuals are not prepared to apply the same criteria to others that they claim should be applied to themselves, then their claim can and should be rejected on the basis of its hypocritical inconsistency.

Third, further problems arise if we use effort and talent and skill to determine distributive shares but do not rely on these factors exclusively. If, for example, we assume that mere ownership of the means of the production entitles one to a share of this increase in value (in other words, if we do not divide the increase exclusively among those who contributed to creating it through their effort, skills, or talents, but allocate some part of this increase to those who own shares in the firm as we actually do), we then have to explain how we balance ownership as a factor against effort, skill, and talent. Economists call this the value allocation problem, and there seems to be no satisfactory answer to this problem if one focuses on the extent to which each

[89] Brian Bell and John Van Reenen, "Firm Performance and Wages: Evidence from Across the Corporate Hierarchy," CEP Discussion Paper No 1088 (Center for Economic Performance, London School of Economics: November 2011). For a particularly egregious example of this, compare how Apple compensates its executives with how it compensates the vast majority of its employees, those who work in Apple's retail stores. While Apple's new CEO Tim Cook is currently the most richly compensated chief executive in the world and could ultimately receive Apple stock currently worth over $570 million if he remains with the company for ten years and it does well under his leadership, the vast majority of Apple store employees earn only about $25,000 a year and get no share of the money they bring in, even though they are at least part of the reason why Apple stores take in more money per square foot than any other United States retailer and almost double that of Tiffany, which is No. 2. See David Segal, "Apple's Retail Army, Long on Loyalty but Short on Pay," *The New York Times* (June 23, 2012).

relevant factor causally contributed to the increase in the firm's value.[90] The problem is that making such an allocation requires engaging in a large number of "but for" thought experiments in which we ask how much the firm would be worth if we removed this particular factor of cooperative production but held everything else constant, and these cannot avoid being highly speculative. On the other hand, if we focus on the relative cost of production of each factor of production instead of its *ex post* utility, we can easily determine what portion of any increase in value is attributable to each factor of production. In doing this, we do not attempt to make a new, independent, *ex post* assessment of the importance of each contribution, but assume that the parties' *ex ante* assessment is correct, and that what the parties actually paid each factor of production meaningfully reflects the extent to which each factor has contributed to creating that which is to be divided.

Finally, if what we are trying to decide is what amount of compensation is equivalent to an executive's contribution of labor, then we cannot answer *that* question by reference to the amount of value the executive has added to the firm. The amount of value a particular person's labor will add to a firm is at best a measure of the utility of that labor, not its value, as we have been using those terms. Only cost of production acts as a measure of value. So despite any difficulties we may encounter in calculating the cost of production of the services that these highly-compensated individuals provide, it is simply something that has to be done. And it seems fairly clear that if we do evaluate the labor of highly compensated individuals on a cost of production basis, their current compensation packages are grossly unjust.

Note, however, that even if these compensation packages are grossly unjust, it is not necessary to back these unjust costs out from the fully-allocated social cost of production calculation for the firm's goods and services, even though the payment of excessive compensation has caused the cost of the production for the firm to be higher than it otherwise would have and should have been. *All* costs actually incurred or negative externalities actually imposed by the firm are costs for purposes of calculating the cost of production under our reconceived theory of the just price, even if some portion of these costs arose from transactions that were themselves unjust. Violations of the doctrine of the just price may infect subsequent transactions and render these unjust as long as the price paid is higher or lower than it would have been but for that prior rights violation, as Hillel Steiner contends, but whether a transaction is unjust under Steiner's theory because it is morally tainted by a prior rights violation (which could include a violation of our reconceived concept of the just price) and whether a transaction is unjust because it directly violates our

90 For a similar view, see G. A. Cohen, "Marx and Locke on Land and Labor," in *Self-Ownership, Freedom, and Equality* (Cambridge: Cambridge University Press, 1995), 165–94, 184.

reconceived doctrine of the just price are separate and independent questions. Whether a particular transaction complies with our reconceived doctrine of the just price depends solely on the costs each party *actually* incurs or imposes on others as a result of that transaction, not on whether these costs themselves arose out of just or unjust transactions.

This is an important restriction, because it is what prevents our reconceived doctrine of the just price from being subject to something like the circularity/infinite regress objection that Swedish economist Knut Wicksell raised to cost-of-production theories of price back at the beginning of the twentieth century. Wicksell's objection was that if you are claiming that the actual price of a good is determined by its cost of production, you must look not only to the cost of employing the factors used in producing that good, but also to the cost of production of those factors of production, and the cost of production of the factors used to produce those factors, and so on.[91] But ours is not a theory of price; it is a theory of the *just* price. We are not trying to determine the price at which a good will sell—supply and demand determines that. We are trying to determine when the price determined by supply and demand is *unjust*, and whether something is or is not unjust can be determined in context—that is, by using the existing state of affairs as a baseline. Indeed, if we allowed one violation of the doctrine of the just price to infect all subsequent transactions in which it was included as a cost, then whenever we were asked to evaluate the justness of a particular transaction we would have to trace each factor of production endlessly back until we arrived at what we would have to characterize as "the first transaction" to determine whether there had been a violation or not. This would effectively turn finding a violation of the doctrine of the just price into a meaningless exercise, for violating the doctrine would effectively be something that everyone was continuously doing to everyone else. Because the whole point of developing a doctrine of the just price is not to explain why the existing pattern of distribution in our society is currently unjust, but to regulate transactions in the here and now, we have no need to construct our doctrine so as to ensure that we capture injustice created by past transactions. In any event, as I shall argue at some length later, undoing the injustice that has already been done will come as a natural side effect of preventing further acts of exploitation from arising. So while Wicksell's objection makes sense when applied to theories of *price* given the way a cost-of-production theory of price would have to be calculated, it is of no consequence to us here because under our theory the *just* price includes all *actual* costs and not only *just* ones.

[91] See Knut Wicksell, *Lectures on Political Economy, Volume I: General Theory* (London: George Routledge and Sons, 1934), 19–23.

What all this means is that when we are examining the conduct of highly-compensated individuals, it is *they* who are guilty of violating the doctrine of the just price if they overcharge for their services, not the firms who pass on the cost of their exorbitant compensation packages to the consumer in the form of higher prices. When a price is unjustly high, it is the party that *charges* the price, not the party that pays it and then passes it on, that has violated the doctrine of the just price as we have reconceived it. Conversely, when a price is unjustly low, it is the party who *pays* the price, not the party to whom some of those savings are passed on that has violated the doctrine. The point at which we should focus our efforts to prevent injustice is the point at which that injustice occurs, not somewhere down the line where others benefit or suffer from it. Indeed, if we were to require that unjust costs be backed out of the average total social cost calculation, then in other, more modest situations, firms might not be able to charge enough to cover their actual costs of production, and people might no longer be able to charge enough for their labor to satisfy their contextual or even their primary basic needs.

There is one other advantage of using cost of production to measure the value of labor power that I would like to mention. Like Rawls's difference principle, calculating the cost of labor in this fashion ensures that we do not reward the mere possession of natural talents and abilities. At the same time, however, we manage to avoid both the metaphysical and the moral controversy surrounding Rawls's claim that we do not deserve our natural talents and abilities because their distribution is morally arbitrary.[92] Natural talents and abilities do not lead to greater distributive shares under our theory of exploitation, not because we do not deserve them, but because natural talents and abilities have no cost of acquisition.[93] The mere possession of natural talents and abilities accordingly does not entitle anyone to charge more for their labor—only the cost of *developing* these natural talents and abilities is recoverable. Of course, only those who *have* natural talents and abilities have the opportunity to develop them, but it is through developing them, like laboring on unowned assets, that we make whatever natural talents and abilities we are lucky enough to have been given ours. In any event, I do not see why the fact that natural talents and abilities are given to us rather than acquired should make their development costs unrecoverable when these natural talents and

[92] See, for example, the various arguments leveled against Rawls's claim in Nozick, *Anarchy, State, and Utopia*, at 213–31.

[93] Not because they are gifts, for remember, gifts have the same cost basis in the hands of the donee as they had in the hands of the donor. Natural talents and abilities have no cost of acquisition because their cost basis in the hands of the don*or* is zero, for the donor also received them as a gift, and so on and so forth back to the origin of the species. I leave aside for now the question of how to handle the fringe rather than the central case—that is, whether natural talents and abilities do have a cost of acquisition when sperm or eggs are purchased and this is permissible under the applicable legal regime.

abilities eventually pay off. While others are not free to develop our natural talents and abilities in our place, this does not make the development costs we incur any less real, and if the recovery of other kinds of costs is just, there is at least some reason to see the recovery of these development costs as just too.[94]

[94] Even Rawls agrees on this point. See Rawls, *A Theory of Justice*, 277: "The function of unequal distributive shares is to cover the costs of training and education, to attract individuals to places and associations where they are most needed from a social point of view, and so on."

5

Exploitation and Intolerable Unfairness

While we have now established that the sale of any good at anything other than its average total social cost is unjust, this does not mean that all such sales must be prohibited. A liberal society also embraces the principle of toleration—indeed, the principle of toleration is widely seen as one of the key presuppositions that allow us to describe a society as "liberal." Before we can determine how and when deviations from the just price should be prohibited—in other words, before we can determine when deviations from the just price constitute exploitation—we must accordingly take the principle of toleration into account.

5.1 The Scope of the Principle of Toleration

Before I do so, however, I should note that some liberals to whom I have made this argument deny that it is so. They claim that the principle of toleration was never meant to include the toleration of injustice, and therefore the principle of toleration is irrelevant when it comes to evaluating deviations from the just price. But I do not see how this could be correct. As a historical matter, no doubt, it is true that the principle of toleration was and typically still is primarily used to explain why a liberal state does not suppress certain individuals or groups merely because a majority of their fellows dislike their conception of the good, comprehensive moral doctrine, religious views, or way of life. But these are not the only situations to which the principle of toleration may have application. In a liberal society, toleration is supposed to be a *general* moral imperative, and therefore to apply whenever the following three conditions are met: (1) there is some attitude or conduct that is morally wrong in some important way; (2) this attitude or conduct has a significant negative impact on certain members of society and is therefore worthy of suppression; and (3) this attitude or conduct could be effectively suppressed by the power of the state.[1] There is no reason (at least no moral reason) to suppress attitudes or conduct that we do not view as morally wrong, so our failure to suppress such attitudes or conduct is not the result of toleration. Attitudes or conduct that we believe are morally wrong but do not have any detrimental effects on anyone are simply not worth the cost of suppressing, so our failure to suppress them is the result of pragmatic concerns about the efficient allocation of resources, not toleration. And dangerous attitudes or conduct that we could not effectively suppress even if we tried may again be permitted for pragmatic reasons, but when we do this we cannot properly describe what we are doing as toleration, for doing otherwise is not an option. Once there is a moral wrong that is both worthy and capable of suppression, however, I do not see why it should matter what kind of moral wrong it is. Why should injustice be exempt from toleration when other forms of morally objectionable behavior are not? Why should injustice be so uniquely privileged? If we embrace political liberalism, the principle of toleration must be viewed as a general principle, not a special one. Indeed, if liberals were *not* willing to tolerate some degree of injustice they would not be what we typically think of as liberals, but would more properly be described as perfectionists, for their concept of justice would allow no exceptions, although they might be soft perfectionists rather than hard ones.[2]

Perfectionists, of course, have their own criticisms of toleration, and I would be remiss if I did not at least note this here, especially since these criticisms go well beyond this slight disagreement among liberals over the proper scope of the principle of toleration. Regardless of whether one adopts the broad or narrow view of toleration, both are liberal views in the sense that they both attempt to mark out some territory between a willingness to accept that which is not a moral wrong and a desire to suppress that which is a moral wrong that is not occupied by impotence or indifference. Perfectionists, however, deny there is any territory here to be claimed. They deny that there are non-instrumental reasons for resisting a desire to suppress that are not also reasons

1 For similar definitions, see Glen Newey, *Virtue, Reason, and Toleration* (Edinburgh: University of Edinburgh Press, 1999), especially 18–52; *Toleration: An Elusive Virtue*, ed. David Heyd (Princeton: Princeton University Press, 1996), especially the introduction by David Heyd, at 4–10 and the essays by Bernard Williams and John Horton, 18–27 and 28–43; Susan Mendus, *Toleration and the Limits of Liberalism* (London: Macmillan, 1989), especially 18–19; Peter P. Nicholson, "Toleration as a Moral Ideal," in *Aspects of Toleration*, ed. John Horton and Susan Mendus (London: Methuen, 1985), 158–74, at 160–2.

2 Soft perfectionists reject toleration and/or one or two other presuppositions that liberals typically accept. Hard perfectionists reject most if not all of these presuppositions, including both toleration and neutrality, and therefore hold a much more intrusive conception of justice, one that embodies a very specific comprehensive theory of the good and is enforced by using the coercive power of the state. For a discussion of these other presuppositions and more on the distinction between soft and hard perfectionism, see Mark R. Reiff, "The Attack on Liberalism," in *Law and Philosophy*, ed. Michael Freeman and Ross Harrison (Oxford: Oxford University Press, 2007), 173–210, especially 176–8.

for accepting that to which we object. And they contend that if no such reasons actually exist, then toleration is not a distinct moral attitude that anyone could actually hold, but simply another way of saying that a plurality of incompatible sets of moral judgments are equally correct or, more nefariously, that *no* set of moral judgments is correct, both positions that perfectionists vigorously reject.[3]

But I shall not engage this argument here. Just as our theory of exploitation presupposes that the battle between capitalists and their critics has already taken place and the underlying presuppositions of capitalism are ones that we already accept, our theory also presupposes that the battle between liberals and their critics has already taken place, leaving liberalism and its embrace of the principle of toleration essentially intact. While liberals may disagree about the proper scope of the principle of toleration, and this is an issue that our theory of exploitation must address, the underlying existence of the principle is no longer open for debate. At least it is no longer open for debate within the confines that our theory of exploitation is designed to operate. Within those confines, the broader interpretation of the principle is the only sensible one to accept.

But remember, just because the principle of toleration applies to injustice as well as other moral wrongs does not mean that all or even a great deal of injustice must be tolerated. Clearly this is not the case—the principle of toleration is not unlimited. Whether the principle of toleration does apply to a particular instance of injustice—and if it does, whether the limits of toleration have been reached—requires that we balance whatever reasons we may have for toleration against whatever reasons we already have for concluding that the conduct or attitude at issue is morally wrong in the first place. To complete our theory of exploitation, then, we must sort the tolerable deviations from the just price from the intolerable, for only when the degree of deviation reaches intolerable levels can it constitute exploitation and be prohibited. Before we can do that, however, we need to know what reasons there might be for tolerating any deviation at all.

5.2 Three Reasons for Toleration

The first reason for tolerating some variation from the just price is the same reason we have for tolerating all sorts of departures from the requirements of morality. This is what Rawls calls "the burdens of judgment."[4] The burdens of judgment are the reasons why reasonable people can reasonably disagree.

[3] See Reiff, "The Attack on Liberalism," at 177–8.

[4] See John Rawls, *Political Liberalism* (New York: Columbia University Press, 1993, 1996), 54ff.

Evidence, for example, is often complex, conflicting, and hard to assess, as is the weight to be assigned to relevant considerations; normative concepts are often vague and open to different interpretations; and our judgments on these matters are influenced by our personal experiences and our personal experiences are diverse, leading us to reasonably assign different priorities to competing considerations. Because of the burdens of judgment, it is not unreasonable to expect good faith errors to occur in calculating average total social cost. Although we may be convinced that certain calculations are mistaken, we should nevertheless tolerate some degree of error as a concession to the difficulty involved in making these calculations.

A second and far more important reason for tolerating deviations from the just price is that justice is not the only interest involved in deciding what should or should not be prohibited. To paraphrase H.L.A. Hart, there is a limit to the amount of justice any society can afford.[5] A society that adopts capitalism as its economic system accepts the view that people need financial incentives if they are to maximize their productive capacity, take risks they would otherwise be inclined to avoid, and search for and implement both substantive and methodological technological innovation. Such a society further believes that if people do engage in such activities, its members as a whole will be better off (in the Kaldor-Hicks sense, in that the gains to some will more than offset the losses to others), and perhaps even each segment of society will be better off (in the Pareto-superior sense, in that at least some people will be better off and no one will be worse off). To provide these financial incentives, a capitalist society must accordingly allow its members to profit from their activities: that is, to sell goods at more than their just price, for merely being able to recover the costs of these activities is not enough if we are to encourage people to engage in the kind of risky business that drives a capitalist economy forward.[6] And while just price theorists have often struggled to account for this—after all, if profit is understood as something in excess of the just price, the pursuit of profit must be unjust—the fact that the pursuit of profit is unjust is not problematic under liberalism as long as the degree of profit sought is within the tolerable range. I shall discuss how we determine the limits of this range in a moment, but for now the point is simply that the recognition of the incentive effect that the profit motive provides is a reason to tolerate some deviation from the otherwise strict requirements imposed by the doctrine of the just price.

[5] See H. L. A. Hart, *Concept of Law*, 2nd edition (Oxford: Oxford University Press, 1994), at 166.

[6] For a discussion of the various incentives that the availability of profit can provide, see Joel Dean, *Managerial Economics* (New York: Prentice Hall, 1951), 6–12. See also Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper Perennial Modern Thought Edition, 2008), 75–5 ("economic activity in a capitalist society . . . turns on the profit motive," and is driven by the idea that "maximum performance is in the interest of all").

Indeed, this is why our theory of exploitation is not a critique of capitalism but a creature of it. It accepts the capitalist presupposition that the best way to incentivize the talented and make them economically productive is to offer them the opportunity for profit. As an assessment of human nature, of course, this presupposition may or may not be correct, and regardless of whether it is correct it may or may not be just, but neither of those questions is a matter for our theory of exploitation to address. Instead, our theory of exploitation sits inside an economic system we have already selected on other grounds and assumes that the underlying presuppositions of that system are just, or perhaps more precisely, that these presuppositions form facts on the ground that cannot easily be changed and therefore are not subject to the daily task of being evaluated as just or unjust.

The final reason for tolerating some deviation from the just price is that under the right conditions, people will support this to a certain degree, even when they are disadvantaged by the inequality it promotes. As I have argued at length elsewhere, most people prefer a life characterized by synchronic inequality and diachronic equality over one characterized by synchronic equality alone, even though they are among the ones who are currently disadvantaged by this, as long as they perceive themselves as enjoying a reasonable possibility of economic mobility and therefore believe that the privileges of synchronic inequality could one day be something they enjoy.[7] While this may make society unjust, any less unjust society would be politically unstable because it would lack sufficient popular support. Any rule precluding the pursuit of profit and the inequality that such a pursuit promotes would accordingly not be able to withstand what Rawls calls "the strains of commitment," and we have reason to reject any rule that would not withstand these strains even if that rule would otherwise be just.

5.3 Toleration and Sales below the Just Price

Not all of these reasons for toleration, of course, apply both to sales below and to sales above the just price. While the burdens of judgment do, of course, in the sense that errors from the burdens of judgment can result in a deviation from the just price in either direction, the most important reason for tolerating deviation—that of providing incentives to produce more to those in a position to do so, at least up to the socially optimum amount of

[7] Ironically, this is true even if their perception of a reasonable possibility of mobility is false, at least as long as they did not know it is false. For an extended discussion of the reasons for and the extent of this phenomenon, see Mark R. Reiff, "The Politics of Masochism," *Inquiry* 46 (2003): 29–63, especially at 50.

production—will usually only apply to sales over the just price. Indeed, the whole idea of using average total cost as our determinate of the just price is to ensure that the price is not inappropriately low because there are unaccounted for externalities, for the exclusion of these is distorting to the most efficient allocation of resources in a capitalist economy. Even sales below cost that are not the result of the imposition of externalities, however, work to distort the most efficient allocation of resources, at least in most cases. Accordingly, there is usually no special reason to tolerate sales below cost that the acceptance of capitalism provides.

There are exceptions, however. For example, if a seller is a new entrant to the market, or is attempting to introduce a new good or way of doing business, it may be necessary for the seller to sell below cost until he or the good or the new way of doing business becomes established. While such sales are unjust to the seller in the short term, they offer a potential long-term benefit for the seller, they benefit the buyer in both the short and the long term, and they potentially benefit everyone in the long term because they offer the possibility of increased competition in the relevant market segment and the more rapid introduction of technological change. Indeed, introducing technological change can often be rather tricky, for when there are tangible or intangible transaction costs to moving to a Pareto superior equilibrium, existing technologies and the current (now Pareto inferior) equilibrium based upon them can be extremely "sticky."[8]

Similarly, when goods become obsolete, and therefore their market price drops, it may not be possible for a seller to recover their full cost of production. While selling such goods for less than their average total social cost may be unjust to the seller, it is a windfall for the buyer, and it would be even more unjust to the seller to prevent him from mitigating his losses. Forcing the seller to simply dispose of goods that have already been produced would also be an act of waste, and therefore harmful to everyone. As long as the seller does not drop his price below what would be the current market price for such goods, and as long as he still recovers a sufficient amount to cover any externalities produced by the transaction, allowing him to do so would have no anti-competitive or other antisocial effects and therefore this is no reason not to allow him to do so.

[8] For example, Amazon sold goods at a loss for a good number of years after it first came into existence. It was only after people became used to the idea of making purchases online that Amazon finally turned a profit, allowing it to sell goods for their average total cost. See generally Gary Rivlin, "A Retail Revolution Turns 10," *The New York Times* (July 25, 2005). In this case, it was the way of doing business, not the good itself, which had become sticky and resistant to technological change. For other examples of how a Pareto inferior coordination point can be sticky even when there is another coordination point that everyone recognizes is Pareto superior in the long run, see Shaun P. Hargreaves Heap and Yanis Varoufakis, *Game Theory: A Critical Text*, 2nd revised edition (London: Routledge, 2004), 217–18.

Toleration of downward deviations from the just price would also be justified during times of economic distress, when it may be impossible for even the most efficient member of a market segment to recover the average total social cost of his goods. In these circumstances, as long as the price charged remains above marginal social cost, we have reason to tolerate sales below average total social cost in the short term in order to ensure that a particular industry or market segment does not disappear or become an oligopoly or even a monopoly once economic conditions improve. As in each of the prior cases, while the relevant sales below cost are still unjust, there is another value (in this case preserving the long-term benefits of heightened competition) that capitalism tells us is very important and which accordingly outweighs the injustice that violation of the doctrine of the just price would produce.

Finally, when average total cost exceeds marginal cost and price discrimination is possible, there may be goods that cannot be sold in certain markets or certain market segments or even to certain specific customers at average total cost, but which could be sold at or above marginal cost. In these cases, allowing some sales below average total cost may be Pareto superior, since it reduces the price to be paid by the first group to the extent some fixed costs are recovered from the second group and at the very least does not increase it, while at the same time it makes the second group better off, especially if the goods involved have a direct and substantial impact on social welfare. For this kind of price discrimination to be possible, however, the seller must have some degree of monopoly power.[9] And because this kind of price discrimination can be engaged in only by a monopolist, such discrimination always raises the possibility that it is predatory—that is, designed to prevent entry into the market or drive new entrants out, something that ought to be prohibited as anti-competitive regardless of whether it is unjust or exploitive. While there is a great deal of controversy within both economic and legal circles over whether and if so when such pricing practices are predatory, the emerging consensus seems to be that sales above average total cost are never predatory, sales below marginal cost are always predatory, and sales between marginal and average total cost, which are the kind of sales we are interested in here, are sometimes predatory and sometimes not.[10] But it is important to keep in mind that while related, the question of whether a sale at marginal cost is predatory is not simply another way of asking whether a sale at

[9] See Fritz Machlup, "Characteristics and Types of Price Discrimination," in National Bureau of Economic Research, *Business Concentration and Price Policy* (Princeton: Princeton University Press, 1955), 397–440, at 399.

[10] See generally James D. Hurwitz and William E. Kovacic, "Judicial Analysis of Predation: The Emerging Trends," *Vanderbilt Law Review* 35 (1982): 63–157; F. M. Scherer, "Predatory Pricing and the Sherman Act: A Comment," *Harvard Law Review* 89 (1976): 868–90; Phillip Areeda and Donald F. Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act," *Harvard Law Review* 88 (1975): 697–733.

marginal cost should be tolerated or deemed exploitive. The issue in the latter case is not whether a pricing decision is anti-competitive and therefore should be prohibited—*all* violations of the doctrine of the just price are unjust and therefore should be prohibited unless there is some countervailing reason to tolerate the violation. Accordingly, the mere fact that a pricing decision is *not* anti-competitive is not a reason to tolerate a deviation from the doctrine of the just price. On the contrary, we must have some *positive* reason for toleration, which means that allowing this particular good or kind of good to be sold at below cost will actually strengthen the market rather than merely not weaken it, or that there are some other overriding moral goals that will be served thereby.

For example, it may be that a drug that combats AIDS can be sold to everyone who needs it in richer nations at its average total cost, which includes among other things the recovery of a portion of the research and development costs and other fixed costs of the production of the drug, and could also be sold to everyone who needs it in poorer nations for its marginal cost, but could not be sold to anyone in these poorer nations if it was offered there only at its average total cost. As long as the drug is still under patent and trans-shipments and resale can be prevented, the producer enjoys a certain amount of monopoly power, limited perhaps only by the threat of entry by illegal "black market" producers, and it may wish to offer the drug at marginal cost or slightly above to poor nations while charging average total cost to rich nations.[11] This increases the producer's profits, satisfies what would otherwise be unsatisfied demand, a demand based not on mere wants but on real needs (unlike the demand for many other kinds of goods), and ensures that many if not all those who need the life-saving drug will get it. And if the price of the drug in poor nations is even slightly above marginal cost, it also reduces worldwide average total cost and therefore the price paid by customers in rich nations because some fixed costs of production of the goods which they go on to purchase are also being recovered. While the price paid for the drug in poor nations is nevertheless unjust under the doctrine of the just price as we have conceived it, it is not exploitive, for the existence of a clear and substantial net increase in social welfare for some and some net increase in social welfare for everyone makes this pricing practice Pareto (not merely Kaldor-Hicks) superior to all available alternatives, and therefore provides us with a sufficient reason to tolerate this injustice and allow sales at or slightly above marginal but below average total cost in selected markets to occur.

Finally, let us consider the impact of the strains of commitment on downward deviations from the just price. The burdens of judgment provide a

[11] See generally F. M. Scherer and Jayashree Watal, "Post-TRIPS Options for Access to Patented Medicines in Developing Nations," *Journal of International Economic Law* 5 (2002): 913–39, 925–34.

limited justification for some unintentional downward deviation from the just price, and the presuppositions of capitalism provide a justification for such downward deviation in a select group of cases, but it is unlikely that the strains of commitment would ever provide such a justification. While people will tolerate creating privileges for the rich if these privileges are ones they believe they may someday enjoy, this phenomenon is far less pervasive when such privileges have to be purchased with actual losses rather than merely forgone gains. This is because most people are loss averse, and such people tend to be unwilling to absorb actual losses to create or maintain these privileges, even if they think these privileges are ones they may someday get to enjoy. As a result, while the maintenance of a just price ceiling is likely to attract the requisite political support only when people believe their chances of economic mobility are rather slight, the maintenance of a just price floor is likely to be politically stable under all conditions. Which means that the scope for downward deviation under our reconceived doctrine of the just price is very limited indeed. Only when calculation of the just price is very difficult, thereby triggering the burdens of judgment, or when special circumstances apply is any significant degree of downward deviation likely to be tolerable.

One important ramification of this is not only that it is a violation of our theory of exploitation to *sell* below the just price in other situations, it is also a violation of our theory of exploitation to *buy* below the just price when none of the applicable reasons for toleration are present. This means that domestic companies that farm out production to factories overseas that do not pay their workers enough or otherwise charge enough to cover their full social costs of production are themselves engaging in exploitation. Companies in liberal capitalist economies are required by our theory of exploitation to take steps to ensure that the price they are paying for goods manufactured in other kinds of societies are not unjustly underpriced. Of course, a mere individual purchaser of products from abroad cannot turn other societies into liberal capitalist ones, but large corporate purchasers of such products who are engaged in the business of assembling and then reselling them within liberal capitalist economies can add provisions to their contracts with foreign manufacturers to ensure that these sellers cover the true social costs of their own production, as, for example, companies like Apple already claim to do.[12] And we can prohibit companies who fail to do

[12] Apple includes various provisions into its contracts with foreign suppliers that attempt to ensure that these suppliers will cover the social costs their production imposes, such as ensuring decent working conditions and taking care of worker injuries, but it has recently come under some intense criticism for allegedly failing to enforce these provisions vigorously enough. See, e.g. Charles Duhigg and David Barboza, "In China, Human Costs are Built into an iPad," *The New York Times* (January 25, 2012); Charles Duhigg and Nick Wingfield, "Apple Asks Outside Group to

so from purchasing goods from abroad for a price below their true social cost. So even though we cannot be sure that the producer of justly priced goods is indeed fulfilling their responsibilities to pay a just price for labor and cover the externalities of production, we can indeed take steps to monitor this and cease doing business with those foreign producers who consistently fail to fulfill their obligations. For items sold directly to the public rather than through a domestic intermediary, in turn, liberal capitalist societies can effectively enforce our theory of exploitation simply by refusing to allow the importation of items into the country that are sold by foreign producers below their just price, something that we actually already have a right to do under Article VI of the General Agreement on Tariffs and Trade 1994 (the 'Anti-Dumping Agreement'). This will not only ensure that foreign manufacturing jobs are not exploitive, it should also have some desirable side effects: it should increase the price of foreign manufactured goods so that they more accurately reflect their true social cost of production. This, in turn, should slow down the flow of jobs overseas to where labor is more easily exploited and therefore supposedly "cheaper," and if it does this it might even help increase domestic GDP and reduce unemployment.[13]

One final note before I move on from this point: why isn't the implementation and enforcement of rules against exploitation with regard to goods sourced overseas simply a way of re-enacting the Corn Laws?[14] In other

Inspect Factories," *The New York Times* (February 13, 2012). Part of the problem, no doubt, is that not only Apple but also many other firms feel competitive pressure to let their foreign suppliers ignore some of their contractual obligations. But if our theory of exploitation were implemented and enforced, all (or at least all large) companies would need to impose and enforce such constraints on their overseas suppliers, and much of the incentive for competitive backsliding would accordingly be removed. See Eduardo Porter, "Dividends Emerge in Pressing Apple Over Working Conditions in China," *The New York Times* (March 6, 2012). It does seem, however, that even without industry-wide enforcement, one key foreign supplier is already ready, willing, and able to comply. See Charles Duhigg and Steven Greenhouse, "Apple Supplier in China Pledges Big Changes in Working Conditions," *The New York Times* (March 29, 2012). And this confirms that the obligations imposed by our theory of exploitation are not so onerous that they would be impossible to meet.

[13] This, of course, assumes a free-floating currency. If the currency of the country of manufacture is not allowed to float according to its market value, these side effects in the country of importation could be significantly reduced and perhaps might not even occur at all. In other words, ensuring that goods made in China for sale in the US are not made under exploitive conditions will not solve and perhaps may not even dent the current trade imbalance between the two countries if the Chinese currency is not allowed to find its true market level. See Paul Krugman, "Holding China to Account," *The New York Times* (October 2, 2011). And we have reason to worry that this may continue to be the case. See Keith Bradsher, "China Lets Currency Weaken, Risking New Trade Tensions," *The New York Times* (May 31, 2012).

[14] The Corn Laws were protectionist tariffs enacted by Parliament in Victorian England on the importation of cheap foreign corn. The tariffs were designed to protect domestic cereal manufacturers but also contributed to widespread starvation among those who were unable to afford higher-priced domestic corn. They were supported by Malthus, opposed by Ricardo, and eventually repealed in 1846. See generally B. Hilton, "Corn Laws," in *The New Palgrave: A Dictionary of Economics*, ed. John Eatwell, Murray Milgate, and Peter Newman (London: Macmillan Press, 1987), 670–1.

words, why isn't this just a form of protectionism that increases prices for our own citizens and deprives struggling foreign economies overseas of needed income and struggling participants in those economies with a way out of poverty? Because in a just society, we do not seek to increase our own quality of life by making slaves of others overseas, even if this would make goods cheaper and more widely available for us, a proposition that is dubious at best (some goods might be more expensive if we manufactured them ourselves but those among us with the greatest marginal propensity to consume would then also have more money, making nominally more expensive goods actually more affordable). And if we are truly concerned for the welfare of those foreign workers who would lose their jobs if we did not allow (encourage?) them to be exploited, we can simply provide aid to such countries to help them develop their economies in a way that does not depend on the exploitation of others. We do no man a favor by taking him on as a slave even when he would otherwise starve. His unfortunate situation is an argument for giving him food or a job at a just wage; it is not an argument for treating what would otherwise be his unjust exploitation as suddenly just.[15]

5.4 Toleration and Sales above the Just Price

While our three reasons for tolerating deviations from the just price apply either not at all or only in limited circumstances to sales below cost, all three reasons for toleration are in operation when it comes to sales above cost. There is accordingly much more room for toleration when the sales price exceeds the just price rather than fails to meet it. Indeed, when it comes to drawing the line between the tolerable and the intolerable with regard to sales above the just price, what I will propose, in effect, is a threefold division.

5.4.1 *The First Level of Tolerable Unfairness*

The first level includes what we might call a reasonable profit. Under our reconceived notion of the just price, a price that includes a reasonable profit is an unjust price, but given the incentivizing effects of the availability of profit, we allow the pursuit of a reasonable profit nonetheless. As is the case for many things, however, there is a declining marginal utility to the incentivizing effect of profit, ultimately, at least, if not immediately (the utility of this incentivizing effect may first go up before it goes down). At some point, then, the further incentive that greater profit provides will be insufficient to outweigh our

[15] For a similar argument, albeit one raising some additional and different points, see Hillel Steiner, "Morality, Justice, and International Trade," *Rechts Philosophische Hefte* 7 (1997): 97–108.

concerns for justice. Of course, we could say that as long as the pursuit of profit has *any* incentivizing effect, capitalism allows it, but this would be true only if we accept unbridled capitalism, what we might today call "cowboy capitalism." If we reject unbridled capitalism, however, in favor of a gentler form of capitalism that is coupled with democratic political institutions, moderated by various social welfare programs, and regulated by legal prohibitions on discrimination—in short if we accept the kind of capitalism that is consistent with political liberalism—then we need not wait until the pursuit of profit has no incentivizing effect whatsoever before we prohibit it. Instead, we carefully balance the incentivizing effect of the pursuit of profit against the sacrifice in justice this entails and try to determine the point at which this incentivizing effect is low enough that any further sacrifice should not be tolerated. The question, then, is where does the hinge point between incentives that have a strong influence on investment decisions and those that have no effect whatsoever lie? To what extent does the incentivizing effect of the pursuit of profit outweigh our concern for justice?

The way we begin to determine how much unfairness we should be willing to tolerate in a capitalist society is to think about the degree of incentive required to attract the reasonably prudent investor. The reasonably prudent investor is very much like "the good man" on whom those seeking to enforce the just price often relied. In his original incarnation, the good man was the one to whom the courts looked when determining the current market price, and, in later years, what level of profit was reasonable.[16] The good man was often an actual person, selected for his reputation in the community, but the reasonably prudent investor is a hypothetical construct designed to help us give content to the idea that incentives are permitted under capitalism but are not unlimited, and that at some point the achievement of any further incentivizing effect is not worth the further sacrifice that greater deviations from the just price require. What we are looking for, then, is the degree of incentive required to get the reasonably prudent investor to invest, neither more nor less, for that is the degree of departure from the just price that liberal capitalism allows.

We construct our reasonably prudent investor using our knowledge of human nature and the circumstances under which he will invest. Our reasonably prudent investor is moderately risk averse, since that is the most common attitude to be found among people in capitalist societies, but he is not excessively risk averse. He invests only after gathering and considering all readily available information on the relevant investment opportunities, but does not

[16] See John W. Baldwin, "The Medieval Theories of the Just Price: Romanists, Canonists, and Theologians in the Twelfth and Thirteenth Centuries," *Transactions of the American Philosophical Society* 49 (1959): 1–92, at 20, 27–9, 48, 49, 53, 71, and 76.

engage in any specialized or individualized research or have or seek out any specialized investment skill or knowledge. He is not investing for the short term, but for the medium to long term, because it is the investor who is trying to create capital appreciation, not the short-term gambler, whom we are trying to attract. The reasonably prudent investor is accordingly prepared to ride out short-term price fluctuations, and will not be dissuaded by market shocks or changes in circumstances that are not expected to have long-term re-allocative effects. We assume his capital (human or otherwise) is completely mobile, in that he can place it wherever he likes, for while this is not true for most real individuals, it is true if we look at the pool of potential investors as a whole and we accept that capital (human or otherwise) can and will tend to flow to the most attractive investment opportunities as capitalism predicts. The reasonably prudent investor does not insist on unusually large profits in order to put his capital at risk, but merely a reasonable rate of return, given the degree of risk he will encounter. In order to ameliorate that risk, he holds a diversified portfolio, both in terms of types of investments and industries and activities represented. In short, what he looks for is the kind of medium- to long-term return one could expect from a diversified investment in a package of equity-based mutual funds.

We are now in a position to determine the first point up to which our toleration of violations of the just price doctrine should lie. Over the last 100 plus years, the equity markets in the United States have returned an average annual 11.7 per cent nominal rate of return, the equivalent of a 8.5 per cent real (inflation-adjusted) rate of return.[17] This, in turn, represents an average risk premium of 7.6 per cent over the return generated by United States Treasury Bills during the same period, which, despite the current financial crisis, are still about as close as one can come to a riskless investment, as the flood of money pouring into T-bills since the onset of the latest financial crisis makes all too clear.[18] What this means is that on a long-term basis, an average annual nominal return of 11.7 per cent and a 7.6 per cent risk premium is the best an investor looking to invest in a diversified portfolio of United States equity securities could reasonably expect to do.[19] While there is no guarantee that

[17] These figures come from Richard Brealey, Stewart C. Meyers, and Franklin Allen, *Principles of Corporate Finance*, 9th edition (Boston: McGraw-Hill, 2008), 174. The Brealey, Meyers, and Allen figures, in turn, are up-to-date extensions of the figures set forth in Elroy Dimson, Paul Marsh, and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton: Princeton University Press, 2002), 163–75.

[18] Dimson, Marsh, and Staunton, *Triumph of the Optimists*, 163–75.

[19] Note that some economists think this figure is too high, and that investors today are not as demanding as this. See Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 177, 180. Many chief financial officers agree—they put the current average expected risk premium somewhere closer to 5 per cent. See John R. Graham and Campbell R. Harvey, "The Long-Run Equity Risk Premium," *Finance Research Letters* 2 (2005): 185–94. For our purposes, however, it is not important whose estimate is correct, but merely what range of estimates would be considered reasonable, for

historical returns will always be a reliable guide to what a current reasonable investor must actually expect in order to be willing to invest, and therefore when there are changed conditions or other evidence that suggests historical practice may not be a reliable guide to current expectations this must be considered, the US equity markets have had remarkable success as a source of capital, so at least for now, it seems fair to say that such a return is sufficient to attract the reasonable investor. Indeed, in order to reasonably expect a greater long-term return on investment, an investor would have to be willing to tolerate a much greater degree of risk.

But we have not yet arrived at the line between our first and second levels of tolerable unfairness. So far, we have our reasonable investor investing in a fully diversified portfolio of equity securities. By doing so, he has all but eliminated any unique risk from his portfolio—that is, risk that is peculiar to the particular companies or industries in which he is invested. He remains subject only to average market risk, that is, the average effect of macroeconomic factors—wars, recessions, and so on, the kind of risk that affects the movement of the economy as a whole. But the companies in which he invests are not themselves heavily diversified, for within a mature and diversified economy companies make themselves no more attractive to investors by doing so.[20] More importantly, in a capitalist economy, we need not only investors, but also entrepreneurs—those who marshal the ideas, capital, and labor (usually but not necessarily) of others and turn these into goods that others want and sometimes even need. And while it is reasonable to expect the investor *qua* investor to diversify—indeed, to *insist* that he do so, the same does not apply to the investor *qua* entrepreneur. Each of us can *invest* in many things, but most of us and the companies we create can *do* only one thing, or at least only one thing well, or at least only a comparatively small number of things well, although some multinational conglomerates may come close to being diversified entrepreneurs. The whole point of the division of labor, after all, is to create a collection of complementary experts, each of whom is in a position to contribute far more to the collective good through their expensively acquired personal expertise than any generalist possibly could, and who are all tied together into a coherent social and economic whole by their mutual need for the products of each other's expertise.

In any event, we both cannot and should not insist that the reasonable entrepreneur diversify. What this means is that the actual companies that

everything that is reasonable is tolerable, and so what we want to do is identify the top of the reasonable range. That is why I have used 7.6 per cent in the text rather than a perhaps more realistic lower figure.

[20] For further explanation of why this is so, see Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 197–8.

make up the equities market *are* subject to risk that our investor in a diversified portfolio of equity securities is not. First, some industries, investments, and activities are more or less sensitive to market risk than the market average, and some may even move against the market. Second, each industry, investment, and activity is subject to some unique risk—a factory may burn down, for example, or technological innovation or regulatory change may render a previously highly profitable type of good or activity obsolete, although many of these risks can be covered by insurance and therefore figure in our calculation as a cost of production rather than as a factor influencing the expected rate of return. At any rate, in light of these additional risks, the expected return and the risk premium available to the entrepreneurial investor are both going to have to be higher than that available to the non-entrepreneurial investor for us to reasonably expect the entrepreneur to engage in the kind of activity that his role in a capitalist economy requires.

How much higher, of course, depends on the degree of additional risk that the particular project or investment involves. Measuring risk is both an art and a science, so this can never be determined with absolute certainty, but there are various calculations we can make that will give us some idea of the degree of additional risk we will encounter. The first thing a reasonable entrepreneurial investor would do, for example, is calculate a proposed investment's "beta." This is a calculation of the degree to which a particular industry, activity, or type of investment has been more or less sensitive to market risk in the past.[21] Treasury bills have a fixed rate of return and are therefore not subject to market risk, so they have a beta of 0. A diversified basket of common stock has an average market risk, and therefore a beta of 1.0. An investment that has the same market risk as a diversified portfolio of common stock accordingly also has a beta of 1.0. One that is twice as risky has a beta of 2.0, meaning that it is twice as sensitive to macroeconomic factors as a diversified portfolio of common stocks. Because the beta is positive, the return on this investment will move in the same direction as the market, but it will cover twice as much ground on a percentage basis. An investment that is half as risky, in turn, has a beta of 0.5, meaning that it will move in the same direction as the market but only half as much, and so on.

[21] The actual formula for calculating the beta β of a particular investment *i* is:

$$\beta_{\mathrm{i}} = \sigma_{\mathrm{im}} / \sigma^2{}_{\mathrm{m}}$$

where σ_{im} is the covariance between the returns on that investment or investment type and the average market return during the relevant period and $\sigma^2{}_m$ is the variance of the market return. The variance of the market return is equivalent to the expected squared deviation from the expected return. In other words, variance σ^2 = the expected value of $(\tilde{r}_m - r_m)^2$ where $\tilde{r}_m$ is the actual return and r_m is the expected return. See Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 181, 196–7, 242–5.

To calculate the beta for a particular investment, we need various kinds of historical data, usually going back sixty months, which may or may not be available for the exact investment we have in mind. If the required data is not available, we abstract out to the type of investment, and then to the industry as a whole, as the reasonable investor would, until we find a level at which the required data *is* available. We may not have sufficient historical data to determine the sensitivity to market risk of a restaurant of a particular type in a particular place, for example, but we will be able to find it for restaurants of that type generally and probably even for restaurants of that type in that type of location. Because, individually tailored betas can have a high degree of error, standard industry betas are often used even if more individualized data is available.[22] So while it is true that "past returns are no guarantee of future performance," it is often the most reliable guide we have, and certainly no reasonable investor would make an investment decision without considering the past performance of similar investments. Remember also that we are not concerned with how risky an investment *actually* is, but rather with what risk premium must be expected to get a reasonable investor to invest, so the extent to which any particular predictor of risk is inaccurate is not important, as long as it is accurate enough that reasonable investors continue to use it. What *is* important is what factors a reasonable investor will consider and what degree of premium they will require in order to engage in an activity given the degree of risk that they think they will encounter based on what the standard calculations that can be made using these factors predict. In short, the risk premium a reasonable investor is likely to require on an individual investment is the market risk premium (which, as we saw, is currently around 7.6 per cent) times the beta applicable to that kind of investment.[23] The degree of return a reasonable investor will require before making such an investment is accordingly this adjusted risk premium plus the rate that then can be had on a "riskless" investment, our benchmark thirty-day fixed interest T-bill, a formula known as the "capital asset pricing model," or CAPM.[24] A company that cannot do better than the average market rate of return will return any additional investment capital to its shareholders, for they can always obtain that return by spreading the amount returned across their diversified portfolios, or perhaps invest in a diversified portfolio of other companies' common stocks

[22] See Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 244–5.

[23] See Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 214.

[24] The capital asset pricing model for calculating expected return r_e is formally expressed as follows:

$$\mathrm{r_e} = \mathrm{r_f} + \beta(\mathrm{r_m} - \mathrm{r_f})$$

where r_f is the return on a risk-free investment and r_m is the average return on a diversified portfolio of common stocks. See Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 214, 238.

itself. A company that does expect to beat such a return after it is adjusted for any additional risk involved can do better for its shareholders than they could do for themselves, and will accordingly make the investment.

We are now in a position to determine where to draw the line between the first and second levels of tolerable unfairness. For a diversified portfolio of investments, a reasonable investor can expect a long-term return of no more than 7.6 per cent plus the return on a T-bill, or 11.7 per cent. For an individualized project, activity, or investment, however, a reasonable investor *qua* entrepreneur must expect more than this—he must expect a return of 7.6 per cent times the applicable beta plus the return on a T-bill. While this is all the entrepreneur can reasonably expect, such expectations have proved spectacularly successful in attracting capital to the US markets. So absent significant changes in worldwide financial conditions, these are the rates of return our acceptance of capitalism currently suggests we tolerate. This is accordingly where the borderline between the first and second level of tolerable unfairness must lie.

There are two points, however, I want to make before we move on to locating the line between the second level of tolerable unfairness and intolerable unfairness. First, there are other ways to measure risk for a particular investment and to determine what return must be available given that degree of risk for the investment to be worthwhile, and further ways to make each of these calculations may be developed in the future. Indeed, for some years now, the capital asset pricing model has been subject to an increasing amount of criticism.[25] Should a more accurate model be developed, a greater or lesser return than currently expected may be required to justify encountering similar projects or investments once those projects or investments are adjusted to reflect a more realistic assessment of their risk. Nevertheless, as far as things stand today, the capital asset pricing model remains the most popular method for deciding which investments and projects to pursue for the overwhelming majority of both economists and CFOs, both in the US and abroad.[26] Despite its failings, the CAPM is accordingly still the best guide for determining what kind of return must be expected given the anticipated risk in order to get the reasonable investor to invest. But it is important to remember that in special

[25] See, e.g. Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance* 47 (1992): 427–65. Fama and French found that while there was a relation between average return and market β during the early years of the NYSE, as see, e.g. Eugene F. Fama and James D. MacBeth, "Risk, Return, and Equilibrium: Empirical Tests," *Journal of Political Economy* 81 (1973): 607–36, this relation disappeared during the more recent 1963–1990 period. The Fama and French paper has since become known among economists as the "beta-is-dead" paper. But see Haim Levy, *The Capital Asset Pricing Model in the 21st Century* (Cambridge: Cambridge University Press, 2012) (defending beta and the CAPM).

[26] See John R. Graham and Campbell R. Harvey, "The Theory and Practice of Corporate Finance," *Journal of Financial Economics* 60 (2001): 187–243; Franck Bancel and Usha R. Mittoo, "Cross-Country Determinants of Capital Structure Choice," *Financial Management* 33 (2004): 103–32.

situations, we might have insufficient information to use the CAPM, or even if sufficient information is available, using some other method might seem more reasonable, either because of the existence of special circumstances, or because some other test has been found more reliable under the applicable circumstances even though we cannot envision now what this test might be. It is accordingly important to remember that the test here is what level of expected return is necessary to get the reasonable investor to invest, given the risk involved, and while this test may currently be best implemented through the capital asset pricing model, this model is just a tool, not the test itself.

Second, it is important to note that the figures used in the calculations made above for beta apply only with regard to investments made by US investors in the United States. With regard to foreign investments in the United States, or US investments in other liberal capitalist economies, or foreigner's investments in their own economies, a greater or lesser long-term return may be required to get reasonably prudent investors to invest, depending on the conditions currently obtaining in the relevant foreign market. The formulae required to calculate what is a reasonable return on such investments would bear the same structure, but instead of the market average for US equities, for example, we would employ the market average for equities of the relevant foreign market, and so on.[27] Once again, the test is always the same—we must determine what rate of return a reasonably prudent investor must expect under the conditions then obtaining in that investor's home economy before being willing to invest in whatever economy would be the location of the investment.

5.4.2 *The Second Level of Tolerable Unfairness*

Once profits have exceeded the rate of return that comprises our first level of tolerable unfairness, the seller has generated more profit than we are willing to simply allow him to keep, since any further incentivizing effect provided by the availability of these additional profits is not necessary to get the reasonably prudent investor to invest. But any further incentivizing effect is still helpful, so we do not want to completely deprive the reasonably prudent investor of the opportunity of receiving it. We accordingly have good reason to continue to tolerate the seller pursuing profits that exceed 11.7 per cent times the applicable beta to some extent. But for profits in excess of this, we will insist that the profit received be shared with everyone who contributed to creating it in proportion to his or her relative contribution. By doing this, we encourage members of society to engage in the most economically productive

[27] See Brealey, Meyers, and Allen, *Principles of Corporate Finance*, 255–8.

activities all the way down (or rather all the way round, to the extent that the production cycle is better understood as circular, in the sense that one product, such as water, may be used in making another, such as electricity, which is in turn used in the production of the first), because all those who contribute to producing these extra profits will be rewarded. Indeed, why should the incentives that capitalism provides stop with the most immediate seller? If we accept the presupposition that incentives are necessary or at least helpful if we are to ensure that society is maximally productive, these incentives should be available to all those who made whatever profit that is ultimately realized possible, and not merely to the last seller in the chain or cycle of production.

Note, however, that this second level of tolerably unjust profits need not be shared out to *everyone* who contributed to the production of the goods used by the ultimate producer, no matter how causally attenuated their contribution might be. The required redistribution goes back only one level. Only if this brings the profit earned by those who receive a share of these profits up into the second level themselves is further redistribution required. This ensures that the incentive thereby made available is not endlessly diluted until it becomes so small as to not constitute any incentive at all. Conversely, profit that does not rise to this second level of tolerable unfairness, but remains within the confines of what we have set as the first level, need not be shared out at all, even though others have contributed to producing it. Up to the top of the first level, we tolerate both the overcharge and the failure to share in order to give full force and effect to the incentive that the pursuit of profit offers. But as the rate of profit moves into the second level, the need for such a powerful individual incentive diminishes, and therefore our relative concern for fairness becomes stronger. Not strong enough yet to prohibit the pursuit of profits entirely, but strong enough to insist that these second-level profits be handled differently. At this level we tolerate the overcharge, but not the failure to share. If the seller does not share these second-level profits with the relevant workers, suppliers, land owners, financiers, and so on who have contributed to the creation of the profits in proportion to each contributor's respective share of the costs of production, the seller has violated our theory of exploitation.

Of course, under our theory, the fact that some of this profit is to be redistributed rather than prohibited does not make the original acquisition of this profit just. But the fact that something is unjustly acquired does not mean that it cannot also be unjust to refuse to share it with those who helped acquire it. A team of bank robbers may acquire money unjustly, for example, but it is still unjust if one member of the team makes off with the loot without first splitting it up as he and his fellow bank robbers previously agreed. Indeed, almost *everything* that everyone currently owns is in some sense the proceeds of goods that were unjustly acquired, so if justice could only regulate the exchange of goods that were justly acquired, there would be very little work for a theory of justice to do. If there is a history of injustice behind the holdings that are the subject of a current exchange, we may indeed have reasons to interfere with that exchange to put things right, but identifying and remedying such historical injustice is not a prerequisite for determining whether the terms of any current transaction involving these holdings are just. The potential existence of a wrong in the past simply gives us an *additional* ground for relief; it does not immunize the terms of the transaction before us from moral inquiry.[28] So even if the profits received from a transaction are the proceeds of an historical injustice, as long as we choose not to remedy that injustice—in other words, if the transaction for whatever reason is otherwise permitted by law—the party who receives tolerably unjust profits under our theory of exploitation is under an obligation to redistribute them out.

Nor is there any reason to believe that the calculations required to divvy up these profits will be too difficult to make. A seller must know what it has cost him to produce his product, regardless of what this product is; otherwise, he cannot know whether he should continue this activity or abandon it. And if he knows his costs of production, then he knows how these costs were incurred. So he has all the information he needs to determine how the profits he receives should be shared out. In some cases devising a remedy for this failure to share may be somewhat problematic, especially where the good produced by one producer is also used in the production of some of the goods on which that producer relies, and accounting for this accordingly becomes circular. In such cases, if the relevant co-contributors cannot be identified, it may be appropriate to tax the producer and redistribute these profits to society at large. But I shall set this issue aside for the moment. For now, I am simply interested in establishing that there is a level above which upward deviations from the just price are conditionally exploitative, requiring that profits be redistributed rather than retained exclusively by the seller.

To some, this may seem like little more than a restatement of Marx's principle of justice for the early stages of a communist society—to each according to his contribution.[29] But Marx did not embrace such a broad principle. For Marx, "contribution" was measured solely in socially necessary labor time, whereas under our theory, "contribution" includes all forms of

[28] A similar approach is taken by traditional just war theory, under which the conduct of the parties may be judged just or unjust regardless of whether their cause is just. See generally, Michael Walzer, *Just and Unjust Wars*, 4th edition (New York: Basic Books, 2006). And while the traditional separation between *jus ad bellum* and *jus in bello* in just war theory has recently come under attack, no one argues that those engaging in an unjust war cannot also conduct themselves unjustly—they merely argue that even if they do conduct themselves justly, their actions remain unjust as long as their cause is unjust. See, e.g. Jeff McMahan, *Killing in War* (Oxford: Oxford University Press, 2009).

[29] See Karl Marx, "Critique of the Gotha Program," in *The Marx-Engels Reader*, Robert C. Tucker, 2nd edition (New York: W. W. Norton), 525–41, at 530–1.

consideration. While Marx's principle is independent of the economic system to which it applies, ours is wholly dependent on it, for only once an economic system is chosen and established can we know what counts as consideration and what does not, and how much each particular form of consideration counts. Most importantly, the principle of redistribution that our theory of exploitation employs kicks in only after the first level of tolerable unfairness is reached. Up until that point, no redistribution is required. And if we have calculated that point properly, the vast majority of all profitable activities will fall below it. In most cases, no redistribution will actually be required.

5.4.3 *Intolerable Unfairness*

This brings us to defining the third level of injustice, the level at which the pursuit of profits is unjust *even if the proceeds are shared out*, and therefore the price charged must be deemed not conditionally exploitive but absolutely exploitive and prohibited. There are several arguments that have some purchase here. The first is that the borderline between tolerable and intolerable unfairness should lie where it has for most of the last two thousand years—at the point measured by the doctrine of *laesio enormis* in its original form. For sellers, this means that our toleration of the pursuit of profit would stop when the sales price was 100 per cent more than the just price. After all, this could not have remained the conventional view of when we should interfere with voluntary transactions for so many years if it did not accurately capture something essential about our fundamental moral intuitions regarding fairness.

What that something essential is may be this: there is much empirical research establishing that we attribute great decision weight to crossing a prominent border.[30] For example, it is always easier for people to accept an increase in the price of a good once the precedent of charging for it has been set than it is to start charging for a good that people have previously received for free, for the latter move represents crossing a prominent border while the former (usually) does not.[31] And the 100 per cent mark-up is a prominent border, for this determines who receives the greatest benefit from the transaction. When a seller receives more than twice whatever he is selling is worth, the primary beneficiary of the value the buyer created to fund his part of the exchange is not the buyer but the seller, and a move across this border is accordingly likely to have much more psychological significance for a buyer

[30] See, e.g. Amos Tversky, Shmuel Sattah, and Paul Slovic, "Contingent Weighting in Judgment and Choice," *Psychological Review* 95 (1988): 371–84.

[31] See Daniel Kahneman and Amos Tversky, "Preface," in *Choices, Values, and Frames*, ed. by Daniel Kahneman and Amos Tversky (Cambridge: Cambridge University Press, 2000), ix–xvii, at xi–xii.

than equivalent changes within the 100 per cent range. Indeed, given our egoistic nature, it is not unreasonable to expect people to experience a significant disincentive to create something for exchange if someone other than themselves will be the primary beneficiary of their efforts. (Remember, an exchange involves an exchange of value created by both parties, so when an exchange is a great deal for one party, it may be correspondingly one-sided for the other.) Allowing more than a 100 per cent mark-up on the just price accordingly threatens to impede production because it would dishearten buyers and undermine their incentives to produce anything to exchange with anyone else. And if buyers lose their incentive to create value to exchange with anyone else then sellers will too for there will be no one (or at least less people) willing to purchase whatever they have to sell.[32]

But there is yet another reason for thinking that in placing the borderline at a 100 per cent mark-up the proponents of *laesio enormis* got it right. To see this reason, we merely need to look at the results of modern research on what is known as the ultimatum game. The ultimatum game was developed by experimental economists to investigate whether and to what extent fairness concerns will override self-interest in human decision-making, and it has probably been the subject of more experimental study than any other game except the Prisoner's Dilemma.[33] In the ultimatum game, two players are provisionally given a sum of money to divide, say \$10. The first player is told to propose a division to the second player, who is permitted to either accept or reject the first player's offer, but is not permitted to make a counter-proposal. If the proposal is accepted, each player receives the specified share. If the proposal is rejected, each player receives nothing. To ensure that the players are not influenced by their past relationship or by a desire to establish or maintain a reputation for toughness or fairness, the game is played under conditions of complete anonymity and with no opportunity for retaliation. The game accordingly consists of only a single round, neither player knows

[32] Further support for this proposition can be found in the debate surrounding the effect of high marginal tax rates on the incentive to work and to produce. While the empirical data on the extent to which high marginal tax rates disincentivize further productive efforts is subject to a variety of conflicting interpretations, it does seem clear that whatever disincentive effect there is it is not linear, and that the effect jumps and then subsides at the 50 per cent border. See, e.g. Martin Feldstein, "Tax Rates and Human Behavior," *The Wall Street Journal* (May 7, 1993), A14, and Martin S. Feldstein, "Effects of Taxes on Economic Behavior, NBER Working Paper 13745" (Cambridge, MA: National Bureau of Economic Research, January 2008) (citing various empirical studies).

[33] Many of these studies are summarized in Alvin E. Roth, "Bargaining Experiments," in *The Handbook of Experimental Economics*, ed. John H. Kagel and Alvin E. Roth (Princeton: Princeton University Press, 1995), 235–348. Two of the most important and accessible are Werner Guth and Reinhard Teitz, "Ultimatum Bargaining Behavior," *Journal of Economic Psychology* 11 (1990): 417–49 and Daniel Kahneman, Jack L. Knetsch, and Richard Thaler, "Fairness as a Constraint on Profit Seeking Entitlements in the Market," *American Economic Review* 76 (1986): 728–41.

the other before the game begins, and the players' identities are concealed from one another both during the game and after.

The fairest proposal the first player can make, of course, is to divide the $10 equally. But the first player may realize he has an advantage over the second player. His proposal is, after all, an ultimatum. If he proposes an unequal division—perhaps that he will keep $6 and give the second player only $4—the second player has only two choices: accept the smaller share or reject it and receive nothing. The first player accordingly has reason to believe that the second player would accept an unequal division. Indeed, if the second player is rational, he should accept any proposed division no matter how one-sided as long as he gets something out of it, for the alternative is he will get nothing.

This is not, however, what happens in practice. In practice, only a certain amount of unfairness will be tolerated—at a certain point the second player would rather reject an offer and deprive himself of some gain than allow the first player to obtain an intolerably unfair share. What the game shows is that considerations of fairness do override self-interest when an offer is significantly one-sided, for the second player will reject an offer below a certain level even though this will leave him worse-off. How one-sided an offer must be before a second player rejects it will vary—some players will be more or less sensitive to unfairness. But the experimental evidence suggests that most second players consistently put their minimum demand at around a 30 per cent share of whatever is being divided.[34]

Notice how the numbers work out here. By insisting on only a 30 per cent share, a second player is essentially allowing the first player to keep just a little bit more than twice as much (70 per cent instead of 67 per cent) of the total *res* to be divided. Similarly, in every sales transaction, we could imagine that there is a *res* to be divided, consisting of the total value (average total social cost of production) of the good to be sold by the seller *plus* the price to be paid by the buyer. What justice requires is reciprocity—that is, that the total value of these two components be equally divided between seller and buyer. Since the seller gets the price and the buyer gets the good, what this reduces to is that the average total social cost of production of the good at issue should be roughly equivalent to the price paid for the good, which is indeed exactly what our doctrine of the just price requires. But just as in the ultimatum game, some departure from the just price will be tolerated. If we use the ultimatum game as a guide to how much deviation from equality will be tolerated, the seller could receive up to two-thirds of the *res,* or 67 per cent, in which case the buyer will

[34] See Jon Elster, *Ulysses Unbound* (Cambridge: Cambridge University Press, 2000), 50; Herbert Gintis, *Game Theory Evolving* (Princeton University Press, 2000), 253; Guth and Teitz, "Ultimatum Bargaining Behavior," 430; Kahneman, Knetsch, and Thaler, "Fairness as a Constraint on Profit Seeking Entitlements in the Market," 736.

receive one-third, or 33 per cent, or almost exactly the limits set by the doctrine of *laesio enormis*.

Of course, the ultimatum game is usually played with modest sums of money, for experimenters do not have the financial resources to do otherwise. As a result, most experimental economists initially believed that a player's tolerance for unfairness expressed as a percentage of the amount to be divided was not a constant, for the absolute cost of insisting on a fair division would go up as the amount to be divided would be increased. These early experimenters accordingly conjectured that the amount the second player would demand will gradually move towards (but never reach) 0 per cent as the stakes to be divided grow larger.[35] By conducting studies in foreign countries where modest stakes by Western standards have large purchasing power, however, later experimenters did manage to test this conjecture. Surprisingly, these later studies revealed that even very large changes in stakes have only very modest effects on the amount a second player would demand expressed as a percentage of the whole. More importantly, perhaps, they also showed that offers tended to be less likely to fall below the average minimum necessary to avoid rejection as the stakes increased, reflecting the fact that the first player also risked more by being greedy as the stakes increased. It turns out that as a prediction of where the line between tolerable and intolerable unfairness lies, the 30 per cent figure is surprisingly robust.[36]

This means that we have three reasons for thinking that this is the point where any capitalism-based argument for tolerating deviations from the just price runs out of steam. First, we have the argument from prominence, which suggests that crossing the 2:1 split crosses an important psychological and motivational border. Next, we have the argument from convention, which tells us that this is where a variety of societies have placed the border between tolerable and intolerable unfairness for most of the last two thousand years. And finally, we have the argument from the ultimatum game, which suggests that this is the point at which most people in a fully-developed liberal capitalist economy would rather suffer economic harm than allow someone else to get away with imposing more economic injustice. Given the convergence of

[35] See Roth, "Bargaining Experiments," 329–30; Guth and Teitz, "Ultimatum Bargaining Behavior," 426.

[36] For a discussion of these later experiments, see Colin Camerer, *Behavioral Game Theory* (Princeton: Princeton University Press, 2003), especially 60–2. Note that the average minimum acceptable offer expressed as a percentage may indeed change depending on the conditions in effect in the country in which the experiment is conducted. Roughly, the less industrialized the society the lower that average percentage will be. What does not change (much) is the amount demanded in that economy as the stakes increase. But this is as it should be. We would expect the line between tolerable and intolerable unfairness to depend on the economic, social, and cultural conditions in effect in the particular society and at the particular time at issue. These conditions can always change, and if they do, the line between tolerable and intolerable unfairness may change also.

these three arguments on the 2:1 figure, it seems safe to say that this is where our willingness to engage in toleration of upward deviations from the just price is ultimately exhausted. At least in a fully-developed liberal capitalist economy, pursuit of a greater than 100 per cent mark-up is simply not worth the cost in fairness for most people, regardless of its incentive effect, and is accordingly to be prohibited as intolerably exploitive of the buyer.

There is one possible exception to this, however, that we need to consider. A return of 100 per cent over the cost of production seems like a lot, and indeed, only a few activities could ever generate profits in excess of this. And in order to do so for any significant period of time, the production of the good would have to require trade secret knowledge, be protected by patents, involve the use of copyrighted material, or be surrounded by some other high barrier to entry, for otherwise such extreme profits would simply attract new entrants into the market thereby increasing competition and driving the rate of profit down. But when the good at issue represents a significant enough technological or cultural innovation, such as a new drug or device that involves the use of some patentable, copyrightable or otherwise protected process or material, or a blockbuster movie, musical recording, or book, sales of that good can indeed generate an extreme amount of profit. What we need to consider, then, is whether the availability of such extreme profits is necessary to ensure that the technological and cultural innovation protected and thereby encouraged by such intellectual property rights does indeed occur. It is to that issue that we now turn.

5.5 Toleration and Innovation

The argument that the lure of extreme profits is a necessary incentive for innovation is perhaps most clearly articulated by Joseph Schumpeter. In *Capitalism, Socialism, and Democracy*, Schumpeter says:

> Spectacular prizes much greater than would have been necessary to call forth the particular effort are thrown to a small minority of winners, thus propelling much more efficaciously than a more equal and a more "just" distribution would, the activity of that large majority of businessmen who receive in return very modest compensation or nothing or less than nothing, and yet do their utmost because they have the big prizes before their eyes and overrate their chances of doing equally well.[37]

A few years later, in his 1946 entry on "Capitalism" for the *Encyclopedia Britannica,* Schumpeter continues along much the same lines:

[37] Schumpeter, *Capitalism, Socialism, and Democracy*, 73–4.

> Looking back into the past, we can hardly fail to perceive the prime importance of the stimulating atmosphere of inequality. The lure of big prizes coupled with the threat of complete destitution no doubt produced a scheme of motivation of perhaps unique effectiveness. The importance of inequality *within* the highest income brackets should be particularly noticed. A single spectacular success may draw far more brains and means into an industry than would be attracted to it by the same sum if more equally divided. To this extent current views about unnecessarily or even absurdly high rewards and about the total cost to society of entrepreneurial performance should be modified.[38]

And I myself have argued elsewhere that the availability of spectacular rewards does indeed provide a powerful incentive for those who think they may someday be eligible for such rewards to engage in or at least support whatever conduct might conceivably trigger them.[39] So if we agree with Schumpeter and believe that spectacular rewards are an efficacious way to encourage innovation, then we might indeed have reason to tolerate gains that exceed 100 per cent, at least in cases where these gains are the result of the kind of innovative conduct that we want to encourage to continue.

5.5.1 *The Investor and the Entrepreneur*

The first thing to note is that even if we agree that allowing spectacular returns is an effective way of encouraging innovation, returns like this are not necessary to secure *investment*. The reasonable investor diversifies, and therefore aims for something approaching the average market return. One who does not is simply gambling, and one of the few things on which economists of a wide variety of ideological persuasions agree is that unadulterated gambling is not something that a capitalist system should be designed to encourage.[40] So if the availability of spectacular returns is going to be necessary to provide incentives for anything, it is going to be necessary to provide incentives for the innovative entrepreneur, not for the investor who finances him.

Even if we focus solely on the incentives provided to the entrepreneur and agree that allowing spectacular returns is a very effective way of encouraging entrepreneurial innovation, it is still not obvious that a 100 per cent cap will

[38] Joseph A. Schumpeter, "Capitalism," *Encyclopedia Britannica* 4 (1946): 801–7, reprinted in Joseph A. Schumpeter, *Essays on Entrepreneurs, Innovations Business Cycles, and the Evolution of Capitalism* (New Brunswick, NJ: Transaction Publishers, 1989), 189–210, at 204.

[39] See Reiff, "The Politics of Masochism."

[40] As Keynes famously said, "it is generally agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges." *The General Theory of Employment, Interest, and Money* (San Diego: Harvest/Harcourt edition, 1964), 159. See also F. M. Scherer, "The Innovation Lottery," in *Expanding the Boundaries of Intellectual Property*, ed. Rochelle Cooper Dreyfuss, Diane Leenheer Zimmerman, and Harry First (Oxford: Oxford University Press, 2001), 3–21, at 16 n. 24.

prove inadequate, for why would we think that a 100 per cent return is not spectacular enough? After all, a 100 per cent return is already way above average. Between 1945 and 2005, the average annual net profit for the US non-financial sector never exceeded 16 per cent, this level has not been seen since 1965, and there is good reason to believe that the more current figures, which are already substantially lower, are actually overstated.[41] Even if we look only at manufacturing, average net profit never exceeded 25 per cent in the US (36 per cent in Japan, 30 per cent in Germany); this was in 1969, and while net profits have fluctuated quite a bit since then, the overall trend is that net profits are declining.[42] Microsoft, once the most highly valued company of all time (a title it only recently lost to Apple), had a post-tax rate of return on invested capital and research and development in 1999 (one of its best years) of "only" 88 per cent, and at least some of this is alleged to be the result of predatory conduct, which would be unlawful regardless of whether it was or was not exploitative.[43] True, the figures for Microsoft net out across all product lines, and the other figures also average over entire sectors of the economy, and therefore some companies and product lines are doing much better than this. But even so, there is no denying that anyone who is producing a good that can consistently return a 100 per cent profit is already doing very well indeed. It is simply not clear that the marginal incentive of allowing a seller to generate even more profit than this is anything but negligible.

Indeed, it is not at all clear how the additional incentive provided by the availability of excessive profits is supposed to operate. Remember, this kind of return is not what an entrepreneur must expect in order to engage in the activity—it is not the amount of profit that is produced when we multiply the applicable beta times the average risk premium. On the contrary, these returns are what are called "alpha" returns, which are defined as returns *in excess of* that predicted by the relevant benchmark. They are accordingly equivalent to windfalls, and by definition, windfalls cannot act as incentives for anything. At least they cannot provide incentives for the *rational* entrepreneur. What

[41] See Robert Brenner, *The Economics of Global Turbulence* (London: Verso, 2006), 333–4, fig. 15.15, and n. 69. The overstatement stems from the fact that companies such as GE, GM, and Ford, while categorized as non-financial, actually owe a huge share of their profits to their financing operations.

[42] Brenner, *The Economics of Global Turbulence*, 282, table 15.1. Some see this as confirmation of Marx's theory that capitalism necessarily produces a falling rate of profit, but this is controversial. For a discussion of Marx's theory, see Samuel Hollander, *The Economics of Karl Marx: Analysis and Application* (Cambridge: Cambridge University Press, 2008), ch. 4, pp. 110–33; and John E. Roemer, *Analytical Foundations of Marxian Economisc Theory* (Cambridge: Cambridge University Press, 1981), especially chs. 3–6. See also Simon Mohun, "The Rate of Profit in the US Economy, A Class Perspective," p. 15, fig. 4 (January 16, 2012) (showing a bumpy but overall long-term falling rate).

[43] The figures for Microsoft come from Robert E. Litan, Roger G. Noll, William D. Nordhaus, Frederic Scherer, *United States v. Microsoft Corporation,* Civil Action No. 98–1232, Remedies Brief of Amici Curiae (April 27, 2000), p. 71, available at <http://ssrn.com/abstract=241448>, or DOI: 10.2139/ssrn.241448.

they do provide is an incentive for the *irrational* entrepreneur, for they provide well-publicized examples of unlikely events, and we tend to evaluate the probability that unlikely events will occur by how easy it is to call examples of the event to mind, a technique called the availability heuristic.[44] In this context, then, using the availability heuristic will lead us to dramatically underestimate the risk involved and overestimate the associated probability of a spectacular return. Yet it is not clear that irrational entrepreneurial activity is something we want to encourage. As I have argued elsewhere, when such excessive rewards are available they tend to encourage people to engage in a kind of economic masochism—they seduce people into engaging in activity that they rationally expect will actually hurt their economic interests simply because they irrationally covet the privileges that obtaining such excessive profits would allow.[45] Do we really want to encourage that?

There are other reasons to be concerned about the incentive effects of excessive profits as well. In some cases, these incentives can be perverse. Take the development of new drugs, for example. A drug that is going to be in a position to generate excessive profits on an ongoing basis is almost certainly going to be the kind of drug that controls some disease or condition through long-term continuous use rather than one that cures or prevents this disease or condition from arising through a single or short series of doses. Yet we do not want to provide an incentive structure that encourages entrepreneurs to search exclusively for the former and ignore or perhaps even suppress research that might lead to a discovery of the latter. And as we have already seen, the availability of excessive profits can also encourage recklessness, and this can cause great injury to everyone, not merely to those taking such risks themselves, as recent events within the financial industry have made all too clear. The availability of spectacular gains may accordingly on balance actually hurt the economy, not help it. Finally, innovation is not the only thing that drives capitalism and it is accordingly not the only conduct that capitalists should want to encourage and continue. We also want to encourage maximal productivity, which means hard work combined with *sensible* risk-taking. But if the rewards for innovation are so out of line with the rewards for maximizing productivity, this may in fact suppress the latter in favor of the former.

This, I believe, is the lesson we should draw from that well-known quip attributed to Jean Paul Getty, who when asked by an eager young admirer how to achieve economic success is reported to have said, "Get up early; work hard; find oil." This is a joke, of course, rather than an offer of serious advice, for if one finds oil, the first two pieces of advice are superfluous, and if one does not

[44] See Amos Tversky and Daniel Kahneman, "Availability: A Heuristic for Judging Frequency and Probability," *Cognitive Psychology* 4 (1973): 207–32.

[45] See Reiff, "The Politics of Masochism."

find oil, the first two are insufficient—in other words, the remark is a jibe at the protestant work ethic that is supposed to underlie capitalism itself. But for capitalism to be successful, hard work and sensible risk-taking must indeed be routes to maximal rewards. If luck (such as in "finding oil") is enough all by itself, or may actually produce rewards even greater than hard work and sensible risk-taking, then there is less reason to do the latter and more reason to take gamble after gamble, in which case the fundamental presuppositions on which capitalism relies to drive economic development will be undermined. So whatever incentives the availability of returns in excess of 100 per cent might provide, it is not clear that these incentives are consistent with the goals of capitalism rather than contrary to them.

Indeed, even Schumpeter seems to be somewhat ambivalent about the need for such incentives, despite what his remarks might initially suggest. After all, he begins by describing what he has in mind as "spectacular prizes *much greater than would have been necessary* to call forth the particular effort," and after repeating this argument in his *Encyclopedia Britannica* entry, he goes on to say, "Under modern circumstances, this argument has lost some of its importance, and there is room for difference of opinion on the question what weight should be attached to it in the future."[46] And even those who think that the availability of spectacular rewards generally *does* provide a more efficacious incentive for innovation than would exist without it recognize that this conclusion is subject to some important caveats. "Especially in the arts but to some extent also in the realm of technology, creative activity is often driven by non-pecuniary motives."[47] Indeed, there has obviously been a great deal of artistic and cultural innovation throughout history even though the creative forces behind such innovation are not always or even often particularly well paid or otherwise rewarded within the artist's lifetime. Even with regard to more commercial endeavors, the most creative minds are not always and perhaps not even often the ones that end up enjoying large amounts of commercial gain. Often the creative minds behind such innovation benefit little from them or not at all, with the real financial benefits being secured by others who are more commercially savvy or simply more ruthless. In which case, while larger returns might indeed be preferred over smaller ones, the existence of the former is by no means a necessary condition for the creation of innovation.

[46] Schumpeter, *Essays*, 204.

[47] F. M. Scherer, "The Innovation Lottery," 19. See also F. M. Scherer, "The Emergence of Musical Copyright in Europe from 1709 to 1850," *Review of Economic Research on Copyright Issues* 5 (2008): 3–18, 15 (arguing that "The world would be full of glorious music even if copyright laws had not come into being").

5.5.2 *The Problem of Skew*

There is another way of understanding the fact that innovation sometimes brings spectacular rewards, however, that needs to be considered. What the existence of these rare but spectacular rewards shows is that the distribution of returns from acts of innovation is highly "skew." When a distribution is highly skew, there is a large differential between the median and the mean; when a distribution is not skew, it will fall into a pattern resembling a symmetric bell-shaped curve, with the largest and smallest observations occurring with much lower frequency than those in the middle of the distribution (that is, near the mean or average value of the observations in the sample). A distribution that is skew will accordingly have more observations at one end or the other rather than huddling around the center, and a graph of such a pattern will accordingly not look like a bell but more like a hockey stick with a "tail" going in one direction or the other, with the length and thickness of the tail determining the degree of skew characterizing the distribution.[48] If there is a concentration of observations at the very high end of the distribution, the distribution is skewed to the right. If there is a concentration of observations at the low end of the distribution, the distribution is skewed to the left.

For example, if we invested $1,000 in each of the 110 companies that launched successful initial public stock offerings in high-technology industries between 1983 and 1986, we would find that by 1995, the total value of our $110,000 investment would be $534,580, or only slightly more than if we had invested in a NASDAQ index fund. But the distribution of the return for the companies that produce this average is highly skew to the right. Indeed, in this case, the 11 best-performing companies would have contributed 62 per cent of the total new portfolio value, although none of these companies produced annual returns in excess of 100 per cent.[49] Similarly, if one looks at the returns from various sets of patent applications, or the returns from various new drugs marketed in the 1970s and 1980s, or the returns on the top-selling 70 music records and recordings of 1997, "a relatively small number of top entities accounted for the lion's share of total invention or innovation value."[50] The question then becomes what to make of this, and more precisely, whether this suggests we should be prepared to tolerate exceptional returns on innovation even when they manage to exceed 100 per cent.

[48] For a graphic illustration of various kinds of skew distributions and a discussion of their properties, see Scherer, "The Innovation Lottery," 4–7.
[49] See F. M. Scherer, Dieter Harhoff, and Jörg Kukies, "Uncertainty and the Size Distribution of Rewards from Innovation," *The Journal of Evolutionary Economics* 10 (2000): 175–200.
[50] Scherer, Harhoff, and Kukies, "Uncertainty and the Size Distribution of Rewards from Innovation," 178.

The answer is I think not. While it may be true that people prefer their distributions to be skewed right rather than have a more normal shape because they would like to think these skewed distributions are something they have a shot at capturing themselves,[51] this is a far cry from showing that they will not engage in the conduct that currently produces such distributions or not engage in it with a similar degree of enthusiasm if these distributions were less skew. And if the same degree of innovation would occur even if it produced a more normal distribution, then there is no argument that our acceptance of capitalism provides for tolerating gains in excess of this.

There is, however, an argument for tolerating such gains provided by the strains of commitment. If people do find skew distributions more attractive than "normal" ones under certain conditions, then whenever these conditions apply, they will resist attempts to limit the returns that make these distributions skew in the first place. Although I consider this problem to be formidable, I do not think it warrants abandoning our efforts to control this kind of irrationality. It provides pragmatic reasons to be concerned, but insufficient reason for toleration, if only because under the right conditions, these pragmatic concerns will not apply, and the right conditions include conditions of economic contraction such as those we find ourselves in now. In other words, people may be tolerant of highly-skew distributions when times are good, but intolerant of these when times are bad, say, in the midst of a recession or its aftermath, which is why there is currently so much public disgust being expressed at present at the outrageously high levels of compensations being enjoyed by financial traders, corporate executives, and other managers of firms or capital. Accordingly, my tentative conclusion is that despite these difficulties, and despite the argument that returns in excess of 100 per cent might provide some additional incentive for technological and cultural innovation, no exception to our 100 per cent cap for excessive returns from technological or cultural innovation is warranted. Absent further empirical evidence that this cap would indeed decrease the amount of such innovation, the line we have established between tolerable and intolerable unfairness should be held firm.

But I must attach a proviso to this. While I do not think that returns over 100 per cent must be tolerated in order to ensure technical and cultural innovation, the existence of highly skew patterns of returns on certain kinds of economic activities raises another potential problem. In a normal distribution, every data point adds its value to the whole, but no single one has much effect on the average. In a skew distribution, in contrast, a few data points can have a large effect—the extreme returns are in that sense dictatorial. If these

[51] See generally Reiff, "The Politics of Masochism."

extreme returns are eliminated, *average* returns will decline significantly, given that the upper tier in these cases contributes so much to the total. This does not mean that the activities which generate these extreme returns will not take place—we have already seen that an actual decline in this kind of innovative activity is unlikely to occur. But if the profitability of these activities is limited, thereby causing average profitability to decline substantially, the historical numbers will no longer be a reliable guide for the reasonable investor as to the level of returns he can reasonably expect from a diversified portfolio of investments. The risk premium available on such a portfolio of investments would accordingly decline, and everything would need to be re-calculated.

This, of course, is largely a technical matter, and does not *necessarily* raise any normative problems once we are aware of the need for such re-calculation to take place. But there is nevertheless some reason to be concerned. The *absolute* amount by which the market average exceeds the risk-free return (that is, the risk premium) matters too, at least to some extent, for if the average market return is too close to the risk-free return people will lose their enthusiasm for the opportunity to invest, and there is only so much room for both figures to drop. There is even some possibility that the average might fall *below* the return on a risk-free investment, in which case no one will invest in technological and cultural innovation at all, and the investment capital for such projects will dry up. So we must ensure that the average remains above the risk-free return and enough above it to ensure that entrepreneurs and their investors continue to have the same enthusiasm for the capitalist process of what Schumpeter calls "creative destruction" that we find among entrepreneurs and their investors now.[52] This, in turn, means that when it comes to technological and cultural innovation, we may need to allow a significantly skew upper tier of returns to exist.

The first thing to note is that even if we limit the maximum prices for which innovative goods can be sold, this does not necessarily mean that the total returns generated by highly successful innovative goods will change. By definition, highly successful innovative goods will generate large demand, and it is only because they are protected by de facto or de jure barriers to entry (such as trade secret, copyright, or patent protection) that they will be able to be priced for much more than their average cost of production. True, a producer can often maximize his profits by taking advantage of these barriers to entry and charging a higher price for these goods than he could if these barriers did not exist, but this will not always be the case. And of course, even if our

[52] See Schumpeter, *Capitalism, Socialism and Democracy*, 81–6.

100 per cent limit bites into the price the producer would otherwise charge, as price comes down volume of sales and therefore output is likely to go up. So it seems unlikely that limiting profitability to a 100 per cent mark-up over average total cost will significantly erode the total profits generated by these activities. And as long as this is the case, there is no need to worry about the effect of such a limitation on average profitability.

5.5.3 *The Definition of "Goods"*

Nevertheless, given the right confluence of conditions, it could make a difference. Part of the strength of our theory, however, is that it has the resources to deal with this. In order to measure the degree of return, it of course matters greatly how the activity on which the return is to be calculated is defined. With regard to technological and cultural innovation, it is accordingly important that when we look at the good being produced we define "the good" at a fairly macro level. In other words, we do not define the good as "drug X" or "drug Y," but as "new drugs." No serious pharmaceutical company will have only one drug that could fit into this category, and if it does, then it is essentially gambling, something we want to *dis*courage, not *en*courage (what we want to encourage is *reasonable* risk-taking), and there is no reason to allow it to keep excessive profits if it is lucky enough to develop a highly successful new drug with only one try. While it is not reasonable to expect a pharmaceutical company to diversify in the sense of investing in real estate and telecommunications and a host of other ventures that reduce the unique risk to which it is exposed, it is reasonable to expect it to diversify in the sense that if it is in the drug business, it should seek to develop a variety of new drugs, not only one. Included in this category will probably be a few drugs that will be highly successful, but some will be only moderately successful and many will not be successful at all. It is thus the profitability of all these activities we want to run through our theory of exploitation, not each individual potential new drug itself. And if we do this, then we need not be concerned by the skewed returns those individual drugs produce, or the effect of our 100 per cent limit on average profitability. By broadening the definition of the good involved, in most cases we will have reduced the degree of skew of the resulting pattern of distribution so even at the top it does not exceed 100 per cent.

We can now summarize what we have accomplished. We have established an empirical test for the line between tolerable and intolerable unfairness—the point at which most members of society who accept the presuppositions of modern capitalism are nevertheless willing to pay a price (in the sense of being made economically worse off) to enforce fairness, as defined by the doctrine of the just price. Each of the tests associated with our theory of exploitation is objective, but not arbitrary, the accusation to which most objective tests of unfairness are subject, because each is based on measurable psychological reactions to known or reasonably discoverable empirical economic facts. Moreover, while the lines these tests identify are not immovable, for the empirically testable reactive attitudes on which they are based can change over time or along with changing background conditions, they are determinate. They do not depend on counterfactual comparisons that are necessarily subject to a great deal of uncertainty, as the Rawlsian difference principle does, or on the impossibility of drawing a principled line between luck and choice, as the difference principle's leading competitor, luck egalitarianism, does. If attitudes change, so do the limits applicable to our theory of exploitation. The limits provided by our test for exploitation are accordingly not only objective, they are objective in precisely the right way.

Given these limits, the final and complete statement of our liberal theory of exploitation can be set forth as follows: exploitation is the *intolerably* unjust extraction of value from another through a voluntary exchange transaction that is not otherwise prohibited by law. This is the theory of exploitation, I submit, that defines how we must regulate exchange transactions in a liberal capitalist society. While implementation and enforcement of such a theory of exploitation will not produce a just society, it will produce a society that is optimally balanced between the restraint of justice and the level of welfare that the incentives entailed by capitalism can be expected to provide. And this is all that those of us who live in such a society can reasonably hope for and expect.

Note how our ultimate statement of our theory of exploitation moderates our reconceived notion of the just price. If our conception of the just price is built on the principle of reciprocity, it is difficult to see how the doctrine of the just price can account for profit, for profit is not a cost. (Economists, remember, consider profit (or rather forgone profit) to be a cost, but not accountants, and it is the accountant's conception of cost we are using here.) Indeed, this is probably the source of the resistance to the view of those Schoolmen who equated the just price with the cost of production—under that conception, it seems like the pursuit of profit is impermissible, and therefore must be prohibited. Because the pursuit of at least *some* profit seems *necessary* if we are to have a thriving economy, the subjective market-price based conception of the just price has always seemed more appealing, at least to most people. But if we arrive at a theory of economic justice by moderating our conception of the just price with the notion of tolerable unfairness, and only treat deviations from the just price that are *intolerably* unfair as exploitive and therefore subject to prohibition, we avoid this problem. We can have an objective theory of the just price and allow for reasonable profits too, which is exactly what those who have been attracted to a just-price based theory of exploitation have long sought to accomplish.

It is also worthwhile to note that the final statement of our conception of exploitation is very close in spirit to the definition of the just price announced by President Woodrow Wilson when he served notice on manufacturers, mine operators, and the shipping industry that the government intended to fix prices to prevent profiteering from undermining the war effort in 1917. Wilson said that preventing profiteering during wartime meant the difference between "victory and defeat." He then directed special criticism at the shipping industry, which by raising freight rates in response to the tremendous demand on shipping facilities had made prosecution of the war all but "impossible." Indeed, by behaving in this manner, Wilson said, our own shipping industry had "taken the most effective means in their power to defeat the armies engaged against Germany."[53] Not that he wanted ship owners and those in control of other essential industries to forgo profit seeking entirely. The price fixed, he said, must of course be a just one.

> By a just price I mean a price which will sustain the industries concerned in a high state of efficiency, provide a living for those who conduct them, enable them to pay good wages, and make possible the expansion of their enterprises which from time to time may become necessary as the stupendous undertakings of this great war develop. We could not wisely or reasonably do less than pay such prices. They are necessary for maintenance and development of industry, and the maintenance and development of industry are necessary for the great task we have in hand.[54]

In other words, the price fixed must not only enable industry to recover its costs of production; the just price must also, in Wilson's view, "insure reasonable profits."[55] Translating this into the taxonomy we have been using here, which treats reasonable profits not as part of the just price but as an addition to it, the price charged could be unfair, but it should be no more than *tolerably* unfair. And while our degree of tolerance may be less when the economy is under the pressure of all out war, there is no reason to think our tolerance should be unlimited when the weight of such an enterprise is not so heavy upon us. If exploitation must be prohibited during war, exploitation must be prohibited in more normal circumstances too, for in the economic sphere, the

[53] See "President Denounces Profiteers; Says Fair Prices Must Prevail in War; Assails Ship Owners for High Rates," *The New York Times* (July 12, 1917).

[54] "Text of President's Appeal to Business Men Calling for Unselfishness in War Prices," *The New York Times* (July 12, 1917).

[55] Robert Cuff, *The War Industries Board: Business and Government Relations During World War I* (Baltimore: John Hopkins University Press, 1973), 127 and n. 40. See also "Just Prices," *The New York Times* (July 13, 1917).

whole point of political liberalism is to ensure that the potential excesses of capitalism, no matter what the context, do not go entirely unregulated.

5.6 The Nature and Role of Profit

One of the things that our theory of exploitation tells us now that it is complete is how to think about the concept of profit. The concept of profit is surprisingly complex, and there are many ways in which it can be cashed out. Ultimately, which direction we take depends on the purpose for which the concept will be used. So it is important here to keep in mind that our purpose is to develop a concept of profit that helps us understand when a transaction is exploitive and when it is not. If we have some other use for the concept in mind—for example, if we want to determine whether an activity is profitable in an economic rather than an accounting sense, or how profitable it is, or if we want to distinguish the gain that we call profit from some other sort of gain, such as a gain from labor, land, or capital, as economists sometimes want to do, our concept of profit may have to be adjusted accordingly.

Regardless of the purpose for which the concept will be used, however, we want to be sure that we do not explore the concept by simply asking "profit is the reward for what?" While relatively common, this way of approaching the question of the nature and role of profit is actually responsible for generating much confusion, for it assumes that we already know what profit is, that there is only one concept of profit to be found, and that there is no need to distinguish between the practical question of how profit is to be obtained and the moral implications of allowing the opportunity for the pursuit of profit to exist. Any failure to take these complications into account, however, is a mistake, for the overall question of the nature and role of profit actually has three parts to it that are separate and distinct.[56]

First, there is the question "what is profit?" The answer here is that under our theory, profit is defined as the difference between value, understood as the out-of-pocket average total cost of production, adjusted for inflation, plus the cost of externalities, discounted to present value, on the one hand, and utility, measured by the price of the good, which in turn is understood as a product of the subjective demand for that good and its objective scarcity, on the other. To distinguish this conception of profit from conceptions that might be employed for other purposes, however, it may be useful to give this

[56] For a summary of the various ways in which the debate over the nature and role of profit can be framed and for an interesting contribution to it, see Frank H. Knight, *Risk, Uncertainty, and Profit* (Boston: Houghton Mifflin, 1921), especially 22–48. See also Mark Blaug, *Economic Theory in Retrospect*, 5th edition (Cambridge: Cambridge University Press, 1996), 439–47; Dean, *Managerial Economics*, ch. 1, pp. 3–28.

conception its own name. So let us call this kind of profit a measure of the "retrospective efficiency of capital." For our purposes, the retrospective efficiency of any element of capital is simply the return obtained on the application of any factor of production over and above its cost, and may take the form of interest, rent, wages, capital gain, or any other kind of income.

Of course, when it comes to the return on the sale of commodities, the sale or leasing of land, and the interest on loans, there is nothing unusual about thinking of the resulting sources of income as constituting two elements: one that represents reimbursement for the cost of production and another that represents an element of profit (when there is a profit to be had). But for some people, this may seem like a strange way to think about the exchange of labor for wages. Nevertheless, for our purposes, even wages can be deconstructed into these two elements, and therefore even human capital can have a positive or negative retrospective efficiency. The amount of wages and other compensation earned that cover the contextual basic needs of the worker plus the average total cost of developing whatever talents and abilities the worker devotes to the ends of his employer represent the reimbursement of costs of production; any residual is profit.

Now if it is indeed true that long-term market prices will tend to approach the cost of production under conditions of perfect competition, as Cantillon first claimed and Adam Smith and many economists since have consistently reaffirmed,[57] we also have another question to address if we are to fully understand the nature and role of profit: "how is (this kind of) profit possible?" The answer is that in the short term almost all sellers enjoy some monopoly power, or to put it differently, there are almost no goods for sale under perfectly competitive market conditions. Markets are not perfectly efficient, parties rarely have perfect information, and one party almost always has some degree of monopoly power, even if this is relatively modest. While markets are dynamic, not static, they are not that dynamic—they do not respond to innovation instantaneously. Simply put, all markets operate with some degree of friction, so there is always a lag between market innovation and market response—it takes time before the market can catch an innovator and drive his profit margins down to zero, and sometimes we even endeavor to extend such time by granting patents or copyrights or otherwise temporarily protecting innovation from imitation. And this means that there is always some way to profit from entrepreneurship and innovation.

[57] See Karl Pribram, *A History of Economic Reasoning* (Baltimore: Johns Hopkins University Press, 1983), 80, 129. For Cantillon's argument itself, see Richard Cantillon, *Essay on the Nature of Commerce in General*, trans. Henry Higgs (New Brunswick, NJ: Transaction Publishers, 2001), ch. 10, especially pp. 15–16.

Which brings us to the third and final question in our search for understanding the nature and role of profit: "why should we allow the opportunity for profit to exist?" This is the question that troubled the Schoolmen, which they resolved by casting the pursuit of profit as justifiable to the extent that it represented compensation for the labor and expenses involved in bringing goods to market. But that answer is not available to us, for under our theory, each of these elements is a part of the cost of production. Under our theory, profit is the difference between cost and price, and we tolerate the pursuit of profit because we believe that the availability of profit provides a necessary incentive for certain kinds of activities; specifically invention, innovation, and other forms of productive and socially beneficial risk-taking that cannot be eliminated through diversification and cannot be insured against and therefore simply reduced to another element of cost. Although providing that incentive has a cost in terms of distributive injustice, this is a cost we are willing to pay—up to a point. That point is the point our theory identifies as the hinge between tolerable and intolerable unfairness, the point where a violation of the doctrine of the just price becomes not just a violation of that doctrine, but a much more serious violation, a violation of the right against exploitation.

The claim that profit is justified as a reward for risk-taking is of course nothing new, but there are important differences between the standard version of such a claim and the claim I am making here. The risk-taking I have in mind is not simply the risk-taking that those contributing capital undertake. As Marx pointed out, the claim that those contributing capital take risks others escape and that these contributors are therefore exclusively entitled to the fruits of these risks if and when they pay off is simply not borne out by the facts. Indeed, as recent events make all too clear, workers, suppliers, wholesalers, retailers, those in the surrounding community, and even taxpayers in general often bear the brunt of losses well before those who made the decision to undertake the risk that produced these losses do, if they ever come to bear them at all. Marx put the point nicely in the *Grundrisse*:

> All economists, when they come to discuss the prevailing relation of capital and wage labor, or profit and wages, and when they demonstrate to the worker that he has no legitimate claim to share in the risks of gain, when they wish to pacify him generally about his subordinate role *vis-à-vis* the capitalist, lay stress on pointing out to him, in contrast to the capitalist, he possesses a certain fixity of income more or less independent of the great adventures of capital. Just as Don Quixote consoles Sancho Panza with the thought that, although of course he takes all the beatings, at least he is not required to be brave.[58]

[58] Karl Marx, *Grundrisse: Foundation of the Critique of Political Economy (Rough Draft)* (London: Penguin Books, 1973), 891.

The reward for risk-taking we are focusing on here, however, is not the reward for risk-taking that Marx derides. Under our theory of exploitation, the reward on offer is not available only to those who have contributed capital to the enterprise, but rather to all those who have contributed consideration of any kind. Everyone shares the risk that their enterprise will fail in proportion to their contributions, and therefore everyone shares in the profits generated by that enterprise in proportion to their contributions too once the first level of tolerable unfairness has been reached. The extra incentive allowed by that first level does indeed go to just one contributor, but not because the nature of his contribution exposes him to a risk that others have eschewed. Rather, it goes to him because he is the one charged with marshalling the contributions of the others and deciding which particular projects to pursue. It is not a reward for his contribution, but an incentive to direct his efforts in certain ways. We want him to take risks that are reasonable and responsible and avoid those that are not. We accordingly design the incentive we provide to maximize the possibility that this is how he will conduct himself, although there is no way to guarantee that he will comply. The best we can do is insist that the super-normal profits that sometimes result from taking unreasonable and irresponsible risks or from just plain brute good luck be shared out with each contributor according to their respective contributions. And this, in turn, should make the financial beatings of those who do not necessarily get to decide what risks to take somewhat easier to bear.

What we now have, then, is a way to conceptualize value, price, and profit within a liberal capitalist theory of exploitation, and an explanation of how to understand and balance the incentives that the availability of profit creates and the restraints on the pursuit of profit imposed by the principle of reciprocity. The one thing we have not yet discussed is how to translate these insights about exploitation into practical rules of distributive justice. For if a theory of distributive justice is to be worthy of our consideration, it must be workable. It must provide practical solutions to actual problems facing our society as it exists today. If the solutions it provides are impractical, in the sense of requiring information that we do not have and cannot reasonably be expected to obtain, then it is utopian and will not provide a realistically achievable alternative to the arrangements under which we currently live. If the solutions it provides depend on unrealistic assumptions about human nature or the capability of human institutions, then it will be unstable and will not provide a politically feasible alternative to the arrangements under which we currently live. Given that our theory of exploitation is a theory of commutative as well as distributive justice, it already has a leg up on pure theories of distributive justice, because theories of commutative justice tend to be more practical from the proverbial get go. Nevertheless, we still have to show that our theory of exploitation can be translated into workable policy initiatives that might actually be adopted by a liberal capitalist society interested in solving the problems to which our theory of exploitation is addressed if we are to offer it as a practical principle of justice. And there are some potentially tricky practical problems to be overcome here. It is to the nature of these problems, and how we might go about solving them, that we now turn.

6

Implementation and Enforcement

To review, here is the content of the right against exploitation that we have now established. Sales at anything less than the just price, defined as the average total social cost of production, are prohibited unless the difference is made up by public subsidy, subject to an allowance for good faith errors in calculation and to exceptions for the introduction of new products, entrants, and ways of doing business, the disposal of obsolete inventory, and the mitigation of losses during temporary periods of recession. Sales at prices above average total social cost are also unjust, but in a liberal capitalist society these are to be tolerated to a certain extent. A seller is allowed to charge and to retain a reasonable profit of up to 11.7 per cent of the just price, or whatever degree of profit is necessary to motivate the reasonably prudent entrepreneurial investor to produce the particular good at issue given the risk arising out of the conditions in effect at the time, if the latter figure is different. A seller is further allowed to charge up to twice the just price—a 100 per cent mark-up. But allowing the seller to retain all of these proceeds would be intolerably unfair to those who made these profits possible, and therefore the seller is not permitted to retain all these additional profits himself. Instead, any profits between 11.7 per cent (or its risk-adjusted equivalent) and 100 per cent of the just price must be shared out among those who have most directly contributed to the creation of the good in proportion to their respective shares of the cost of production. Sales at more than a 100 per cent mark-up are intolerably unfair to the buyer and are accordingly prohibited.

6.1 The Indeterminacy of the View from Nowhere

There is one preliminary objection to implementation and enforcement of our theory of exploitation that I want to get out of the way at the beginning. This is the claim that it is impossible to make the kinds of adjustments to an ongoing capitalist economy that our theory of exploitation would require given the fact that we would have no fixed point from which to begin. The cost of everything depends to some extent on the cost of everything else, and once we raise or lower the cost of one factor of production, the cost of others will change too. This will require that we make further adjustments to the factor we have just adjusted, and so on. If there are no costs that we can treat as fixed, transforming an already existing economy into one in which everything exchanges only at its just price (or at a price that is not intolerably unjust) would require the use of a staggeringly complex set of simultaneous equations, and even then, the chances that these would produce a single determinate result are exceedingly small. Most likely, multiple possible solutions would result, and we would have no principled way of choosing between them.[1]

I have three responses to this objection. First, there may indeed be multiple equilibria for any particular economy that satisfies the requirements of our theory of exploitation. But this is not the same as saying that the solution to the problem of exploitation is wholly indeterminate. There are a huge number of possible equilibria that are ruled out by our theory, including the one that we are in now. While there may be no unique solution to aim at, the number of possible solutions is dramatically smaller than the number of possible states of affairs for an economy in equilibrium. And while the choice between each of the acceptable equilibria may in some sense have to be arbitrary, all of these equilibria are just—or rather they are all tolerably unjust to the same extent, and thus we need not be concerned that any intolerable injustice could result. In other words, whether the minimum wage is set at \$5 an hour or \$50 does not matter. All that matters is that everything else bears the right relation to the figure ultimately chosen. The mere fact that there may be no unique equilibrium for an economy that is not exploitive is by no means fatal to the project (of first reducing and then eliminating exploitation) in which we are ultimately engaged.

My second response to this objection is that there are indeed certain costs that we can treat as fixed, and therefore some and perhaps even a large number of the remaining "tolerably unjust" equilibria can be eliminated too. Most liberal capitalist economies are open, and typically very open, even to goods from economies that are largely closed. The prices for at least some factors of production in a liberal capitalist economy are accordingly fixed in the world market, independently of what occurs in "our" economy. This would include the price of many natural resources, some basic commodities such as cement and steel, certain kinds of heavy equipment, and various

[1] For a similar argument, albeit in a somewhat different context, see Duncan Kennedy, "Cost-Benefit Analysis of Entitlement Problems: A Critique," *Stanford Law Review* 33 (1981): 387–445, at 438–9.

types of manufactured goods. We are accordingly not free to start from just anywhere, even if we wanted to. While there may still be multiple equilibria for an economy that are not exploitive, and we accordingly may still have to choose between them, there are a lot fewer of these equilibria available than those who would make this objection might be inclined to claim.

My third response is that our theory of exploitation is not intended to provide a blueprint for creating a just (or tolerably unjust) society out of whole cloth. It is not an ideal theory, meant to describe some utopian end-state, but an action-guiding theory, meant to apply only to already existing liberal capitalist economies, and to tell us what we should do in order to make these already existing capitalist economies more just.[2] Accordingly, our starting point is not arbitrary—we start from where we are, and we neither expect nor attempt to do everything at once. First we raise the minimum wage a little and place a generous ceiling on the compensation that can be offered to highly compensated individuals; then we see how the economy reacts. Adjustments to other prices are then made, and then further adjustments to wages, and so on, until we close in on a stable non-exploitive equilibrium. If this search for what Rawls famously called "reflective equilibrium"[3] works when we are trying to arrive at a set of moral principles that match our considered intuitions, why should it not also work when we are trying to arrive at a set of price points that match our moral principles? If we proceed carefully, deliberately, and incrementally when phasing in enforcement of our theory of exploitation, there is every reason to believe that we can move from one stable equilibrium with x amount of intolerable unfairness to one with x-1, and then to one with x-2, and so on, with society becoming more and more just (or less and less unjust) as a result.[4]

Moving, then, to more specific problems we might encounter when implementing our theory of exploitation, I think it is best if we address these for goods and labor and for minimums and maximums separately, for the alleged problems that implementation and enforcement of our theory of exploitation would create in each of these categories are actually quite different. I shall accordingly take up each of the possible variations of these implementation questions individually in turn.

[2] For argument in favor of action-guiding theories over ideal theories, see Amartya Sen, *The Idea of Justice* (Cambridge, MA: Harvard University Press, 2009).

[3] See John Rawls, *A Theory of Justice* (Cambridge, MA: Harvard University Press, 1971, rev. ed. 1999), 18–19, 42–5.

[4] Of course, unlike the result of the process of reflective equilibrium to which Rawls referred, we are not trying to move society toward what is in fact a unique equilibrium between our moral principles and our moral intuitions. There are many price point equilibriums that accord with our moral intuitions and moral principles, with the one we are aiming at depending on where we start. So the analogy here is not perfect. I am using the idea of reflective equilibrium here simply to illustrate what I mean by the process of an incremental journey toward justice, not to imply that there is only one port in that particular storm.

6.2 The Minimum Wage and Unemployment

Ensuring that the prohibition on sales below cost with regard to labor is not violated should be relatively unproblematic. To implement this prohibition, we simply recalculate and amend the applicable minimum wage. Because this recalculated minimum wage will require the satisfaction of contextual and not merely primary basic needs, it will be higher and probably significantly higher than the existing minimum wage, which for example has actually declined by 27.5 per cent in the US since 1968 as a result of inflation.[5] This recalculated minimum wage would accordingly have to be phased in responsibly to prevent any untoward shocks to the economic system. The reach of its requirements would also have to be extended to apply not just to hourly workers, but to all workers across the board, including those performing what might be currently described as managerial functions. And employers could not be allowed to avoid such requirements by requiring employees to undertake "preparation time" off the clock. If school teachers, for example, must spend substantial time preparing their lesson plans and providing feedback to students and their parents, then they must be compensated for this, even if such activities take place outside the hours they are required to be in school. But enforcement of this minimum should nevertheless be relatively unproblematic, for even though the reach of this requirement would be substantially increased, the mechanisms for enforcing it already exist in most liberal capitalist systems.

What is the effect, however, of raising the minimum wage on unemployment? If increasing the minimum wage would lead to a significant increase in unemployment, this would seem to raise the possibility that even though enforcement of the just price might seem just on an individual or case-by-case basis, its overall societal impact could be unjust, for it would reduce the standard of living for at least some of the next to least advantaged (that is, the working poor, for the least advantaged are already not working and would therefore be unaffected) and increase the impact if not the degree of economic inequality in society by increasing the number of those at the bottom of the income distribution. Indeed, attempts to raise the minimum wage are often met by claims that this will increase unemployment among the youngest and poorest workers, such as teenagers and immigrants. And it is pointless to deny that many academic studies have found a limited but still statistically significant increase in unemployment among the least-skilled workers following some past increases in the minimum wage.[6] On the other hand, there are

[5] In 1968, the minimum wage was roughly $10 an hour in 2012 dollars. As of June 2012, it was $7.25. See Rebecca Berg, "Bill Pushes for Increase in Wages," *The New York Times* (June 6, 2012). A similar decay though inflation has also occured in the UK. See Matthew Pennycook, "The High Cost of Low Pay," *New Statesman* (September 29, 2012).

[6] See David Neumark and William Wascher, *Minimum Wages* (Cambridge, MA: MIT Press, 2008), especially 37–106; David Neumark and William Wascher, "Minimum Wages and Employment,"

also a significant number of studies that point to troubling methodological problems and biases within the data sets used by those critical of attempts to raise the minimum wage, and show that once these biases and other problems are corrected, any alleged statistically significant causally-connected increase in unemployment disappears.[7]

Part of the problem here is that not only are the relevant empirical studies conflicting and therefore inconclusive, the theoretical models that tell us what kind of effects on unemployment to expect are also contradictory and inconsistent. The neoclassical view is that setting the minimum wage above the market wage will have two economy-wide effects. First, if the cost of labor goes up, the cost of production will increase, leading to an increase in the price of the involved goods, leading to a reduction in demand, leading to a decline in output, leading to a reduced demand for labor. And if this increase applies to all sectors of the economy, the result will be greater unemployment throughout the economy (the "scale effect"). Second, if the cost of labor goes up, firms will seek to replace labor with capital in the form of labor-saving devices, leading again to a reduced demand for labor and greater unemployment, assuming once again that the increase in labor costs applies economy-wide (the "substitution effect"). The neoclassical view accordingly predicts that except in unusual circumstances, none of which would seem to apply here, increases in the minimum wage cannot help but increase unemployment.[8]

Opposing the neoclassical view is Keynes, who characterizes neoclassical reasoning, especially its claim that decreasing the minimum wage will increase employment and its corresponding claim that increasing the minimum wage will necessarily have the opposite effect, as "crude."[9] For Keynes,

NBER Working Paper No. 12663 (November 2006), <http://www.nber.org/papers/w12663>; David Neumark and William Wascher, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania: Comment," *American Economic Review* 90 (2000): 1362–96.

[7] See Sylvia Allegretto, Arindrajit Dube, and Michael Reich, "Do Minimum Wages Really Reduce Teen Employment? Accounting for Heterogeneity and Selectivity in State Panel Data," *Institute for Research on Labor and Employment Working Paper Series* (University of California, Berkeley, June 2008), <http://repositories.cdlib.org/iir/iirwps/iirwps-166-08>; Arindrajit Dube, T. William Lester, and Michael Reich, "Minimum Wage Effects Across State Border: Estimates Using Contiguous Counties," *Institute for Research on Labor and Employment Working Paper Series* (University of California, Berkeley, October 2008), <http://repositories.cdlib.org/iir/iirwps/iirwps-157-07>; David Card and Alan B. Krueger, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania: Reply," *American Economic Review* 90 (2000): 1397–420; David Card and Alan B. Kruger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton: Princeton University Press, 1995).

[8] See Neumark and Wascher, *Minimum Wages*, 39–53. Note that the neoclassical view is also the view behind supply-side economics, the theory that cutting taxes on the rich will stimulate savings, investment, and the production and supply of goods and thereby improve the economic well-being of everyone, an empirical claim that is at the very least open to a reasonable degree of doubt given the dramatic increase in economic inequality since such policies were put into effect.

[9] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (San Diego: Harvest/Harcourt ed., 1964), ch. 2, sec. 6, p. 19.

any increase in the minimum wage that is to apply across an entire economy is not simply going to increase the cost of production, it is also going to increase the real income of the working poor, especially when we take into account the wider distribution of profits our theory of exploitation would also require if it were fully implemented and enforced. Because there is a declining marginal propensity to consume as income increases, increasing the real income of the working poor the poor should increase consumption, leading to an increase in effective demand, leading to an increase in production and a greater demand for labor, leading to a *decrease* not an increase in unemployment, leading to increased total consumption by the previously unemployed and further increases in demand, and so on.[10] Indeed, if the increase in production is substantial enough, the average total cost of production may actually decrease, not increase, despite the increased cost of labor, producing lower prices, not higher. But even if prices do go up, the greater demand for goods should grow the economy to a sufficient extent to provide more jobs despite the higher cost of labor. Of course, there are other variables here that could undo the effect of all this on effective demand, but at least there is no reason to assume that an increase in the minimum wage will necessarily have the disastrous effects that the adherents of neoclassical economics are so ready to predict.[11]

Indeed, we might even look at the redistribution of wealth and income that would result from the implementation and enforcement of our theory of exploitation as another Keynesian tool for combating recession and depression, along with monetary and fiscal policy. After all, we can only lower interest rates to stimulate demand so far—once interest rates have reached zero or near zero, as they have today, monetary policy is left without its most direct and probably its most effective tool for influencing the economy. And while there are other things that committed monetarists can still do—such as increasing the money supply through various types of open market operations (often referred to as "quantitative easing"), the use of these tools is likely to encounter great resistance from those who seem to be permanently in the grip of the fear of triggering inflation (I shall talk more about this particular fear and its effects in a moment). Of course, governments can always take the Keynesian approach and engage in tax cutting and deficit spending to stimulate demand as well, and indeed, if the reaction to the last economic crisis is

[10] This latter benefit is the result of the multiplier effect, although there is of course some "leakage" from consumption into savings at each level and therefore the multiplier is a finite number (probably between 1 and 2) and not infinity. See Richard Kahn, "The Relation of Home Investment to Unemployment," *The Economic Journal* 41 (1931): 173–98.

[11] See Keynes, *The General Theory of Employment, Interest, and Money*, especially ch. 24, pp. 372–84. For a recent version of the Keynesian argument, see Doug Hall and David Cooper, "How Raising the Federal Minimum Wage Would Help Working Families and Give the Economy a Boost," *Economic Policy Institute*, Issue Brief No. 341 (August 14, 2012).

any guide, this is what even the most supposedly anti-Keynesian governments are likely to do, at least at first, although after their initial instinctive reactions their ideological commitments may overcome their reason and lead them to favor austerity over stimulation.[12] But if we can also stimulate demand by eliminating exploitation, thereby putting funds in the hands of those with the greatest marginal propensity to consume even more directly, why not do this also? To the extent this does increase effective demand, it will do so without borrowing from future generations or otherwise weakening the national balance sheet, as deficit spending tends to do, although it is unlikely that a depression or even a recession could be overcome by eliminating exploitation otherwise redistributing income alone. On the other hand, if we need evidence of the potentially huge effect on demand of encouraging those with the greatest marginal propensity to consume to do so, we need look no further than the recent events in the US housing market. By deregulating the mortgage industry and allowing those with little or no assets or income to purchase homes, we gave those with the greatest marginal propensity to consume the ability to do so. The only reason why the resulting rapid expansion in the housing market was a bubble and not a sustainable expansion is that while we gave those with the greatest marginal propensity to consume the *ability* to satisfy their pent-up demand for housing, we did nothing to change the fundamentals of their economic situation. When it came time to pay for their purchases it was accordingly not possible for them to do so. But if we increase the minimum wage and take the various other steps our theory of exploitation suggests we should, we *will* change the fundamental economic situation of those with the greatest marginal propensity to consume. We will not only have increased their ability to satisfy their demand for housing and other goods, we will have increased their ability to pay for their newly unleashed demands as well. And because we will have done so by ensuring that income is distributed

[12] Apparently, "Everyone is a Keynesian in a foxhole." See Justin Fox, "The Comeback Keynes," *Time Magazine* (October 23, 2008) (quoting Robert Lucas, a University of Chicago economist who won a Nobel Prize in 1995 for theories criticizing Keynes). Unfortunately, it appears that given enough time people get used to living in a foxhole, and once they do they may stop being so sensible about how best to get out. This appears to be what happened in Europe, where most governments initially went Keynesian and thereby stepped back from the economic brink only to reverse course and adopt austerity measures that have brought them to that brink once again. It is also what happened in the US, where the federal stimulus programs that prevented an initial catastrophic collapse have now largely been undermined by a relentless series of state austerity measures, brought on in part by a lack of support for the states from a federal government now paralyzed by partisanship. See generally Paul Krugman, "The Austerity Debacle," *The New York Times* (January 29, 2012), "Europe's Economic Suicide," *The New York Times* (April 15, 2012), and "The Austerity Agenda," *The New York Times* (May 31, 2012); Christine D. Romer, "What Do We Know about the Effects of Fiscal Policy? Separating Evidence from Ideology" (Hamilton College, November 7, 2011). But nothing in my argument here turns on whether deficit spending or austerity is the most effective way to go, for as we shall see the increase in effective demand that would result from implementation of my theory of enforceability will happen either way.

more equitably as between the rich and the poor, not by adding to the money supply or granting unwarranted credit, we will have a much better chance of producing a more rational and controllable expansion.

Of course, I am not suggesting that we should engage in redistribution *merely* for economic reasons, although the economic evidence that this is exactly what we need to do in the current circumstances is overwhelming, for those who currently have cash are hoarding rather than spending or investing it.[13] Remember, even Hayek warned how dangerous hoarding could be during periods of recession or stagnation.[14] Instead, I am simply noting that if we have independent moral reasons for raising the minimum wage and taking various other steps that will have the effect of redistributing income from the richest members of our society to the working poor, as our theory of exploitation says we do, we have every reason to believe that we will be promoting economic growth, not impeding it, despite what anti-Keynesians might say.[15]

Indeed, making this rather modest effort to correct the extreme inequalities in income distribution that we are currently experiencing is not only most likely to promote rather than inhibit economic growth, *not* doing anything to address this problem is most likely a recipe for disaster. Consider, for example, what Marriner Eccles (Chairman of the Federal Reserve from 1934 to 1948) had to say about the causes of the Great Depression, and whether Eccles' diagnosis is not also eerily applicable to what is happening today:

> As mass production has to be accompanied by mass consumption, mass consumption, in turn, implies a distribution of wealth—not of existing wealth, but of wealth as it is currently produced—to provide men with buying power equal to the amount of goods and services offered by the nation's economic machinery. Instead of achieving that kind of distribution, a giant suction pump had by 1929–30 drawn into a few hands an increasing portion of currently produced wealth. This served them as capital accumulation. But by taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped.[16]

[13] See Lawrence Mishel, "Regulatory Uncertainty: A Phony Explanation for Our Jobs Problem," *Economic Policy Institute*, Briefing Paper No. 330 (September 27, 2011) (showing that companies are hoarding cash rather than spending it on new hires or investment because of fear about weakness in the demand side); Richard Thaler, "Deer in the Headlights, Financially Speaking," *The New York Times* (October 11, 2011) (same).

[14] See T. E. Gregory, F. A. von Hayek, Arnold Plant, and Lionel Robbins, Letter to the Editor, "Spending and Saving," *The Times* (London, October 19, 1932, p. 10) ("hoarding money, whether in cash or in idle balances, is deflationary in its effects. No one thinks that deflation is in itself desirable.").

[15] See Keynes, *The General Theory of Employment, Interest, and Money*, ch. 24, p. 373.

[16] Marriner S. Eccles, *Beckoning Frontiers: Public and Personal Reflections* (New York: Knopf, 1951), at 76.

The problem here, of course, is that no matter what the relevant theorists and practitioners might say about the historical record, there are so many linked and dependent variables to control for in the relevant empirical studies, the measurement issues are so complex, and the theoretical arguments are so conflicting, it is hard to know who has the stronger position in this debate. Because the stakes are so high, the debate has also become quite heated, and rather than gradually moving toward some sort of consensus, after years of having a go at each other each side has only become more entrenched. Personally, I find the Keynesian position more persuasive and the studies that reveal no statistically significant causal connection between increases in the minimum wage and increases in unemployment the better formulated, and accordingly believe that as long as increases in the minimum wage are phased in responsibly it is unlikely that such increases will have any unintended negative effects. But I recognize that those who have already formed a contrary opinion are by this point unlikely to change their minds. So let us assume that raising the minimum wage to a level equal to contextual basic needs *would* preclude some producers from employing additional workers they would otherwise hire for lower wages, and even fire workers they would have retained if they could have paid them lower wages. Let us further assume that there are some individuals who would accept such lower wages if they were on offer because their only other option is to be unemployed. What would we have to say about the implementation of our theory of exploitation then? If certain people would be better off if they worked for less than the new, higher, minimum wage, and such work would be available if we allowed this, do we not have a conclusive reason to do so?

My view is we do not, for to the extent this demand exists, what our theory of exploitation shows is that satisfaction of this demand would be morally wrong because the demand itself is unjustified. There will always be people who will be willing to purchase some good for less than what it justly costs to produce, but why do we think we should allow them to do so, even if this would reduce unemployment? The whole point of our theory of exploitation is to prevent producers from pandering to such demand at the expense of their workers. During periods of recession, the producer can capture this demand by selling below average total cost, for he can recover his losses by selling above average total cost when economic conditions improve. A profitable activity can still be profitable even if it is not profitable all the time. And while this is also true when it comes to the activity of selling one's own labor, workers (unless they are unusually well organized, and few workers are these days),[17]

[17] See Steven Greenhouse, "Union Membership in U.S. Fell Sharply in 2010," *The New York Times* (January 21, 2011) (rate of union membership at lowest level in more than seventy years); Bureau of Labor Statistics, News Release USDL-11-0063, "Union Members—2010," (January 21,

do not typically enjoy the same ability to increase the prices of their labor that producers of other products do, and therefore are less likely to be able to make up their losses when good economic times return. But most importantly, allowing workers who would otherwise be unemployed to subsidize the price of other products by accepting jobs that pay lower-than-just-price wages, even temporarily, requires a sacrifice in dignity that can never be compensated or undone. Whereas profits can be netted against losses, and an activity can therefore be profitable and worthwhile even though for short periods it may generate losses and perhaps even significant losses, positive and negative periods of dignity cannot be netted out over time. Thinking that they can makes about as much sense as thinking that a man with his feet in the fire and his head in the freezer is, on average, comfortable. People either have their dignity or they don't—there are no surpluses that can be used to offset earlier deficiencies and lead one to conclude that an activity that was undignified at the time was not undignified after all. Dignity simply does not work like that. What this means is that during periods of economic recession, when a producer can only maintain his output by selling his goods at less than their just price or by reducing his costs such as the cost of labor and thereby bringing the just price down to what the market will now bear, he must do the former not the latter. He must bear the costs of the recession himself, not impose it on his workers by lowering their wages. And if the producer is not willing to capture what demand there is for his goods during periods of recession by temporarily selling them for less than their just price, the additional units that he could produce and sell if he could pay his workers lower wages and reduce his costs are simply units that should not be produced. This may mean that some people who would otherwise be employed will not be, but we could say the same thing about the effect of our unwillingness to legalize drugs and gambling and prostitution and many other activities for which there is existing demand but limited or no lawful supply.[18]

2011) (percentage of wage and salary workers who were members of a union in 2010 a mere 11.9 per cent, down from 12.3 per cent a year earlier); Steven Greenhouse, "Union Membership Rate Fell Again in 2011," *The New York Times* (January 27, 2012) (rate now down to 11.8 per cent).

[18] After hearing this argument, some people have suggested that being unemployed involves an affront to dignity too, so why not allow those who are willing to work for less than a just wage to do so? My answer to this is that the fact that there are people who are involuntarily unemployed *is* an affront to dignity—but not to the dignity of the worker. Rather, the fact that some members of our society are involuntarily unemployed is an affront to *our* dignity, and an indictment of our failure to do more to ensure full employment. Thinking of it otherwise would be tantamount to blaming the sick and disabled for being sick and disabled. The worker's dignity is only compromised if he is exploited, for only then has he sacrificed his self-ownership and allowed himself to be treated as we would treat a slave. Of course, many of us have been conditioned to feel guilty if we are sick or disabled or unemployed, and the fact that this feeling is irrational does not make it any less painful, but I do not see how doing something (working for less than a just wage) that is also commonly experienced as an affront to dignity makes those who are suffering feel any better. All that does is

In other words, the argument from unemployment proves too much—as long as there is a gap between whatever social minimum society provides and the minimum wage, there will always be people who are willing to work for less even under unsafe or environmentally damaging conditions and who could be employed if producers were allowed to hire workers for lower wages, or provide less safe working conditions, or pollute the environment. But just as we do not allow the production of goods that we find socially pernicious notwithstanding the existing demand for them and the increased employment this would bring, we do not allow the production of goods under unsafe conditions notwithstanding the fact that labor would be cheaper if we did and we could supposedly employ more people, and we do not allow producers to pollute the environment even though once again production would be less costly if we did, for the social benefit of the additional employment this might bring is simply not worth the sacrifice in justice all things considered. And while the unapologetic advocate of unbridled capitalism might not agree, this is not the form of capitalism that acceptance of political liberalism entails. In a *liberal* capitalist society, the solution to the problem of unemployment is not employing people for less than a just wage, it is growing the economy to a sufficient extent by moral means, whatever these may be, so that all those who are willing and able to work for a just wage can find the employment they desire.[19]

6.3 The Maximum Wage and the Flight of the Talented

We turn now to the implementation and enforcement of a wage *ceiling* for highly-compensated individuals. Now, imposing and maintaining economic ceilings of any sort is often difficult, for reasons I have set forth in detail elsewhere, especially in times of economic growth and relative prosperity.[20]

switch one perceived source of indignity for another, more serious and oppressive source of indignity.

[19] Indeed, this should be true in any capitalist society. Those who oppose increases in the minimum wage are being inconstant to one of the fundamental tenets of capitalism itself, for regardless of its effect on unemployment, increasing the minimum wage encourages labor-saving technological innovation, and technical innovation is the very motor of the process that is supposed to make capitalism an economic success. See Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper Perennial Modern Thought Edition, 2008), 81–6.

[20] See Reiff, "The Politics of Masochism," *Inquiry* 46 (2003): 29–63. Note, however, that capping salaries is a very different way of preventing exploitation (and also a more just, effective, and feasible one) than taxing excessive salaries at punitive levels, which is what the French are currently proposing to do. See Liz Alderman, "Indigestion for 'les Riches' in a Plan for Higher Taxes," *The New York Times* (August 7, 2012) (proposing a 75 per cent tax on income above one million euros ($1.24 million) a year). First, because of what is called the endowment effect, people tend to be less resistant to not receiving something than they are to receiving it but then having to give most or all of it back in the form of taxes. See Kahneman, Knetsch, and Thaler, "The

It may accordingly require a period of recession before there is the political will to impose limits on the highly-compensated. But the current economic crisis might offer just such an opportunity. Indeed, for a time it seemed that the beginning of such an effort was perhaps in place as part of the American Recovery and Reinvestment Act of 2009, which imposed some limits on executive compensation for firms that had received substantial government financial assistance.[21] This provision would have to be widened to cover all firms, but enforcement should be relatively easy, for companies in a position to pay such large amounts of compensation are likely to be publically traded and therefore already under an obligation to disclose the amount of compensation they pay their executives, although there are certain loopholes to such disclosure rules that would need to be closed. This more generally applicable cap, which would effectively function as a nationwide maximum wage, would be calculated by using average costs associated with acquiring the skills required of highly-compensated individuals, and would probably have to be phased in rather than put in place all at once to ensure that the overall effects of such limits were well understood and that any undesirable or unintended aspects of these effects could be satisfactorily controlled.

Indeed, a version of such a cap has recently been proposed in the United States by the Securities Exchange Commission pursuant to authority granted by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[22] The concern driving these regulations, of course, is the need to avoid incentivizing excessive risk-taking rather than considerations of the just price, and these regulations have not yet (and given the current state of divided government in the US may not ever) become law. But the fact that this kind of regulation is being contemplated shows that at least some support for controlling excessive compensation already exists within portions of the government. And anger and resentment at the amounts currently being paid to highly-compensated individuals is growing among the general public as well, as the "Occupy Wall Street" movement demonstrates, and even those

Endowment Effect, Loss Aversion, and the Status Quo Bias," *Journal of Economic Perspectives* 5 (1991): 193–206 at 194–7. Second, because capping salaries keeps the money where it should be—in the corporation—which can then use it for other more appropriate purposes, such as research and development, paying other workers more, reducing the prices of its goods or services, or even returning it to shareholders in the form of increased dividends.

[21] See American Recovery and Reinvestment Act of 2009, Title VII, § 7000 et seq. An even more extensive attempt at regulating executive compensation is perhaps on the way to becoming law in Europe. See Liz Alderman, "Cap on Bank Bonuses Clears Hurdle in Europe," *The New York Times* (July 7, 2010).

[22] See Ben Protess and Susanne Craig, "S.E.C. Proposes Crackdown on Wall Street Bonuses," *The New York Times* (March 2, 2011). France is also currently trying to cap the pay of chief executives at companies in which the government owns a controlling interest. See James Boxell, "France to Cap Top Pay in State Groups," *Financial Times* (May 30, 2012). Whether it will be successful, however, remains to be seen.

who have not become active in this movement seem appalled that the amounts paid to these individuals are once again approaching record levels while the rest of us continue to languish in the economic doldrums that those receiving such compensation helped bring down upon us.[23] Even shareholders are finally beginning to assert their opposition to oversized pay packages, although this is still frustratingly rare.[24]

Still, it is pointless to deny that many powerful people are committed to resisting the idea of imposing limits on the maximum amount of compensation that these privileged individuals can be offered. So far, the only companies that seem to have managed to impose a serious cap are Fannie May and Freddie Mac, two quasi-governmental companies that were seized outright by the US government in 2008 and are now closely regulated by the Federal Housing Finance Agency ("FHFA").[25] Elsewhere, significant limits on executive pay are hard to find, in large part because of the argument that imposing such limits will result in the most talented individuals exiting the market, either going abroad where such limits do not yet apply or leaving the market entirely.[26] But the underlying concern here—the fear of losing our most

[23] See Daniel Costello, "The Drought is Over (At Least for C.E.O.'s)," *The New York Times* (April 10, 2011); Preston, "Protest Spurs Online Dialogue on Inequality," *The New York Times* (October 8, 2011); John Plender, "Capitalism in Crisis: The Code that Forms a Bar to Harmony," *Financial Times* (January 8, 2012).

[24] Pay packages for senior executives were rejected by shareholders at only 42 of the more than 3000 companies to hold votes in 2011. See Jessica Silver-Greenberg and Nelson D. Schwartz, "Citigroup's Chief Rebuffed on Pay by Shareholders," *The New York Times* (April 17, 2012) (rejecting $15 million compensation package for Citigroup chief executive who had received $800 million three years ago); Nelson D. Schwartz, "Bank of America Investors Complain, but Approve Chief 's Pay," *The New York Times* (May 9, 2012). And even in these cases, the votes are non-binding, although a company no doubt ignores its shareholders at its peril. See Steven M. Davidoff, "Citigroup Has Few Options after Pay Vote," *The New York Times* (April 18, 2012); Alistair Gray, "Investors in Attack on Payoff for Aviva Chief," *Financial Times* (May 9, 2012) (investors force out chief executive over pay issue); Julia Werdigier, "WPP Chief's Pay Package is Rejected by Shareholders," *The New York Times* (June 13, 2012). There are proposals in Britain, however, to make these votes mandatory and binding (but only every three years) starting in October 2013. See Jim Pickard, Brian Groom, and Brooke Masters, "Cable Plans Binding Votes on Executive Pay," *Financial Times* (June 20, 2012). Nevertheless, in the US, median pay for the 200 top-paid CEOs keeps going up. See Nathaniel Popper, "C.E.O. Pay Is Rising Despite the Din," *The New York Times* (June 16, 2012).

[25] See Reuters, "Executive Pay Capped at Fannie Mae and Freddie Mac," *The New York Times* (March 9, 2012) (noting that the FHFA has capped the salaries of the Fannie and Freddie chiefs at $500,000, which is nearly 75 per cent less than what their salaries were when the government seized these firms in 2008). To these two companies we can now add MBIA, which decided to pay no bonuses to its top executives in 2011, but only after enormous pressure was brought to bear by its regulator, the New York Superintendant of Financial Services. See Peter Lattman, "Under Pressure from Regulator, MBIA Pays No Bonuses," *The New York Times* (March 19, 2012).

[26] This, for example, is the response that General Motors (which received $49.5 billion in government aid and still owes $25 billion) had to government orders that it cut top executive pay by 10 per cent, even though this still left its chief executive with $9 million in compensation. See Associated Press, "U.S. Orders Cuts in Pay at 3 Firms," *The New York Times* (April 6, 2012). For criticism of the government's decision to allow executive compensation at GM and other companies that received large government bailouts to remain this high, see Special Inspector General for The Troubled Asset Relief Program, *The Special Master's Determinations for Executive*

talented executives—is not supported by the facts, and even if it were, there is good reason to think we might actually be better off without these people. Those who really do think so highly of themselves that they are only willing to work or at least to work hard if they are paid astronomical sums, or who would rather write novels or sail boats if they are not paid such sums, are better left to occupy themselves in these less socially critical ways rather than be bribed to take jobs that will require them to make decisions on which the financial security of many other people's lives depend and which supposedly require intense effort and dedication to get right. So even if these people *are* especially talented, it seems unlikely that they really would apply themselves in the way we would want and expect no matter what we pay them given their underlying attitude toward the work they would have to do. Indeed, if money is that critical to their decision to apply their talents for the benefit of others, they would have effectively identified themselves as utterly corruptible and we would have to be concerned that they might act against the interests of those they were supposed to represent if the opportunity to make even more money by doing so ever came along. Such people are simply not to be trusted.

More importantly, however, why should we assume that the best paid are the most talented, and that by losing access to their talents we would actually be depriving ourselves of something of value that we could not replace? The fact that certain individuals are highly-compensated merely indicates that they have a talent for taking maximum advantage of the opportunities for social cooperation open to them. As Robert Musil observed in *The Man Without Qualities*, one of the most influential German-language novels of the twentieth century, *appearing* to be good at something requires a very different talent than *actually* being good at it:

> He had an air about him that seemed to matter more than any specific achievement. Perhaps he had a particular genius for passing as a genius . . . a talent found in every degree up to the level of those who really are highly gifted, in whom it usually seems, to all appearances, to be missing.[27]

What Musil was suggesting, I think, is that those who are the most talented in a substantive way—that is, particularly good at business, or chemistry, or computers, or the arts, are hardly ever as effective when it comes to presenting themselves in a favorable light. Those who are the most successful in the classical sense of the word are often merely competent when it comes to substantive skills and talents, and simply manage to ride to their success by

Compensation of Companies Receiving Exceptional Assistance under TARP (Washington, DC: January 23, 2012) and Mary Williams Walsh, "U.S. Faulted Over Pay at Rescued Firms," *The New York Times* (January 24, 2012).

[27] Robert Musil, *The Man Without Qualities*, trans. Sophie Wilkins (New York: Knopf, 1995), ch. 14, p. 49.

capitalizing more effectively on their modicum of talent and the substantive innovations made by others.[28] The absence of such a "talent for success," in contrast, is often fatal, regardless of the degree of substantive talent an individual might possess. Indeed, all one need do is look around in any business or other organization from the profound to the mundane and one can find countless examples of those whose talents have not generated the financial rewards one would expect, and those whose financial rewards vastly exceed their substantive contributions. And if substantive talent is no guarantee of success, and success is no guarantee of the possession of some special substantive talent, then we need not be overly concerned that those who can demand the highest salaries—those who have the greatest talent for success, but not necessarily the greatest talent—may choose to forgo work entirely or, if they can obtain higher salaries overseas, go work for someone else.

There is even reason to believe that many of those who are most successful actually possess no particular gifts or substantive talents at all. Over the course of any time period, even one that is quite significant, a few members of any large group of decision-makers will appear to be great sages, having made a series of decisions under conditions of uncertainty that appear "right" in retrospect, even if these decisions were actually made randomly rather than deliberately. In other words, the appearance of such individuals could easily be the product of the invisible hand of chance rather than an indication they possess any special talents or abilities.[29] This is especially true when it comes to certain kinds of managers or traders, the kinds of people who are typically among the most highly compensated anyway. Indeed, a number of experienced and successful former traders have argued that in the financial industry especially, where many if not most of the highly-compensated are currently found, the *only* way to achieve success legitimately is through sheer dumb luck.[30] A similar view has also been expressed by various behavioral economists and cognitive psychologists who have looked into the issue, including some Nobel Prize winners, although those in charge of setting compensation

[28] For a similar view, see Nassim Nicholas Taleb, *Fooled by Randomness* (New York: Random House, 2004), 255–6.

[29] See Karl Deutsch and William Madow, "Note on the Appearance of Wisdom in Large Bureaucratic Organizations," *Behavioral Science* 6 (January 1961): 72–8. For more on invisible hand explanations, see Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), at 18–22; Robert Nozick, "Invisible Hand Explanations," *American Economic Review* 84 (1994): 314–18; and Edna Ullmann-Margalit, "Invisible Hand Explanations," *Synthese* 39 (1978): 263–91.

[30] See, e.g. Taleb, *Fooled by Randomness*. Satyajit Das, another experienced financial trader, is even more cynical. He says "other than sheer luck, there are really only two ways to make money [in the financial markets]—inside information and overwhelming force [that is, market manipulation]." Satyajit Das, *Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives*, rev. edition (Harlow, England: Pearson Education, 2010), 133. While popular, both these latter methods, of course, are illegal.

for the highly-compensated seem determined to ignore this.[31] But if those who are currently highly-compensated really are just "lucky idiots" who do not care about their clients[32] rather than true sages or, even worse, if they are actually generating their profits through some sort of criminal or quasi-criminal activity, there is no cost to losing them. In any event, if the current group of supposed sages are unwilling to work for less, we have no cause to worry, because a similar group of supposed sages will rise to replace them, even if they are paid far less, for the existence of such a group is the natural result of probability theory in action and does not actually require the identification, retention, and promotion of those with the greatest talents and abilities despite any illusion to the contrary.

And there are other reasons not to be afraid that the imposition of a cap on executive salaries might cause flight of the irreplaceably talented as well. First, even if we assume that there is a high degree of correlation between level of compensation and substantive talent, the number of individuals who are capable of running major corporations well—or rather the number of individuals who are capable of running major corporations as well as our current group of corporate managers, which is not very well at all—almost certainly exceeds the number of positions available. So even if some members of this group were to leave the market entirely or avoid the cap by working for companies based in foreign lands that had not imposed similar caps on executive salaries themselves, these positions would not become impossible to fill. Indeed, they would be filled by younger and perhaps more innovative people, who actually might be more in tune with the current trends in what is continually becoming an ever more dynamic economy, and therefore might be more likely to grow their companies both more quickly and in more sustainable ways. In any event, given the horrendous job that many of the supposedly most talented business minds in major corporations seem to be doing recently, many of those whom we currently find at the top are clearly not irreplaceable.[33]

[31] For references to some of this research, see Daniel Kahneman, *Thinking, Fast and Slow* (New York: Farrar, Straus & Giroux, 2011).

[32] See Greg Smith, "Why I am Leaving Goldman Sachs," *The New York Times* (March 14, 2012); Nelson D. Schwartz, "Public Exit from Goldman Raises Doubt over a New Ethic," *The New York Times* (March 14, 2012).

[33] Indeed, a recent study by the Institute for Policy Studies suggests that rather than rewarding chief executives for making their companies more innovative and efficient enterprises, the best paid CEOs were actually being rewarded for having the best tax lawyers, those who were most effective at locating socially dubious tax loopholes and devising methods for reducing the taxes to which their companies were otherwise exposed, rather than actually improving their company's products, marketing, or efficiency. See David Kocieniewski, "Where Pay for Chiefs Outstrips U.S. Taxes," *The New York Times* (August 31, 2011). To the extent that this is even a valid basis of reward, implementing aggressive tax strategies devised by others is surely not something that can be done only by a handful of select individuals.

Second, while some people will no doubt go wherever the pay is best, many of the talented individuals among this group will be less ready to leave their positions for greater pay in foreign lands (assuming such positions were available) than those who are concerned about this are going to claim. Almost everyone has some non-monetary ties to their community, and for many these ties are sufficiently strong that they will not be willing to leave their community for a foreign one simply for a somewhat greater economic reward. At least this is likely to be the case as long as the lifestyle they are able to afford at home is already quite good, which it would be even if we were to cap their compensation. For example, Kenneth Feinberg (the special master for executive compensation charged with overseeing the compensation of the twenty-five highest earners at five companies that received US government bailouts) reports that 85 per cent of the previously highly-compensated executives at these companies remained in place despite receiving modest and in a few cases significant pay cuts, and these individuals would not have even had to leave the country to reap greater rewards.[34] Several other recent studies have confirmed that high-earners rarely relocate even within their home country simply because there would be some financial benefit from doing so.[35] After all, what's the point of earning a high income if you can't live where you want to live, where you already have family and personal ties and where you can be at the cultural center of things, which is why so many wealthy individuals remain based in expensive metropolitan areas and/or in high-tax states when they could easily live somewhere else. And remember, even though the ultimate wage profile among all workers would be significantly flatter under our theory of exploitation than it is now, people at the top of the income distribution would still get paid a lot relative to the rest of us, so there would still be ample incentive for those with the ability to do so to seek positions of responsibility that require large amounts of expensively acquired expertise. In any event, almost all wages currently on offer to skilled workers already fall within the permissible range; only those at the very top of the current income distribution would be affected were our theory of exploitation to be implemented and enforced, and this number is relatively small.[36]

[34] See Eric Dash, "Few Fled the Companies Restrained by Pay Limits," *The New York Times* (March 22, 2010).

[35] See Gretchen Morgenson, "C.E.O.s and the Pay-'Em-or-Lose-'Em Myth," *The New York Times*, (September 22, 2012); Cristobal Young and Charles Varner, "Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment," *National Tax Journal* 64:2 (June 2011): 255–84; Jeffrey Thompson, "The Impact of Taxes on Migration in New England," Political Economy Research Institute, University of Massachusetts, Amherst (April 2011).

[36] The number of people affected, of course, depends on where we put the maximum. For example, if we put it on the top 0.01 per cent of the US income distribution—those who made over $7.8 million in wages and bonuses in 2010 and an average income of $16.3 million ($23.8 million if you include capital gains), this would affect only about 15,617 tax units (a tax unit is a return, single or joint). See T. Piketty and E. Saez, "Income and Wage Inequality in the United

Among this already very privileged group, of course, decisions between employment opportunities would have to be based on something other than the amount of compensation on offer, so talent would not be allocated strictly according to economic reward, but I do not see why this should be considered problematic. People often have to choose between employment opportunities that offer equivalent compensation, and I see no evidence that this often or even sometimes leads to decisions that are bad for either employer or employee. Employers will simply have to compete with each other by convincing those they want to recruit that joining their firm will be more fulfilling in some way than whatever other opportunities the potential employee has on offer. Relying on such non-financial criteria to match employers and employees is not necessarily a bad thing; indeed, it may be a very good thing, leading to a better "fit" between position and employee. And once again, given the height of the compensation ceiling we are talking about here, the number of occasions on which employers and employees are likely to have to rely more heavily on non-financial criteria is likely to be small.

6.4 Minimum Prices and Public and Private Goods

With regard to minimum prices for goods other than labor, enforcement depends on whether the good at issue is properly classified as public or private. Private goods are both *excludable*, in the sense that the good can be made available to some without being made available to everyone, and *rivalrous*, in the sense that consumption of the good reduces the amount available for consumption by others.[37] A peanut butter sandwich is a private good—others can be excluded from enjoying it and when it is consumed there is nothing left to be consumed by others. Public goods, in contrast, are non-excludable and non-rival, at least to a significant extent (goods that are entirely non-excludable and non-rivalrous—in other words, *pure* public goods, are rare). National defense, for example, is a public good—if it is made available, it is equally available to everyone, and the enjoyment of the good by some does

States, 1913–2002," in *Top Incomes over the Twentieth Century*, ed. A. B. Atkinson and T. Piketty (Oxford: Oxford University Press, 2007), 144, 187, and Saez, "Striking it Richer: The Evolution of Top Incomes in the United States (Updated with 2009 and 2010 estimates), <http://elsa.berkeley.edu/~saez/saez-UStopincomes-2010.pdf>. Even if we put it on the top 0.1 per cent, those with income of at least $1.5 million and an average of $3.7 million ($4.9 with capital gains) in 2010, this would affect only about 120,000 tax units, leaving over 267 million tax units untouched. See The World Top Incomes Database, available at <http://g-mond.parisschoolofeconomics.eu/topincomes/> (note that the figures for the number of tax units here are as of the year 2000 and as of 2010 would presumably be slightly higher). Initially, at least, I would expect the cap to be set somewhere between these two bands.

[37] See generally Michael Taylor, *The Possibility of Cooperation* (Cambridge: Cambridge University Press, 1987), 7–11, 55–8.

not reduce the amount available for enjoyment by others. With regard to private goods, sales below cost that do not result from fully competitive market pressures are already prohibited in most liberal capitalist countries, and there are multinational unfair competition and antidumping agreements that prohibit this in the international arena as well.[38] All that is required is that we ensure that cost is defined as average total social cost of production rather than in some other way. With regard to pure and even partial public goods, in contrast, there is at least some justification for spreading their cost over more than just the direct consumers of these goods. If everyone benefits equally from a particular public good, as is the case with national defense, then we have at least some reason to think that everyone should pay equally. But if direct consumers benefit more, as is the case with users of highways, airports, national parks, and similar public goods, goods that are only partially excludable (you can charge user fees for such goods but non-users will still benefit from their existence) and are non-rivalrous only up to a point (as is the case when additional users reduce the amount of the good available to be enjoyed by everyone else only after a certain level of crowding is reached), they should pay more, although others who benefit to some lesser degree can rightly be required to pay some share too. In this latter case, the direct consumer may pay only a portion of the average total social cost through user fees, with the remaining portion of this cost borne by the less direct beneficiaries of the good through some sort of taxation. In any event, as it has at various times in the past, a combination of government and private enforcement should be sufficient to ensure that the relevant minimums are not violated.

6.5 Maximum Prices and the Redistribution of Excess Profits

With regard to maximum prices for goods other than labor, very little government involvement should be required. Nothing like the War Industries Board ("WIB"), which set maximum prices for certain key industries in the US during World War I, or the Office of Price Administration ("OPA"), which set

[38] In the United States, predatory pricing—that is, sales below cost with predatory intent—is a violation of section 2(a) of the Robinson-Patman Act, 15 U.S.C. § 15(a), and section 2 of the Sherman Act, 15 U.S.C. § 2. See generally Patrick Bolton, Joseph F. Brodley, and Michael H. Riordan, "Predatory Pricing: Strategic and Legal Policy," *Georgetown Law Journal* 88 (2000): 2239–330. In most US states, selling below cost is also a violation of state unfair competition laws. See, e.g. CA Bus. & Prof. Code §17043. Sales below cost can also be a violation of Article 82(c) of the EC Treaty. See generally Gunner Niels and Adriaan ten Kate, "Predatory Pricing Standards: Is There a Growing International Consensus?" *Antitrust Bulletin* 45 (2000): 787–809. And international sales below cost are generally prohibited by the Agreement on the Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (the "Anti-Dumping Agreement').

maximum prices for non-agricultural commodities in the US during World War II, would be necessary or even helpful.[39] Remember, the maximum is very generous, and will usually be well above the market price that a good can command in any market that lacks high barriers to entry. Absent worldwide war or other special circumstances that dramatically increase short-term demand in industries in which there are high barriers to entry, any good that is able to be sold at a price that is more than 100 per cent over its average total social cost will attract so many new entrants into the market that this extreme degree of profitability is going to be very short-lived, and no government intervention will be required. And where there are high barriers to entry, the solution is simply to regulate the market to replicate the competitive conditions that would otherwise apply, something that governments already do now with regard to non-competitive markets. So the prohibition on sales at more than 100 per cent above the just price can be mostly left to the market to enforce. Any lingering concerns can be dealt with through a combination of government regulation and private enforcement, as has traditionally been the case under the doctrine of *laesio enormis*.

The limit that does provide a serious enforcement challenge is the one that requires the distribution of profits between the risk-adjusted maximum that goes to the seller exclusively and the 100 per cent ultimate cap. Under our theory of exploitation, these are supposed to go to those who contributed to the creation of such profits in proportion to each contributor's respective share of the cost of production, and so we need to ensure not only that these profits are identified and that those who initially received them are not allowed to keep more than their share, but also that these profits are redistributed in the right amounts to the right people. Leaving this entirely to private enforcement is likely to create difficulties, primarily because the information required to make this determination, even for publically traded companies, is not generally publically available. Those who are entitled to share in these proceeds will therefore often not know of their entitlement. Because there is no way for anyone to know if there is a share to which they are entitled in advance, a great deal of speculative litigation might ensue, and the claims contained therein might require large amounts of documentation to adjudicate, meaning that the resolution of such claims will require all sides to incur large amounts of time and expense. The best way to enforce this right is accordingly going to be through government-mediated collection and

[39] For a discussion of the operation of the WIB and its successes and failures, see Robert Cuff, *The War Industries Board: Business and Government Relations During World War I* (Baltimore: John Hopkins University Press, 1973). For a discussion of the OPA and its successes and failures, see J. K. Galbraith, "Reflections on Price Control," *The Quarterly Journal of Economics* (1946): 475–89. For a more general discussion of price control, see John Kenneth Galbraith, *A Theory of Price Control* (Cambridge, MA: Harvard University Press, 1952).

redistribution. In other words, instead of imposing the burden on each taxpayer—that is, each individual or firm, as the case may be, to redistribute the relevant profits from each especially profitable transaction to the taxpayers that helped create such profits, we use the usual government tax reporting and collection system to do this for us. But to avoid the administrative burden of reporting and redistributing nominal amounts, we require that transactions be reported only if they generate over the requisite percentage *and* a certain dollar amount of profit, either individually or cumulatively as a class or activity, and provide that once reported, such transactions or activities are no longer subject to private actions for enforcement. The requisite reports would show the costs incurred in the transaction or activity and the taxpayer identification numbers of those to whom they made payments so the identity of those entitled to redistributive payments and the amounts due could be calculated. There would be penalties for inaccurate reporting, but private parties would not be entitled to go behind the claims contained in these reports themselves, once again to ensure that any private litigation is kept to a minimum. Lesser transactions and transactions that are not reported in violation of these requirements would be subject to private enforcement, but the transaction costs of bringing such an action should ensure that the number of frivolous actions for redistribution is no greater than what we already experience with regard to other claims.

While it is true that the preparation of the reports required to facilitate the disgorgement and redistribution of these "level two" profits would impose an additional administrative *reporting* burden on certain taxpayers, for these reports would have to be somewhat more detailed than most firms currently file, no additional *record-keeping* burden would actually be imposed. Indeed, it is difficult to imagine that a firm that did not know the cost and profitability of its various product lines and business activities could stay in business very long. So all we would be doing is requiring firms to disclose information they already collect and maintain, a task which is becoming only easier and easier to manage given the computerization of record-keeping and general business operations.

Actually, such "segmental" financial reporting was required by the Federal Trade Commission ("FTC) for a short period during the 1970s, and there are strong independent regulatory reasons for requiring it again regardless of its usefulness in implementing our theory of exploitation.[40] Such information is at least helpful (and probably essential) if the government is to be able to design and enforce sensible antitrust legislation, competently manage

[40] For a discussion of the FTC initiative and the reasoning behind it, see, Frederic M. Scherer, "Segmental Financial Reporting: Needs and Trade-Offs," in *Business Disclosure: Government's Need to Know*, ed. Harvey Goldschmid (New York: McGraw-Hill, 1979), 3–57.

inflation and unemployment and otherwise shape well-informed macroeconomic policy, accurately identify industries and activities in which resources are currently underinvested and otherwise assist both regulators and investors to impose pressure on firms to maintain a more efficient allocation of resources, facilitate more meaningful economic studies of industry performance, enable managers and investors to evaluate the performance of their firm's specific activities against industry averages, and so on. Indeed, given the number of benefits that would flow from such a reporting requirement, it is difficult to understand why the FTC's 1970s initiative generated such vociferous opposition from management, and how those opposed to it managed to quash the growing support for the FTC program coming from a variety of other government agencies. If one were being cynical, one might be inclined to conclude that the source of management's opposition was its fear that greater information would invite greater regulation, and greater regulation would limit their respective firm's ability to engage in what were profitable but would also be revealed to be socially pernicious business activities and practices. In any event, given the weight of the reasons supporting segmental financial reporting, any additional administrative burden such a reporting requirement would impose seems well worth the cost.

Along with reporting additional information, of course, producers would also have to turn over any profits received that exceed the appropriate risk-adjusted amounts to the government for redistribution to those who helped create them in proportion to their respective contributions to the cost of production. The amount to be turned over would be calculated by taking the ratio of outside cost to value added by the producer, a calculation that is made every day in societies that impose a value added tax, although not currently at the required level of detail, but once again, this calculation would be based on information the taxpayer already maintains and there is no reason to think that this calculation is too difficult or burdensome to make.[41] While no producer is going to be happy about having to turn over a portion of its profits to someone else, remember that many producers will have no profits that exceed the appropriate risk-adjusted amounts and will accordingly have nothing to report much less turn over. And producers who do have something to turn over may receive offsetting redistributive payments from

[41] On the calculation and reporting requirements of the value added tax generally, see A. Schenk and O. Oldman, *The Value Added Tax: A Comparative Approach* (Cambridge: Cambridge University Press, 2007). For an argument that the United States will have to adopt a value added tax as an additional source of revenue soon regardless of the usefulness of such a tax in generating the kinds of information that will be required to implement and enforce our theory of exploitation, see Reuven S. Avi-Yonah, "Designing a Federal VAT: Summary and Recommendations," University of Michigan Law School, The John M. Olin Center for Law & Economics Working Paper Series, Paper 104 (Berkeley Electronic Press, 2009) (available at <http://law.bepress.com/umichlwps/olin/art104>), and the other papers cited therein.

the profits turned over by someone else, reducing their burden and possibly even making them net beneficiaries of the whole enterprise. Indeed, on a net-net basis, it is likely that more people will be financial beneficiaries than financial losers as a result of the required redistribution, in which case the program is likely to enjoy wide public support.

6.6 The Fear of Full Employment and Inflation

This redistribution of excess profits is also likely to have a calming effect on what we might call "the fear of full employment" among certain segments of the population. Whether this fear is justified or not, it is widely held among those who are currently in a position to appropriate for themselves much of the surplus value that labor produces, and this fear is accordingly a potential obstacle to efforts to reduce unemployment. The concern is that if unemployment drops below a certain level and there is no "industrial reserve army" of workers ready, willing, and able to work for whatever they can get, there is a possibility that the surplus value labor generates and which currently goes exclusively or mostly to the owners of capital and to management can be captured in whole or in greater part by the worker. This would be true even if the worker were not unionized, for the closer one gets to full employment, the less important unions become, because workers do not need to band together to have bargaining power. Full employment accordingly threatens to render the endeavors of the capitalist and of management less profitable, and in extreme cases, not profitable at all, making the capitalist and management dependent on the worker for the means of *their* subsistence. Accordingly, if they want to protect their bargaining power and its corresponding economic reward, those who own capital and those who manage it may see themselves as having reason to resist efforts to reduce unemployment, and to increase their resistance the more successful efforts to reduce unemployment may become.[42]

Unfortunately, this fear of full employment has been encouraged or at least supported since the late 1960s by the work of some prominent economists. Milton Friedman, for example, argued strongly against any deliberate effort to push unemployment below what he called its "natural" level, which in 1968 Friedman thought was about 6 per cent in the United States but is currently thought by most economists (at least prior to the recent financial crisis—now it is not so clear) to be around 4.8 per cent.[43] The argument is that while there

[42] The argument that this fear is an inherent feature of capitalism can be found in Marx in *Capital* (London: Penguin, 1976), ch. 15, sec. 5, p. 557 and ch. 25, sec. 3, pp. 781–94.

[43] See Milton Friedman, "The Role of Monetary Policy," *American Economic Review* 58 (1968): 1–17; Paul Krugman, "How Did Economists Get It So Wrong?" *The New York Times* (September 6, 2009).

is a trade-off between unemployment and inflation, this holds only in the short term, and thus while government can temporarily lower unemployment by taking various inflationary measures, government can force unemployment below its natural level in the long term only by causing the rate of inflation to continuously rise and, more importantly, by causing it to rise at an ever-increasing rate,[44] which is why the natural rate is now commonly called "the non-accelerating inflation rate of unemployment," or "NAIRU" for short. But the natural rate is not fixed—it is ever-changing and therefore hard to calculate, which is why there is little consensus on what it might be at any particular point in time. As a practical matter, it is often pegged at whatever the average rate of unemployment has been for the last few years, at least during periods of stable inflation, and therefore rises and falls with the actual rate.[45] Combine this with the widely-held view among supporters of the natural rate hypothesis that if left alone, the actual rate of unemployment will gravitate toward the natural rate, and the argument for the natural rate of unemployment essentially and very conveniently boils down to this: the safest thing for government to do with regard to the problem of unemployment is nothing, except perhaps in moments of extreme crisis, and even then government's efforts should be measured, short-lived, and tightly controlled, aimed merely at restoring unemployment to whatever level it was at before the crisis.[46] In other words,

[44] See Friedman, "The Role of Monetary Policy," at 11; Milton Friedman "Inflation and Unemployment," *Journal of Political Economy* 85 (1977): 451–72, 458.

[45] See Oliver Blanchard, "Preface," in *The Natural Rate of Unemployment*, ed. Rod Cross (Cambridge: Cambridge University Press, 1995), xiii.

[46] To be fair, rather than doing absolutely nothing to reduce unemployment in non-emergency conditions, proponents of the natural rate hypothesis often advocate taking action to improve the efficiency of the labor market. Suggestions for doing this include establishing retraining programs, making pensions portable, and (most importantly) allowing employers to fire workers without cause and limiting collective bargaining rights. If the labor market were more efficient, the thinking goes, wages would adjust more quickly to supply and demand and once wages adjusted unemployment would return to its natural rate. But we live in a liberal capitalist state, not a totalitarian one. With the exception of retraining programs, which have never had any significant impact on the efficiency of the labor market (see, e.g. James Heckman, "Assessing Clinton's Program on Job Training, Workfare, and Education in the Workplace," NBER Working Paper No. 4428 (1993)), these other means of improving labor market efficiency come at a high price in terms of liberty and autonomy. If we resist giving the government arbitrary power over such important aspects of lives, as many people do, why would we want to give private employers such power, regardless of the effect of this on labor market efficiency? What all these attempts to limit the power and autonomy of labor really are are attempts to turn workers into cans of soup, whose prices naturally behave more efficiently and adjust more quickly to the ebb and flow of supply and demand. Having a job, however, is what gives most people their identity and their sense of self-respect, and so protecting certain features of employment is a matter of human dignity in a way that making the price of a commodity respond quickly and efficiently to market forces is not. Workers, unlike mere commodities, are living, breathing autonomous beings and therefore are entitled to be treated as free men and women with the usual panoply of rights that free men and women typically enjoy. And the protections against arbitrary dismissal and reduction in pay for which unions have fought so hard are essential components of these rights, for they ensure that workers will not be subject to the arbitrary will of another. While employers may simply be responding to impersonal market forces in seeking to reduce wages or dismiss employees, when

full employment is not simply a pipe dream, it is an inflationary nightmare, and is therefore something to be avoided at all costs.

Of course, aiming for full employment does not actually mean aiming for an unemployment rate of zero, for the labor market is dynamic, not static. The rate of people entering and leaving the employment pool will not usually sum to zero; there will always be people looking for different jobs or better ones; some type of skills and the people who have them will become less marketable as a result of technical or cultural change, while other skills and the people who have them will become more marketable. Every economy must leave room for such shifts in the demographics of employment to occur if it is to function smoothly and be able to reallocate labor efficiently and as needed by the development of new technologies and culture. Efforts to reduce unemployment will accordingly always aim to allow some "frictional unemployment" to remain. But no one thinks that the current natural rate is anywhere near the frictional rate (which is probably between 2 and 3 per cent),[47] nor did they think so before the recent financial crisis. And given our current situation (relatively stable high unemployment and stable low inflation), the natural rate is probably rising toward the dismaying rate we are at now, for the natural rate will gravitate toward the current rate of unemployment whenever unemployment and inflation appear to be in equilibrium. The whole idea that the natural rate is something we must never fall below is therefore destined (if not designed) to act as a brake on efforts to decrease unemployment by stimulating the economy no matter how high unemployment might happen to be.

In response, we might point out that the argument that implementation of our theory of exploitation may trigger a greater and ever-increasing rate of inflation is inconsistent with the argument that implementation of our theory will actually *increase* unemployment, not reduce it, given the increase in the minimum wage it requires. Because even adherents of the natural rate theory admit that increases in unemployment usually work to limit rises in inflation in the short term, there is no need to fear the kind of inflation the natural rate hypothesis predicts if that criticism is correct. In any event, the correlation between unemployment and inflation is very weak, even in the short term (at least it is when unemployment is relatively high), there are far better

humans have this kind of power over others we usually see a dramatic increase in corruption and despotism. If workers have no power, managers would be free to demand payoffs and other favors from workers to retain their jobs, and even those who were not so corrupt would be free to make employment decisions on the basis of whim, bias, and prejudice, and there is nothing economically efficient about that.

[47] See William H. Beveridge, *Full Employment in a Free Society* (New York: W. W. Norton & Company, 1945), 127–8.

indicators of what inflation is likely to be, and there are multiple points where unemployment and inflation are in equilibrium and therefore multiple natural rates, including one associated with full employment, if there are any such points at all, making the natural rate hypothesis a very poor guide for economic policy.[48] So even if there is such a thing as a natural rate of unemployment and the redistribution envisioned by our theory of exploitation would cause the actual rate of unemployment to drop below whatever it currently might be, this does not warrant abandoning our efforts to halt exploitation. Inflation can be and usually is well controlled even in times of low unemployment, as it was throughout the post-war years until the 1970s and at many times thereafter, by using various fiscal and monetary techniques.[49] If halting exploitation is indeed a moral imperative, there is no reason to let either the fear of full employment or the fear of inflation interfere with this.

I recognize, however, that those who suffer from a heightened fear of inflation are unlikely to be reassured by this, for critics of minimum wage legislation often argue that such legislation will not only increase unemployment in the short term, it will also increase inflation *despite* increasing unemployment.[50] I suppose the thought is that regardless of their effect on employment, increases in the minimum wage will result in "cost push" inflation, a form of inflation that can arise even in times of high and growing unemployment, as it did (although for other reasons) in the UK and the United States in the 1970s. In other words, the argument goes, experience shows that full or near-full employment may be a sufficient condition for inflation, but not a necessary one. It is possible that increasing costs in times of high unemployment can produce inflation too.[51]

Remember, however, that we will not only be increasing the minimum wage, we will also be imposing a maximum wage, redistributing a portion of the profits generated by extraordinarily profitable activities to suppliers and lenders and all other factors of production and therefore making some currently marginally profitable activities more profitable, and so on. As we shall see in a moment, we will also be incorporating the cost of certain environmental and other externalities into prices, and while this may cause some prices to rise, it should cause the overall cost of living to fall, for there will now be an incentive for producers to prevent injuries caused by their products

[48] See James K. Galbraith, "Time to Ditch the NAIRU," *The Journal of Economic Perspectives* 11 (1997): 93–108. See also each of the various essays included in *The Natural Rate of Unemployment*, ed. Rod Cross (Cambridge: Cambridge University Press, 1995) as well as the introduction by Rod Cross.

[49] See Michael Stewart, *Keynes and After*, 3rd edition (London: Penguin Books, 1986), at 177–202.

[50] See Jerold L. Waltman, *Minimum Wage Policy in Great Britain and the United States* (New York: Algora Publishing, 2008), 14–15.

[51] See Stewart, *Keynes and After*, 150–66.

because they will no longer be able to fob the cost of these injuries off onto someone else. With the introduction of such incentives, injuries should go down, for it is usually cheaper to prevent an injury than to repair it or compensate the injured party after it has occurred, and besides, once the costs of prevention or future compensation are taken into account and the good's price adjusted accordingly, a more socially optimal amount of the good will be produced. And when the number and extent of injuries decline, the overall cost of living should decline as well. So some costs and probably some prices will rise, but other costs and other prices should fall, and the net macroeconomic effect of all these various changes, if introduced together carefully and incrementally, is more likely to reduce the overall cost of living rather than increase it. At worst, these changes should be neutral with regard to the cost of living. There is certainly no reason to believe they will generate the kind of economic shock necessary to trigger cost-push inflation in the midst of high unemployment.

But proponents of the natural rate hypothesis may argue that regardless of what effect the elimination of exploitation would actually have on the overall cost of living, it can still be inflationary because inflation can result not only from objective economic changes but also from changes in psychological attitudes. In other words, it is not economic shocks that produce inflation—or at least it is not only economic shocks—inflation simply is whatever people happen to expect it to be. If people expect inflation to be 3 per cent, workers will adjust their wage demands and producers will adjust prices accordingly and 3 per cent inflation will result. Like the expectation that there will be a run on the bank, an expectation that triggers the run itself, the expectation of inflation becomes a self-fulfilling prophecy—think it and it shall be so. It is therefore absolutely critical that we keep inflationary expectations under control whenever and wherever they happen to arise, no matter what the current rate of inflation happens to be.[52]

While this view has a significant number of powerful committed followers, the phenomenology of the process supposedly at work here has yet to be persuasively explained. What does it mean to expect inflation? The theory seems to presume that people routinely assign a number to their expectations, but surely most people do not think about inflation with anything like this

[52] This is why there has been such vociferous opposition to the Federal Reserve's recent program of quantitative easing. The program is designed to increase the amount of money in circulation, but the more money there is in circulation the less each individual unit is worth and the more inflation is likely to result. At least that is what people might think, so if expectations are what matter, then the Fed's quantitative easing program could indeed encourage people to readjust their expectations of inflation upward, causing higher inflation to result. See Paul Krugman, "The Intimidated Fed," *The New York Times* (April 28, 2011). Of course, even if this were correct, inflation would be quite low, maybe even too low, but this is an argument that is better pursued elsewhere.

kind of precision. And who exactly must have these expectations, regardless of their precision? We are not talking about the customers of a particular bank or financial institution here, a group whose number is finite and whose identities are known or discoverable—many, many people must expect inflation to rise for it to actually do so. What percentage of the population is enough? Fifty-one per cent? Something more? Something less? Few people actually have the kind of direct control over wages or prices that the theory posits, so why should the expectations of the average man on the street matter as much as the expectations of corporate managers and the heads of labor unions? Given that only 11.8 per cent of workers are unionized,[53] however, how are the expectations of labor leaders supposed to result in increased wage demands by all workers?[54] And if this does not happen, how are the expectations of non-union workers supposed to turn into across-the-board demands for uniformly higher wages, let alone demands that employers have to meet? To be fair, Friedman acknowledges that the requisite expectations may take years to form, and years to change, and perhaps even decades.[55] But what happens when inflation is erratic, rather than stable over time—what are people likely to expect then?[56] And what happens if people have conflicting expectations, as they often do? Finally, what if people (not implausibly) have no expectations at all with regard to inflation over the long term, but only form expectations regarding the short term? Is this enough to drive inflation up or down, or are these short-term expectations too unstable and volatile to have any effect?

These questions may be difficult to answer, but some early proponents of "expectations explanation" of inflation claim to have found a way around them. We do not need to know what people actually expect because we can safely assume that people's expectations are rational—that is, while expectations may vary greatly from individual to individual, "people" on average expect inflation to be whatever economic theory predicts it will be; all departures from this view will be randomly distributed and therefore will cancel each other out.[57] So all we need to know is what these predictions are; we need not

[53] See Greenhouse, "Union Membership Rate Fell Again in 2011."

[54] See Eduardo Porter, "Unions' Past May Hold Key to Their Future," *The New York Times* (July 17, 2012) ("[Unions] today are too weak to be standard-setters").

[55] Friedman, "The Role of Monetary Policy," at 6.

[56] Although it is not entirely clear, Friedman seems to think that in this case people are likely to expect that inflation will be as high as the highest it has ever been during this period of erratic fluctuation and act accordingly, ensuring that high inflation will result. Friedman, "Inflation and Unemployment," at 466–8. But this would mean that inflation could only be erratic over the short term, for this would produce stable expectations of high inflation and from these expectations stable high inflation should result. The very figures that Friedman himself relies on, however, show this not to be the case. See Friedman, "Inflation and Unemployment," at 461.

[57] See John F. Muth, "Rational Expectations and the Theory of Price Movements," *Econometrica* 29 (1961): 315–35, 316 ("expectations, since they are informed predictions of future events, are

make any effort to determine what people actually believe. Economic theory tells us what inflation will be and this is what inflation will be, at least absent corrective action, not because the underlying reasoning of our economic theory is correct but because correct or not, the predictions of economic theory (and therefore the predictions of the economic experts who give voice to what economic theory predicts) are what create expectations and expectations are what actually cause inflation to rise or fall. So if economists predict inflation we have to take their concerns seriously and do whatever we can to satisfy those concerns, because if we don't their concerns will become reality no matter how baseless they might be.

In examining this argument, let me begin by noting that there seems to have been surprisingly little attention paid to the assumption that when people's views about inflation rate diverge from what economic theory predicts inflation will be, these will be randomly distributed and will therefore cancel each other out. Most people will not have sufficient economic knowledge or training to form their own opinion as to what economic theory predicts, and will therefore have to rely heavily on what they hear in the media. But the media can have its own agenda, and can be captured by moneyed interests, so there is no reason to assume that the impression people have of what economic theory predicts will indeed be what economic theory predicts or that departures from this will be randomly distributed. Public perception of economic theory can easily end up skewed in one direction or the other. And since the rational expectations theory predicts that inflation will be what people expect it to be, there is no corrective mechanism available in this process—in other words, there would be no opportunity for people to "learn" to distrust the media on this because if the rational expectations theory is correct there will be no opportunity for people to see the real inflation rate diverge from what was predicted in the media and therefore expected. So the theory does not really predict that inflation will be what economic theory predicts, it merely predicts that inflation will be what people think economic theory predicts, and this can bear little relation to what it actually predicts.

But let's ignore this problem for the moment and assume that the public's perception of what economic theory predicts will indeed be based on fair and equal exposure to a full range of expert option. Unfortunately, there are problems still. Economic experts rarely agree on what economic theory predicts future prices will be, those with the most accurate views and

essentially the same as the predictions of the relevant economic theory"). I should note, however, that Muth did not develop his theory to support Friedman's natural rate theory; rather, others seized on Muth's theory to bolster the argument for the natural rate. This can be seen, for example, in a series of papers published by Robert E. Lucas in the 1970s. See generally Steven M. Sheffrin, *Rational Expectations*, 2nd edition (Cambridge: Cambridge University Press, 1996), ch. 2.

not necessarily the most persuasive, experts themselves can be corrupted or unduly influenced by outside interests, and experts can be wrong about what economic theory predicts even when they do agree.[58] Which leads us once again to the conclusion that what the rational expectations theory really claims is that the actual rate of inflation need bear little relation to a rational evaluation of economic realities, for it is more likely to be the product of a hodge-podge of conflicting economic views whose persuasiveness has less to do with soundness of each view than with its particular proponent's popular appeal.

There is also no reason to believe that if divergent views were randomly distributed, these would cancel each other out. Those who believe inflation will be high will act in one way; those who believe it will be low will act in another, and those who believe that deflation is right around the corner will act in another way still. Even if a mathematical average of their views is indeed the inflation rate that economic theory predicts, we still have to explain how this cacophony of different and conflicting behaviors is going to average out in the real world. And there is no reason I can think of why we should assume that these behaviors will necessarily lead to an overall rate of inflation that is similar much less equal to the rate around which all these views were randomly distributed.

Finally, there is an important conceptual confusion built into the theory that seems to have gone unnoticed. If inflation were what the general public expected it to be and their expectations were formed by reliance on expert opinion, should not experts form their opinions based on what they expected the general public to believe, and not on traditional economic data? And should not the general public form their opinions based not on what they believed experts to believe, but on what they believed other members of the general public believed that experts believed? And so on into what may be fairly described as an infinitely reflexive strategic reasoning morass. Indeed, if the rational expectations theory of the causes of inflation were correct, it would not be rational to behave in any other way.[59]

[58] See Sheffrin, *Rational Expectations,* for various examples of this.

[59] Keynes put the matter similarly when describing the process of making investment decisions: "Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of who are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees." Keynes, *The General Theory*, 156.

Or would it? With regard to investment decisions, it is rational to assume that investors try to predict what potential buyers and sellers will think of a particular investment in the future. If the investor expects the investment to become more attractive in the future, he will expect demand for it to go up and therefore its price to go up too; if the investor expects the investment to become less attractive, he will expect demand for it to go down and therefore its price to drop. But people can make money regardless of whether the price of the investment goes up or down, so people have no clear uniform incentive to expect the prices of investments to go in one way rather than the other. But with regard to inflation, the matter is not so clear. Even if inflation is in some sense the product of people's expectations, it is not *directly* the product of their expectations; it is the product of their behavior. In other words, what causes inflation to rise is not that people expect it to rise, but that they behave *as if they expected it to rise* (for example, by making higher wage demands). Behavior, however, is not the unmediated product of one's expectations; it is the product of the will. So if inflation is generally regarded as a bad thing (and it seems plausible to believe that overwhelming numbers of people think that inflation *is* a bad thing), why would rational people not simply will themselves to behave as if they expected the rate of inflation to be low? It would be in everyone's interest to do so, because then inflation would be low (if the expectations explanation of inflation were correct), and it is not clear that it would be in anyone's interest to behave otherwise. In other words, if the expectations explanation of inflation were correct, and people believed that explanation to be correct, and believed that other people believed the expectations explanation to be correct, and so on, then it is impossible to explain why inflation ever results. The only way to do so would be to assume that even though the expectations explanation is correct large numbers of people do not believe this to be so, or believe that others do not believe this to be so, and therefore do not realize it is in their interest to behave as if they expected inflation to be low. But these are exactly the kind of systematic errors that the rational expectations theory expressly rules out.[60] Under its own assumptions, then, the expectations explanation of inflation cannot be correct.

But once again, let's simply ignore all these problems. Even so, there is still nothing in the expectations explanation of inflation to suggest that reducing exploitation can be purchased only by raising expectations of and then accepting accelerating rates of inflation. The theory posits that inflation will rise once people have settled expectations that an upward change in the rate

[60] See William J. Baumol and Alan S. Binder, *Macroeconomics: Policies and Principles*, 12th edition (Mason, OH: South-Western Cengage Learning, 2011), 347. In other words, what we have is a coordination game in which everyone does better if they act as if inflation will not rise, they have no reason to act in any other way unless they fear that others may act irrationally, and the assumptions of the game rule that possibility out.

of inflation has occurred. Assuming that the changes recommended by our theory would mean that the overall cost of living will rise (something that is probably not true), these changes and therefore this rise would be a one-off, or perhaps a two- or three-off but not a long-term continuing phenomenon. There is accordingly no reason to believe that people will adjust their long-term inflationary expectations upward. And there is certainly no reason to believe this will trigger expectations of a continuously rising and therefore *accelerating* rate of inflation. Even if the natural rate theory is true, then, and we cannot reduce unemployment by accepting higher rates of inflation unless we accept ever higher and higher rates of inflation, this does not suggest that limiting or even eliminating exploitation will trigger a rise in inflationary expectations, much less provide a basis for accelerating inflation to result. If the natural rate hypothesis establishes anything at all, it establishes that there is a causal relationship between inflation and unemployment that works in one direction—rising and accelerating rates of inflation will cause unemployment to decrease. Nothing in the theory suggests that reducing unemployment will cause rising and accelerating rates of inflation to result until we approach full employment (for remember, it is the pressure of this that is supposed to lead to increases in wages, which leads to increases in prices, and so on), or that the *only* way to reduce unemployment is to endure rising and accelerating rates of inflation. Indeed, the claim that some natural rate theorists make to the contrary sounds suspiciously similar to the classical view that over the long-term the market will naturally produce full employment and government efforts to speed this process along are almost inevitably counterproductive,[61] a view that Keynes persuasively debunked back in 1936.[62]

There is also good reason to believe that the elimination of or even a mere reduction in exploitation will actually serve as a governor on inflation rather than as a trigger of it. Wage demands may go up if workers are afraid of oncoming inflation, and rising prices of the goods they produce may then follow. But wage demands may also go up even though workers do not see inflation coming if they see their employers raking in excessive profits that are not being shared out except to the most highly-compensated executives within the corporation. By ensuring that this is not the case, implementing and enforcing our theory of exploitation is just as likely to have a sedating effect on inflationary pressures as a stimulating one. So I don't see how the obsessive fear of triggering inflation among some segments of the business

[61] For further comments on this similarity, see James Tobin, "Inflation and Unemployment," *American Economic Review* 62 (1972): 1–18, 2.

[62] See James B. Stewart, *Keynes and After*, 3rd edition (London: Penguin Books, 1986), ch. 4–5.

and economic establishment actually amounts to an argument against doing something about exploitation.

Despite all this, it is no doubt fair to assume that some people will remain unconvinced, or will see it as in their interest to remain unconvinced, and will therefore oppose implementation and enforcement of our theory of exploitation because what they really fear is that this would limit and perhaps even eliminate the amount of surplus value otherwise available for their appropriation. Remember, however, that under our theory of exploitation what is at stake is no longer this entire surplus, but only that portion of surplus value that falls within the range of tolerable unfairness. This range is the same for both the capitalist and the worker, and even if one side manages to outmaneuver the other, anything in excess of the risk-adjusted expected rate of return has to be redistributed to each party in proportion to his or her respective contribution. Labor would not be able to capture the entire surplus for itself even under conditions of full employment, and capital and management would not be able to capture the entire surplus for themselves even in the presence of an industrial reserve army. But neither group can complain about *that*, for were they to do otherwise they would be exploiting the other. So there is nothing to fear about the fact that our theory of exploitation should move us at least a little way toward full employment.

And a little way is all we are likely to go, because I do not expect or contend that unemployment would magically disappear if our theory of exploitation were implemented and enforced. Achieving full or near full employment would require a myriad of government policies designed to stimulate economic growth while at the same time managing to control inflation, and I do not pretend to have a blueprint for what those policies might be, although much greater government support for technical and cultural innovation would undoubtedly be part of it. But implementation and enforcement of our theory of exploitation would remove much of the incentive to resist efforts to address the unemployment problem. By solving the exploitation problem, we also contribute something to solving the problem of unemployment too.

6.7 Maximum Profitability and the Recognition of Income

I now want to talk about what happens to those lucky few who find themselves at the top of the long stick at the far right of a right-hand skew distribution, where the return, even after being adjusted for inflation and to reflect a broad idea of the good involved (for example, after the good is defined as “new drugs” rather than a particular new drug), exceeds and perhaps vastly exceeds 100 per cent. For reasons that I have already discussed, this is unlikely to happen with regard to the sale of goods that take the form of basic commodities, and it cannot happen for the sale of goods that take the form of services because this degree of over-compensation will simply be prohibited. But it can happen for the sale of goods that take the form of or are produced through the use of protected intellectual property, and most importantly, it can happen with regard to goods that take the form of stock and even land, with or without associated mineral rights. While such super-appreciation is much more rare than the general public is apt to believe, stock held by the founding entrepreneurs of an extremely successful start-up company does occasionally rocket up in value in just a few years, and stock in any successful company as well as certain parcels of land can increase substantially in inflation-adjusted value if held for a long enough period. We do want to ensure that the 100 per cent limit our theory of exploitation imposes on maximum profitability is respected, but we also do not want to force people in such a position to divest themselves of assets that may be highly productive in large part due to their own efforts, or even force passive investors to sell assets when there are good business reasons or perhaps even just good personal reasons to keep holding them.

One way to do this, of course, would be to require the lucky owner of an inflation-adjusted super-appreciated asset to sell his holdings and simply buy them back at once on the open market, thereby forcing him to recognize his gain and stepping up the cost basis of the asset. This might be an acceptable approach for the passive investor in a public company, but not for the passive investor in a private company whose shares are not easily marketable and certainly not for the founding entrepreneur of either a public or private company, for the founders would not want to risk even a temporary loss of control. We could of course merely require a kind of fictional transaction, one in which no sale actually takes place but any unrecognized gain is recognized for tax purposes and the cost basis of the asset is accordingly stepped up to what would have been the much higher repurchase cost had the sale and buy-back actually taken place. The problem here is that a substantial tax gain is realized, and without the actual sale of some or perhaps even all the asset involved, the owner may not be able to pay the taxes that would be due, much less redistribute gains in excess of the risk-adjusted rate of return to those beside himself who contributed to their production, although it seems unlikely that there would be any such persons in most circumstances in which this problem would arise. While the owner should of course have the option of paying whatever taxes are due and making the necessary redistributions at the time this fictional transaction takes place, there is a better way to deal with such cases. This is to defer the taxes due and any required redistribution payments until the asset is otherwise sold for business or personal reasons. This allows the holder to offset any losses that later occur through falls in the value of the asset against the rises that led to the fictional sale. The taxes due would be adjusted for inflation but not for interest, because the due date for payment would not have yet occurred. There would be no risk of loss of control and no unnecessary transaction costs associated with an actual sale and repurchase. And most importantly, this would ensure that a great deal of realized but unrecognized gains do not get passed on tax-free by operation of the rule allowing the cost basis of assets to be stepped up on death, for the maximum amount that the basis of any asset could be stepped up would be 100 per cent. Any gain in excess of this would already have been recognized even though payment of any taxes due would have been deferred until death, subject to exceptions for the transfer upon death of an ongoing business or family home that I shall outline below.

Before I do this, however, let me point out that I am not claiming that forced recognition and deferral is the only way our theory of exploitation could be implemented. With regard to all problems of implementation and enforcement, there will usually be a variety of different approaches that will effectively accomplish the same thing. The choice between these is driven by practical and perhaps even cultural considerations that may vary from liberal capitalist society to society. By making the proposal above, I am accordingly not suggesting that any particular approach to implementing and enforcing our theory of exploitation is set in stone. I am merely demonstrating that there is at least one way that our theory of exploitation could be implemented and enforced that is consistent with its underlying concerns and the underlying concerns of political liberalism and capitalism upon which our theory of exploitation relies.

6.8 Exploitation and the Estate and Gift Tax

One very important element of any program of implementation and enforcement of our theory of exploitation would be the effective use of an estate and gift tax, which would go well beyond merely limiting the operation of provisions allowing for a stepped-up basis on death. By definition, if there is any net positive value in an estate after the decedent's debts are paid, there are only two lawful ways for the decedent to account for this. First, these remaining assets could themselves be the remnants of an inheritance or genuine *inter vivos* gift. To the extent this is the case, there may be reason to tax this portion of the estate, but this reason does not arise out of our theory of exploitation, for these assets were not acquired through exploitation. Second, these assets could have been generated by lawful transactions that the decedent entered into during his lifetime. To the extent this is the case, we then need to determine whether the current market value of these assets exceeds the inflation-adjusted equivalent of their cost of acquisition. If this is the case, and it often will be, then this excess can only be the proceeds of unjust (although not necessarily exploitive) transactions, because the only way to accumulate capital over one's lifetime is to profit from one's exchanges, and the only way to do this is to sell goods for more than their cost of acquisition. (Note that even if there are no such assets left, this does not mean that the decedent never engaged in any unjust transactions, for he may have simply consumed or otherwise disposed of all the profits generated by those transactions before he died. But if there are such profits left, then the decedent must have generated them through unjust transactions.) There may be some tracing problems in deciding what portion of the estate to attribute to gifts or inheritance and what portion to attribute to profitable *inter vivos* exchange transactions, although this could be done quite easily if the beneficiaries of gifts above a certain figure (say, $10,000) were simply required to report these as and when received. But these kinds of accounting questions are nothing new; with the proper record-keeping requirements in place, we should be able to resolve these issues simply by applying generally accepted accounting principles. The important question is how should these remaining transactional profits be distributed?

Once again, the answer our theory of exploitation provides is that we must draw a line between tolerable and intolerable unfairness. Under capitalism, we must allow some earned wealth to be passed down, for accepting capitalism means accepting that people need incentives to maximize their productive capacity, and one such incentive is the ability to provide a respectable quality of life for one's family after one is gone. Presumably an estate of 100 per cent of the average cost of producing a highly-compensated individual times the number of children of the decedent discounted to present value, plus enough to support a surviving spouse and any other dependents in the style to which they have been accustomed, would meet or exceed this test. Indeed, one could argue that this is far too generous an allowance, for individuals whose lives have already been fully funded are more likely to end up as non-productive members of society, or at least as less productive than they would have been had they had to generate some of the financial wherewithal necessary for their support on their own.[63] It may be that after sufficient experience on the effect of this more generous allowance it will become apparent that a lesser incentive is all that should be tolerated. But this is an empirical matter, the final resolution of which will have to await the collection of the requisite data. Until then, it seems best to begin by being generous.

There is one caveat to this. In some cases, even this generous allowance may not be generous enough. It may be the case that an estate's capital assets, like land, plant, and equipment, are much more valuable if liquidated than if the

[63] Many theorists have expressed a similar view on this point. See, e.g. J. S. Mill, *Principles of Political Economy*, bk. 2, ch. 2, sec. 4, pp. 287–91.

business they represent is valued as a going concern, like a family farm. In these cases, we should nevertheless value these assets as a going concern, if that is how those who stand to inherit them intend to employ them. To ensure that the decedent's beneficiaries do not misrepresent their intentions here, the tax on the estate could be initially calculated on the basis of liquidation value, but payment of this tax deferred for a number of years, with the tax reduced and eventually extinguished as long as the relevant assets continue to be employed in the business and the business remains ongoing and viable during that period. This would ensure that individuals who create a business because they wish to pass it on to their children have the ability to do so.

In any event, regardless of where we set the limit on the value of assets that can be passed by will or intestate succession from one generation to the next, people who leave an estate greater than this which is not itself the result of an *inter vivos* or testamentary gift have necessarily accumulated more profits over their lifetimes than our theory of exploitation allows. And while this excess should technically be returned to those who were actually exploited by the decedent, identifying each individual who was exploited by the decedent over his entire life is simply not practical. Returning these profits to the general fund will accomplish at least rough justice, and while this might be a second-best solution, it is far more desirable than simply allowing the decedent to determine who benefits from these intolerably unjust profits himself. Indeed, while this remedy may be imperfect, we at least have a justification for taxing estates that is consistent with but more specific than what other liberal theories of distributive justice are able to provide.

For example, compare this to the way that the inheritance of wealth is regulated by the difference principle. Rawls says, "The unequal inheritance of wealth is no more inherently unjust than the unequal inheritance of intelligence . . . Thus inheritance is permissible provided the resulting inequalities are to the advantage of the least fortunate and compatible with liberty and fair equality of opportunity."[64] In other words, to determine the extent to which, if any, the difference principle limits the inheritance of wealth, we have to determine whether this helps or hurts the least advantaged. This, in turn, depends upon what effect limiting such transfers would have on the desire of those in a position to be more productive to produce more. The tests employed by the difference principle and our theory of exploitation accordingly appears to be quite similar. But the limits imposed on inheritance by our theory of exploitation are not so easily evaded, since the difference principle would allow such transfers of wealth as long as they provide *any* incentive to

[64] Rawls, *A Theory of Justice*, 245.

the more advantaged to be more productive and thereby improve the position of the least advantaged, whereas our theory of exploitation would find the unfairness of this intolerable well before such an incentive effect was exhausted. Indeed, under our theory of exploitation, the benefit of providing additional incentives would always have to be balanced against the continuing unfairness of allowing ever greater accumulations of unjustly acquired profits. Thus, while the difference principle would justify the imposition of estate and gift taxes in theory, it is unlikely to lead to the imposition of any significant estate and gift taxes in practice. The cut-off on the amount of wealth that could be passed on under our theory of exploitation, in contrast, would come in at a much earlier stage than it would under the difference principle, if it would come in under the difference principle at all.

But Rawls does not rely solely on the difference principle to determine the extent to which inheritance is permissible—indeed, before we even get to the restrictions on inheritance imposed by the difference principle, whatever these may be, we must first satisfy ourselves that whatever principle of inheritance we have under consideration is consistent with the lexically prior principles of equal basic liberties and fair equality of opportunity. If these principles do impose limits on inheritance, however, these limits are rather indeterminate, far more indeterminate than the limits imposed by our theory of exploitation. More importantly, however, whatever limits these principles create would be available under our theory of exploitation too, for our theory assumes that the background conditions of political liberalism are already in place, which means that the principles of equal basic liberties and fair equality of opportunity or some set of principles very much in this vein are already in force. So while in all likelihood our theory of exploitation does a much better job of regulating inheritance than justice as fairness does even if we take that theory as a whole, at the very least, our theory of exploitation does no worse.

There is one other Rawlsian principle I should perhaps mention, and this is the just savings principle. The just savings principle requires that we accumulate and then transfer to the next generation some amount of capital, but only under certain conditions. In *Justice as Fairness*, Rawls put it like this: "Real saving is required only for reasons of justice: that is, to make possible the conditions needed to establish and to preserve a just basic structure over time. Once these conditions are reached and just institutions established, net real saving may fall to zero. If society wants to save for reasons other than justice, it may of course do so; but that is another matter."[65] The first point to note is that it is not clear that the just savings principle would actually require allowing inheritance by individuals at all, at least not in well-developed liberal

[65] John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: Harvard University Press, 2001), 159.

capitalist democracies, for it seems unlikely that this would be necessary to preserve and maintain the just basic institutions of society. But more importantly, whatever the just savings principle requires, as Rawls notes it establishes a minimum, not a maximum. The generous allowances for inheritance that would apply under our theory of exploitation certainly satisfies this minimum, so there is no conflict here between the just savings principle and our theory of exploitation.

The same is true with regard to luck egalitarianism. For luck egalitarians, the inheritance of wealth is the classic example of good luck, and luck egalitarians are committed to negating the effects of this by providing special support to those who would otherwise be disadvantaged by their lack of similar good fortune. But they would typically do this by making additional funds available to those who would otherwise be disadvantaged, or perhaps by making certain opportunities available regardless of wealth, thereby limiting the advantages of inheritance, rather than by strictly limiting the ability of others to make or receive such gifts, although sometimes they would do this as well.[66] Once again, however, there is nothing in our theory of exploitation that would prohibit the use of such techniques to the extent they were thought necessary. In any event, the imposition of an estate and gift tax is certainly consistent with the underlying ethos of luck egalitarianism, so there is nothing about how our theory would deal with testamentary gifts to which luck egalitarians are likely to object.

But what of *inter vivos* gifts? If we limit the value of assets that can be transferred upon death, we also have to limit *inter vivos* transfers to avoid wholesale evasion of the limits applicable to transfers after death. And again, the same reasoning would apply to such transfers. To the extent that the assets transferred cannot themselves be traced to gifts or to inheritance, they must represent the profits of unjust transactions, profits that are no longer needed to ensure that the contextual basic needs of the person who generated them are met. They accordingly should once again be returned to those who are entitled to them, but given the infeasibility of that, they should be charged against the applicable estate tax allowances and beyond that subject to the applicable rate of estate tax. If a society wishes to grant a further exemption for charitable gifts and contributions, I see no problem with this, for such gifts seem to be as good a second-best solution to the problem of returning funds to their rightful owners as the estate tax. In any event, this is simply a question to be decided by the relevant political institutions by the usual balancing of our interest in rectifying injustice against the benefits and detriments of the remedies available.

[66] See, e.g. Ronald Dworkin, *Sovereign Virtue* (Cambridge, MA: Harvard University Press, 2000), 348–9.

There is one other important point I want to emphasize. Note that the amounts collected and then redistributed by the government under our theory of exploitation sit on top of the traditional income tax, and by traditional I mean a tax designed primarily to cover the cost of government services. These taxes may (and indeed in my view should) be progressive, and therefore accomplish a certain degree of redistribution too, for as a matter of social policy we may collectively decide that every citizen need not pay the true value of the government goods and services they receive but should pay a share based on their ability to pay.[67] But any redistribution accomplished in this case is a side effect, not an intended one. Indeed, even if we opted for a flat tax, most people would still pay more or less than the average total cost of these goods and services, because the payment due would still be figured on a percentage basis, and so some redistribution would still occur. Only fixed user fees could arguably match the average total cost of the goods and services provided. Whatever we do here, however, this is not determined by our theory of exploitation, for taxation is not a "voluntary exchange transaction" to which our theory would apply. Taxation rates and methods are simply something that must be decided according to other principles of justice.[68] And of course income and other taxes are often designed to encourage or discourage various kinds of behavior and further social goals other than covering the cost of government, and these kinds of taxes are also justified (if they are justified) by reasons external to our theory of exploitation and are acceptable as long as they are determined according to the rules and political presuppositions on which our liberal capitalist system is based. The payments made by those who have received more than their share of profits, as well as any payments out, are not taxes in either the cost recovery or the regulatory or the social engineering sense, but are simply the means by which our theory of exploitation would be enforced in a liberal capitalist society.

6.9 Exploitation and Speculation

The next issue I want to discuss is what the implementation and enforcement of our theory of exploitation would mean for that form of economic activity known as "speculation," which for present purposes I will define as the

[67] See generally Peter Diamond and Emmanuel Saez, "The Case for the Progressive Tax: From Basic Research to Policy Recommendations," *Journal of Economic Perspectives* 4 (2011): 165–90.

[68] For a classic discussion of the various justifications for progressive taxation, see Walter J. Blum and Harry Kalven Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953), 39–70. See also Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw Hill, 1959), 98–110. For a more modern discussion, see H. Peyton Young, "Progressive Taxation and Equal Sacrifice," *American Economic Review* 80 (1990): 253–66.

purchase or sale of a good motivated solely by an expectation of a short-term change in market price rather than a gain effected through some transformation of the good, or through its use, or through its transfer from one market to another.[69] For a time it was thought that speculation had a moderating effect on price fluctuations, and helped direct capital from the production of goods with lower utility to the production of goods with higher utility.[70] But it is now generally accepted that speculation probably has the opposite effect, at least where both parties are acting on a speculative motive. In these cases, speculation is just as likely to lead to greater price instability and direct capital to the production of goods with lower rather than higher utility. Indeed, as Nicholas Kaldor noted, "the day-to-day movements on the Stock Exchange, where considerable changes in prices occur in accordance with the day's political news, could hardly be accounted for on any other ground but on the attempt of speculators to forecast the psychology of other speculators" and thereby outmaneuver them.[71] And when this is what is driving the market, it is hard to see how speculation could move us toward fundamental values and a more efficient allocation of capital and therefore be a contributor to rather than a detractor from the common good.

Of course, speculation can take many forms, and sometimes it may be difficult to tell a speculative activity from one that has a rational and reasonable underlying business purpose. But I shall ignore these fringe cases here and concentrate my discussion on the kind of speculation that is accomplished through the sale and purchase of futures, or options to buy or sell a particular good at a specified price at a future point in time, a kind of transaction that at one time was conducted almost exclusively through established stock and commodity exchanges but which is now often conducted through a large and growing unregulated shadow market in various kinds of derivatives and associated financial instruments, including the by now infamous instrument known as the credit default swap. Because more traditional options trading is both more transparent and better understood, however, I will begin my discussion of the problem of speculation there.

In the stock and commodity markets, options come in two forms: puts (the right to sell a specified quantity of a particular stock or commodity at a specified price); and calls (the right to buy a specified quantity of a particular stock or commodity at a specified price). Both puts and calls can be bought or sold, and the positions taken can be either covered or uncovered. A position is

[69] See Nicholas Kaldor, "Speculation and Economic Stability," *The Review of Economic Studies* 7 (1939): 1–27, at 1.

[70] See, e.g. J. S. Mill, *Principles of Political Economy* (New York: D. Appleton, 1864), bk. 4, ch. 2 sec. 4–5, pp. 705–9.

[71] Kaldor, "Speculation and Economic Activity," at 8. For a similar view, see Keynes, *The General Theory*, 152–64, especially 156.

covered if you already hold the requisite quantity of the stock or commodity described in the option contract, and uncovered or "naked" if you do not and will therefore have to go out into the market to purchase that stock or commodity if the option is exercised and you are required to deliver the good at the price to which you previously agreed.

Buying a call is very similar to buying an option to purchase anything else—you simply agree on the price now (for stock and commodity options, this is called "the strike price"), and have some time to exercise the option or not. If the market price of the underlying good rises in the meantime, and especially if it rises above the strike price, your option increases in value. If it falls, your option decreases in value. And if the market price never exceeds the strike price and the option expires, it becomes worthless. If the option does increase in value, you can either sell it to someone else for a profit, or to the seller, allowing him to close out his position and fix his loss, or if you actually want the good covered by the option and not merely the profit, you can exercise the option and take delivery of the good at the strike price, a price that is now less and perhaps substantially less than the current market price.

Selling a call is similar to what is called short-selling in the equity markets, where an investor can sell a stock he does not already own, and everything I shall say about selling calls will apply to short-selling too. When you sell a call, you are betting that the price of the underlying good will go down, rather than up. You receive a premium for selling the call, because you are now obligated to deliver the good at the strike price should the buyer demand you do so before the option expires.[72] If the price of the underlying good goes down, rather than up, the buyer will never exercise the option and the premium you received when you sold it is pure profit, at least after you have recovered any applicable transaction costs. If the price of the underlying good goes up, however, you now have to be prepared to deliver the good at the strike price, which may be substantially less than the current market price. If you already own the good specified in the contract, of course, you need not be overly concerned. Indeed, you may still profit on the transaction if the price you paid when you purchased the good is less than the specified strike price. But if you do not own the good specified in the contract—in other words, if you sold a naked rather than a covered call—you have reason to worry. You now have to go out into the market and purchase the good at the current market price, which could be substantially greater than the strike price. Your downside is potentially unlimited, and the cost of closing out your position

[72] Note that only American-style options can be exercised *on or before* their expiration date. European-style options, in contrast, can be exercised only on their expiration date, not before. See generally, David A. Dubofsky and Thomas W. Miller, Jr., *Derivatives: Valuation and Risk Management* (New York: Oxford University Press, 2003), 374. With regard to our interest in options, however, this variation in the structure of option contracts is not important.

may be huge. Selling a naked call is accordingly extremely risky. Indeed, selling a naked call is, financially speaking, one of the riskiest things you could ever do.

When it comes to buying and selling puts, these behave in exactly the opposite way to calls. If you buy a put, you are betting that the price of the underlying good will go down. If it does go down, the value of the put goes up, because you now have the right to force your counterparty to buy the good at a strike price that is greater than the current market price, and you therefore stand to profit in an amount equal to the difference. You can either sell the put for a profit now, or exercise it before it expires and pocket the full difference between the strike price and the market price then. If the price of the underlying good goes up, in contrast, you face the prospect of a loss. And if the price of the good remains above the strike price at the expiration of the option, the put becomes worthless, and you have lost whatever you paid for the put, plus whatever you paid in transaction costs.

On the other hand, if you sell a put, you are betting that the market price of the underlying good will go up. If it does go up, the put will not be exercised, because the buyer will not want to force you to buy the underlying good from him at a strike price that given the current, higher market price represents a bargain, and the premium you received when you sold the put will be pure profit, again of course less any transaction costs. If the price of the underlying good goes down, in contrast, you will suffer a loss, for you will now have to buy the good at a price that is greater than you could resell it in the market. Puts are less risky than calls, however, because even if you guess wrong and the market price of the underlying good moves in the wrong direction, your maximum loss is limited. If you are a put buyer, your maximum loss is whatever you paid for the put; if you are a put seller, your maximum loss is the difference between the strike price and zero for whatever quantity of the good is specified in the contract. This may still be substantial, but at least it can be calculated in advance. When you sell naked calls, in contrast, your maximum loss is incalculable and potentially unlimited.

There are good business reasons to sell or buy puts or calls if you already own the good at issue or know that you will or at least may need some quantity of that good at some future point in time, for trading in these options can provide a very useful way of hedging various kinds of economic activity against otherwise unavoidable market risk. For example, if you are a farmer, you may buy a put at the start of the season to lock in a certain price for your crop, one that guarantees at least a minimal amount of profit. If the price of your crop goes up by the time it actually gets to market, you simply sell your crop for the higher price, never exercise your put, and the cost of the unexercised put becomes simply another cost of doing business. If the price your crop will be able to command drops by the time the harvest comes along, however, you are protected by the put. You simply deliver your crop to the seller of the put for the strike price, which now exceeds the market price but ensures that you will make enough money to stay in business. And a similar strategy can be used by anyone who is in the business of producing other commodities that take some time to bring to market, or by anyone who wants to protect their downside risk on any stock or commodity they are holding and which they cannot or do not want to sell at the time.

For users or consumers, in contrast, hedging is done with calls, rather than puts. For example, if you are unsure what the price of oil will be in the future but know you will need to use significant amounts of oil in your business, you may lock in a price now by buying calls that protect you if the price of oil increases dramatically. If the price does not increase, you have bought a worthless call, and this will have increased your cost of doing business slightly. If the price of oil does increase, however, you can exercise your option to purchase oil at the strike price specified in the option rather than the current market price and therefore pay much less for your oil than you would have had to if you had to purchase it at the current market price. The cost of purchasing that call has still slightly increased your cost of doing business, but the fact that you can now purchase oil at the strike rather than the market price may have saved you millions, savings which allow you to offer much more competitive prices to your customers. Indeed, this is exactly the method Southwest Airlines used to protect itself against future increases in the price of aircraft fuel. After buying calls in the early years of the new millennium, it was able to purchase oil at $51 a barrel through 2009, a strategy that helped keep it profitable as the price of oil rose to over $140 a barrel in mid 2008, producing gains of $455 million in 2004, $892 million in 2005, $675 million in 2006, and $439 million in the first nine months of 2007, while other airlines that had not executed a similar strategy were suffering losses that in many cases were quite severe.[73]

But trading options may serve no larger business purpose whatsoever, and simply be a way of pursuing profit for its own sake. Indeed, this is becoming more and more common with regard to agricultural commodities, for the availability of government subsidized crop insurance has created an alternative way for farmers to hedge prices and yields, reducing the need for farmers to turn to purchasing puts in the futures market.[74] It is even conceivable that the availability of crop insurance may eventually eliminate the need for farmers to resort to the futures market altogether once they become more familiar with

[73] See Jeff Bailey, "Southwest Airlines Gains Advantage by Hedging on Long-Term Oil Contracts," *The New York Times* (November 28, 2007).

[74] See generally Keith H. Coble, Richard G. Heifner, and Manuel Zuniga, "Implication of Crop Yield and Revenue Insurance for Producer Hedging," *Journal of Agricultural and Resource Economics* 25 (2000): 432–52.

the various products on offer.[75] And speculation has always been the more common motive when it comes to buying and selling calls. If you do not have even a contingent need for oil, for example, and are not in the business of refining, storing, selling, transporting, or consuming it but are simply buying it cheap in the hope of later selling it dear, one is engaged in exactly the kind of speculation that the Schoolmen so vigorously condemned. Of course, one can speculate without using options—you can simply buy the good and hold it, or sell it short, that is, sell it without actually owning it, hoping that when the time comes to deliver it you can buy it for less than you have already sold it for, and everything I have to say about speculating in the options market applies to these more traditional methods of speculating too. But the availability of options makes speculating much, much easier. More importantly, options make speculation possible for the unsophisticated investor as well as for the sophisticated financier. Instead of having to buy oil and store it for a time, thereby incurring the kind of carrying costs and logistical difficulties that make this kind of speculating expensive and, for most people, prohibitively impracticable, you simply sell calls (agree to deliver oil at a specified price at a future date) and avoid the risk and expense of actually handling the commodity.[76] If you guess right about the movement of the commodity, the profits can be high, but if you guess wrong, the losses can be huge. Indeed, this is exactly how 28 year-old Nick Leeson—a single "rogue" trader who bet against a rise in the Japanese market—could ring up $1.4 billion in losses as head of the Singapore futures trading desk and bring down Barings Bank, the oldest investment bank in Britain. It is also how a small group of traders for JPMorgan Chase could recently lose $5.8 billion and possibly more of the bank's money betting on the movement of corporate debt, although the exact details of the trades at issue here and method used are not yet clear.[77] And it is how 31 year-old Jérôme Kerviel, a mid-level trader for one of France's largest

[75] See Nicholas D. Paulson, Gary D. Schnitkey, and Bruce J. Sherrick, "Rental Arrangements and Risk Mitigation of Crop Insurance and Marketing," *Agricultural Finance Review* 70 (2010): 399–413. For an overview of the kinds of crop policies now available, see the United States Department of Agriculture Risk Management Agency website at <http://www.rma.usda.gov/policies/>.

[76] For a discussion of why stocks and commodities traded on established markets make better objects of speculation than, say, durable goods, see Kaldor, "Speculation and Economic Stability," 3–5.

[77] See Peter Evans and Susanne Craig, "The Bet that Blew Up for JPMorgan Chase," *The New York Times* (May 11, 2012) and Ben Protess, Andrew Ross Sorkin, Mark Scott, and Nathaniel Popper, "In JPMorgan Chase Trading Bet, Its Confidence Yields to Loss," *The New York Times* (May 11, 2012); Nelson D. Schwartz and Jessica Silver-Greenberg, "JPMorgan's Trading Loss is Said to Rise at Least 50 per cent," *The New York Times* (May 16, 2012); Jessica Silver-Greenberg and Susanne Craig, "JPMorgan Loss May Reach $9 Billion," *The New York Times* (June 28, 2012); Jessica Silver-Greenberg, "JPMorgan Fears Traders Obscured Losses in First Quarter," *The New York Times* (July 13, 2012). See also Azam Ahmed, "The Hunch, the Pounce, and the Kill," *The New York Times* (May 26, 2012); "As One JPMorgan Trader Sold Risky Contracts, Another One Bought Them," *The New York Times* (May 15, 2012); Karl Russell and Sergio Peçanha, "At JPMorgan Chase, a Complex Strategy that Backfired," *The New York Times* (May 11, 2012) (all describing nature of the trades).

and most respected banks, Société Générale, could lose a staggering $7.3 billion of the bank's money betting against a rise in the European markets.[78]

What should be apparent from all this is that options transactions can be and often are acts of *pure* speculation. An option transaction is an act of pure speculation when both parties are acting on a speculative motive. This is to be distinguished from cases in which one party is engaged in hedging a risk to which he is already exposed by transferring it to another party, at least in part, who may be accepting it for speculative reasons, although this is not necessarily the case. The counterparty for a long/short hedger may be a short/long hedger, or even a risk aggregator, a kind of conduit through which a large number of similar risks can be combined and thereby spread across a wide variety of parties. This is what happens, for example, when a homeowner purchases fire insurance from a company that sells similar policies to a wide variety of other homeowners—in this case, the transfer not only serves to hedge the risk to which the homeowner would be otherwise exposed, the transfer actually *reduces* the amount of risk that existed before the transfer, for in the hands of the insurer, the unique risk that the homeowner faced becomes diluted in a sea of similar risks purchased from other homeowners, and therefore makes the insurer's future loss actuarially possible to predict. What was uncertain is now certain, or at least relatively so, and the reallocation of capital this allows can be both more efficient and more profitable. But even when the hedger does have a speculator on the other side, someone who is purchasing the risk not because he is in a better position to manage it but because he is less risk averse than the seller and/or has different beliefs than the seller as to whether the risk will actually come to pass, the presence of a speculative motive on one side of the transaction plays an important and positive economic role by making hedging easier.[79]

[78] For more on the collapse of Barings and Leeson's role in it, see Judith H. Rawnsley, *Total Risk: Nick Leeson and the Fall of Barings Bank* (New York: Harper Collins, 1996). Less is known about what happened at Société Générale, but see generally Nicola Clark and David Jolly, "Société Générale Loses $7 Billion in Trading Fraud," *New York Times* (January 24, 2008). JPMorgan is still unwinding its positions, so the final details of its loss (and its precise causes) may not be known for some time. Despite the passage of almost a year now, it is also still not clear how Kweku Adoboli was able to lose $2 billion trading for the Swiss bank UBS, but it seems he also did it by taking large naked (that is, unhedged) speculative positions in the derivatives market. See Julia Werdigier and Ben Protess, "Arrest of UBS Trader Rattles Banks in Europe," *The New York Times* (September 15, 2011). The demise of Jon Corzine's MF Global was apparently at least indirectly also the result of engaging in speculative derivatives trading—MF Global had made a $6.3 billion wager on European sovereign debt, and it was the size and risk of this bet that caused a fatal run on the firm. See Azam Ahmed and Ben Protess, "No Criminal Case Is Likely in Loss at MF Global," *The New York Times* (August 15, 2012). And these are just some of the more spectacular losses generated by this kind of trading activity; other cases of losses both small and large abound.

[79] The fact that such speculators are actually providing a service and not merely gambling is the basis of Keynes's theory of normal backwardation, which hypothesizes the existence of a risk premium for the long term speculator over and above whatever profits are to be earned based on the expected spot price prevailing at the date of expiration of the futures contract. See John

But a transaction in which both parties are acting on a speculative motive is different. Here a socially constructive positive economic purpose is completely missing. Neither party in such a transaction is investing, for neither party is contributing capital to the pursuit of any underlying business activity. Neither party is lending, and in fact both may be borrowing if their respective positions are leveraged in any way, thereby tying up capital that could be used for more productive purposes. Neither party is managing risk, for rather than protecting itself or others from a risk to which it was already exposed both parties are instead going out and deliberately creating a risk that did not previously exist and which would not have existed but for their respective decisions to encounter it. And this new risk is not one arising out of an investment in entrepreneurial activity: it is an artificial risk, one created for its own sake. The parties to such a transaction have added nothing to the value of the good in question, created nothing, and hedged no risk to which either of them was already exposed. What they have done is simply engage in a sophisticated and highly technical and therefore more socially acceptable form of one of the world's oldest occupations—that is, gambling.

Nowhere is this clearer than in the shadow market for credit default swaps ("CDSs") on collateralized debt obligations ("CDOs").[80] Collateralized debt obligations are packages of many, many underlying loans, of various types, that are stacked on top of one another and then sold in slices or "tranches" to various investors. Although each loan itself might be fairly risky (as time went on an ever-increasing amount of these were subprime mortgages of more and more questionable quality), the thinking was that if one bought the top slice of the package (called the "senior" or sometimes the "super-senior" tranche), the slice that was the last not to be paid if there were defaults, this would be a relatively safe investment. Indeed, "between 2000 and 2007, Moody's rated nearly 45,000 [of the top slices of these] mortgage-related securities triple A," the same rating given US Treasuries, the safest investment that

Maynard Keynes, *A Treatise on Money: Volume II: The Applied Theory of Money* (London: Macmillan, 1930), 143; John Hicks, *Value and Capital: An Inquiry into Some Fundamental Principles of Economic Theory*, 2nd edition (Oxford: Oxford University Press, 1946), 137–40. Keynes's theory has been heavily criticized and empirical support for it remains equivocal, but if the theory is wrong, this does not mean that pure speculative trading is economically justifiable; on the contrary, it means that there is a case against partial speculation too.

[80] I will limit the discussion that follows to credit default swaps alone because they seem to be the most commonly used form of credit derivative, but the variety of credit derivatives is enormous. One can, for example, purchase a credit derivative that insures against *any* credit-related event, such as the lowering of a credit rating, and not merely against default. See generally, *Handbook of Credit Derivatives*, ed. Jack Clark Francis, Joyce A. Frost, J. Gregg Whittaker (New York: McGraw-Hill, 1999). Even though I will not specifically discuss these other forms of credit derivatives, however, the application of what I have to say about default swaps to these even more exotic instruments should be obvious.

one could possibly make.[81] The middle slices were rated only slightly lower. The lower slices, of course, were much more risky, and they were rated much lower to reflect this, for while the portfolio of debts in the CDO was diversified, the risk of default for the lower slices was concentrated rather than diluted.[82] Despite giving these slices relatively innocuous sounding names such as the "mezzanine" and "equity" tranche, most potential investors were accordingly wary of purchasing them, and the bank creating the CDO often had to keep them, or at least the equity tranche, if for no other reason than to reassure potential investors in the more senior tranches. But these lower slices could then be put together with the lower slices of other CDOs and repackaged into yet another CDO, the top slices of which would again be rated AAA, allowing them to be more easily sold, and so on.[83] In other words, CDOs seemingly offered a way of changing lead into gold—bad credit risks could be turned into good credit risks simply on the theory that no matter how bad the original credit risks were, they would never *all* default, so if one owned the top slice of a large package of these risks, one should do very well indeed.

Credit default swaps, in turn, provided a way of making a bet for or against a CDO, the direction of the bet depending on what one thought about this underlying theory. In one sense swaps are like insurance, for the seller of the swap, like an insurer, is guaranteeing the repayment of the debts covered by the CDO, although notwithstanding this similarity swaps are not subject to supervision and regulation by state insurance commissions as more traditional forms of insurance are.[84] In another sense credit default swaps are

[81] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, (New York: Public Affairs, 2011), xxv. At the same time, the number of American non-financial corporations assigned the coveted triple-A rating was declining, although there were never many members of this club. The all-time high was about thirty-six; by March 2005, however, when the number of triple A-rated CDOs issues was almost at its peak, the number of traditional triple-A rated corporate securities had dropped to only six. See Nicholas Riccio, "The Decline and Fall of the Triple-A," *Business Week* (March 11, 2005). See also Eric Dash, "AAA Is a Rarity in Business," *The New York Times* (August 2, 2011).

[82] The risk of default was concentrated because the owners of the junior tranches began to suffer losses if *any* of the underlying debts went bad and could be totally wiped out if just a small percentage (usually around 8 per cent) went bad, whereas the risk of default was diluted for the owners of the more senior tranches because they suffered a loss only if the number of defaults was high enough to completely wipe out the junior tranches. See Satyajit Das, *Traders, Guns, & Money: Knowns and Unknowns in the Dazzling World of Derivatives*, revised edition (Harlow, England: Pearson Education, 2010), 285–7, 322–3; see Satyajit Das, *Credit Derivatives, CDOs and Structured Credit Products*, 3rd edition (Singapore: John Wiley & Sons, 2005), ch. 4.

[83] *The Financial Crisis Inquiry Report*, 127–9. A fundamental mistake in the whole rating process, of course, was assuming that the various risks being bundled together here were uncorrelated; that is, that one default did not make another more likely. This might have been true in ordinary circumstances, but was certainly not true when the housing bubble burst.

[84] For a time there was substantial controversy between industry representatives who claimed that credit default swaps were not insurance and State Insurance Commissioners who claimed they were, but after an intense lobbying effort this controversy was largely ended by legislation. For example, in 2004, credit default swaps were specifically excluded from the reach of the New York Insurance laws, and many other states subsequently followed suit. See N.Y. Ins. Law § 6901(j-l) (2005); N. Y. Sess. Laws Ch. 605 (S. 6679-A) (approved and effective October 19, 2004).

like options, for they can be used as hedges against risks to which the buyer is exposed—in this case the risk that a debtor will default, at least when the swap is purchased by the debtor's creditor. Unlike more traditional options, however, credit default swaps are not currently subject to supervision and regulation by either the Commodity Futures Trading Commission ("CFTC") or the Securities Exchange Commission ("SEC").[85] Moreover, the name credit default *swap* is really a misnomer because under the existing regime of market non-regulation, *anyone*, not merely the debtor's creditor, can purchase such an instrument. Indeed, in 2008, just before the financial crisis hit, the majority of credit default swaps covered other people's debt. And this is how it is possible for the market in swaps to have become so big. Credit default swaps have been around for some time, but when they began to take off in early 2001 they nearly doubled every year, reaching a peak of $62 trillion by the end of 2007 before receding slightly to $54.6 trillion as of June 20, 2008, according to the International Swaps and Derivatives Association ("ISDA"). To get an idea of how huge this figure is, consider this: the Securities Industry and Financial Markets Association puts the total amount of *all* outstanding corporate debt at the comparatively modest figure of $6.2 trillion. True, with regard to credit default swaps, some of these contracts would cancel each other out, so the amount of money that would actually change hands if all the contracts paid off at once is not really $54.6 trillion, but the amount of money at risk under these instruments is still huge by any standard, even if the total volume figure is dramatically and not merely somewhat overstated.[86]

The problem with credit default swaps is that when a swap is purchased by anyone other than the creditor, the buyer is not *swapping* a risk with the seller, for the risk involved is not a risk to which the buyer was in fact exposed. What is happening is the creation of a whole new risk, an act of pure financial speculation. What the buyer is doing is not remotely like purchasing insurance, for the buyer has no insurable interest. Indeed, rather than hedging a risk to which the buyer is currently exposed and attempting to minimize his loss should the worst occur, when a non-creditor purchases a credit default swap the purchaser is actually hoping that the worst—in this case, the relevant default—will actually occur. Some non-creditors were so anxious to place a bet on default that they even went so far as to agree to purchase the equity tranche of a potential CDO in advance, just to ensure that the CDO would be created

[85] Credit default swaps currently enjoy a blanket exemption from the supervision of the Commodity Futures Trading Commission under the provisions the Commodities Exchange Act, see 7 U.S.C. §§ 1a(13), 2(d), and 2(g), and were exempted from the supervision of the Securities Exchange Commission by sections 206A(a)(3), (b)(1)-(4), 206B, and 206C of the Gramm-Leach-Bliley Act. See 15 U.S.C. § 77b-1 (2000) and § 78c-1 (2000).

[86] See Nicholas Varchaver and Kate Benner, "The $55 Trillion Question," *Fortune Magazine* 158:7 (October 13, 2008): 134–40.

and they would be able to bet against it (over time, because of the difficulty of selling the equity tranche, the banks who were assembling these CDOs became reluctant to create them unless they could be sure that a buyer for the equity tranche could be found), a strategy that had the effect of encouraging the very kind of reckless lending and subsequent securitization that was at the heart of the subprime mortgage crisis.[87] And of course, with regard to more traditional debtors, it has long been known that this kind of "investment in default" can be indirectly destabilizing, for it can increase the cost of further credit, credit that the debtor may need to survive, because potential sources of new credit may become more reluctant to lend as they become aware that the market is betting against the debtor's long-term survival. In either case, the CDS purchaser who has taken large positions betting on a specific default has so much to gain that he may actually be tempted to engage in direct action against the debtor and make its default even more rapid or inevitable.[88]

The obvious moral hazard this situation creates, of course, is why the purchase of traditional insurance by those who have no insurable interest has long been universally prohibited. But with swaps, the number of non-creditors who may bet on the same default is potentially unlimited. Non-creditors may even bet on the same default multiple times. As a result, these instruments do not serve to spread or reduce risk, they actually *increase* it. And they do this in at least two different ways. First, by allowing anyone and everyone to bet that a particular loan default or package of defaults will occur, the risk of that default is now doubled or tripled or quadrupled or otherwise multiplied many times over, depending on the number of swaps sold on the underlying debt, because the lender *and* everyone who sold a swap on this debt is now exposed to it. Second, and perhaps more disturbingly, these swaps can be and in fact were themselves repackaged and used to create what are called *synthetic* CDOs (they are called synthetic CDOs because they contain no actual loans themselves but merely credit default swaps on actual loans—in other words, they are side bets that rise or fall in value depending on the likelihood of default of the loans they

[87] This kind of trading strategy became known in the industry as the Magnetar trade, after the hedge fund that was thought to have devised it. See Jesse Eisinger and Jake Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going," *ProPublica* (April 9, 2010). The strategy also bears a passing resemblance to that employed in the confidence game "the long firm," which was popular in the 1960s, although there appears to be nothing illegal about this more modern version of it. For a colorful description of the original, however, see Jake Arnott, *The Long Firm* (London: Hodder and Stoughton, 1999).

[88] For a description of how one purchaser of a large number of credit default swaps actually tried to do this, see Michael Lewis, *The Big Short: Inside the Doomsday Machine* (New York: W. W. Norton & Co., 2010), 83–4.

reference),[89] and these can in turn be sold on to further investors, and therefore become the subject of further swaps, and so on. In other words, these instruments both *duplicate* the existing risk many times over and *replicate* it, allowing the replicated risk to itself be duplicated and a whole new set of sellers and buyers of credit default swaps to make bets on the outcome of bets that other sellers and buyers of credit default swaps have already made. What we end up with is a risk that in effect has not been shifted but rather exponentially reproduced, like a cancer.[90]

Nevertheless, during the run-up to the financial crises, these instruments were attractive to buyers, or at least to those buyers who could see the real risk that investors in packages of subprime loans were running, because the upside was huge while the downside was comparatively trivial, at least as long as the price at which one could purchase a CDS remained relatively modest, something like 2 per cent of the principle amount insured per annum, which is how swaps on even the *riskiest* subprime debts were priced until the subprime market actually began to collapse (a CDS on the "safest" subprime debts, which of course were not safe at all, was priced at 0.5 per cent).[91] At these prices, those so inclined could buy large numbers of swaps on the same debt or group of debts even though they had no underlying position to protect, which is how, for example, hedge-fund manager John Paulson was able to make an astonishing $15 billion for his firm and $4 billion for himself in 2007 betting against sub-prime mortgages and then another $5 billion for his firm and $2 billion for himself in 2008 and early 2009.[92]

[89] For more on synthetic CDOs, see Andrew Kasapis, *Mastering Credit Derivatives*, 2nd edition (Harlow, England: FT Prentice Hall, 2008), ch. 9. For a more general but also somewhat more accessible discussion, see *The Financial Crisis Inquiry Report*, 142–6.

[90] See Lewis, *The Big Short*, 74–8, 143; *The Financial Crisis Inquiry Report*, xxiv–xxv.

[91] See Lewis, *The Big Short*, 29, 50–1, 65–6, 72, 95, 126, 129–30, and 161–2.

[92] For a discussion of Paulson's success and the success of those who, like him, saw the folly of banking on subprime mortgages in this way, see Gregory Zuckerman, *The Greatest Trade Ever: The Behind-the-Scenes Story of How John Paulson Defied Wall Street and Made Financial History* (New York: Random House, 2009). But even Paulson's 2008 and 2009 success now looks more like the result of a one-off flash of insight rather than evidence that Paulson possesses an uncanny knack for predicting the movement of the market. His flagship Advantage Plus and Advantage Funds were down 47 per cent and 32 per cent respectively through the first three quarters of 2011. HSBC ranked the Advantage Plus as the fourth worst performing hedge fund in its entire universe, and that was before the fund reported its dismal September results. See James B. Stewart, "A Golden Touch Turns Leaden," *The New York Times* (October 14, 2011). Ultimately, the Advantage Plus Fund did even worse, ending the year down a total of 52 per cent. See Reuters, "Paulson's Advantage Plus Fund Cut in Half in 2011," *The New York Times* (January 8, 2012). But even though Paulson's latest efforts have not proved so lucrative for his clients, he still stands to make more than half a billion dollars in management fees, for these fees are not tied to his funds' performance. Indeed, in light of Paulson's success, the eye-popping amounts of compensation paid to other fund managers seem rather paltry. For example, William H. Gross and Mohamed A. El-Erian, currently the number one and two men at Pacific Investment Management Company, known as PIMCO, one of the world's biggest bond funds, are reported to have earned "only" $200 million and $100 million respectively in 2011. See Geraldine Fabrikant, "The Bond Market Discovers a New Leading Man," *The New York Times* (July 28, 2012). Yet if Gross and El-Erian

For sellers, in turn, who mistakenly believed that the real estate market could only go up, swaps seemed to offer easy money. True, this may have been only a modest amount—given the premiums at which these swaps were sold, the upside for the seller was nowhere near what it was for the buyer, so while risk was amplified exponentially, reward was not. Indeed, given the actual risks that were on the table here, swaps were ridiculously underpriced.[93] At these prices the net profit from total premiums earned was not going to be especially impressive even if there were no defaults on the underlying debts (although the commissions for creating these investments and the bonuses these generated were responsible for an ever-increasing amount of the income of the firms and individuals involved). And if there were defaults, there was no way for the seller of such swaps to redistribute the risk of that much loss, for they had swapped the same debts with multiple counterparties, making the payout on even a single default potentially enormous. So enormous, in fact, that many institutions had insufficient reserves to cover these obligations, thereby putting even non-speculative purchasers of these swaps at risk.

But there was a further enticement built into these transactions: one form of them effectively required no capital up front. Indeed, there were two kinds of synthetic CDOs—funded and unfunded. With a funded CDO, investors had to put up principal covering any potential defaults on the tranche or particular slice of the package of CDSs for which that investor would be responsible. Charges against that principal were then made as and when defaults occurred. But with an *unfunded* synthetic CDO, an investor got premium income without having to put up any cash or maintain any reserves to cover losses, just as he would if he had sold a CDS, for these "investments" were exempted from all reserve requirements. The investor would only have to put up money as defaults occurred.[94] So once again, for investors who thought the real estate market would only go up, buying unfunded synthetic CDOs and selling naked CDSs offered modest but guaranteed returns for no outlay of capital. How could one do better than that? At least, that was what investors who were optimistic about the housing market were thinking at the time. Which is why so many investors were willing to expose themselves so many times to the same risk, and why even a *slightly* higher rate of default than these investors

were included on the list of the 200 most highly compensated chief executives with US public companies for 2011, they would rank number two and four respectively. See Waananen, Feaster, and McLean, *The New York Times* (June 16, 2012).

[93] The same mistake in pricing was repeated with regard to swaps on sovereign debt. For example, an investor buying protection on Greek debt in 2008 had to pay only $22,000 annually to insure against default on $10 million of Greek bonds over five years. Now, that protection would cost about $7.6 million. See Peter Evans, "Greek Credit-Default Swaps are Activated," *The New York Times*, (March 9, 2012).

[94] See generally Don M. Chance and Robert Brooks, *Introduction to Derivatives and Risk Management*, 8th edition (Mason, OH: Cengage Learning, 2010), 554–5.

anticipated could have caused such large losses, although the actual rate of default turned out to be substantially higher than this.

There were two additional reasons why the risks undertaken here had a much greater impact than anticipated. First, once the junior tranches started to be wiped out, the ratings on the more senior tranches were lowered, and some investors were therefore required to sell their CDO shares because of rules requiring them to hold only investments of a certain grade. Second, even investors who were not technically prohibited from holding these now lower-rated securities faced increasingly larger calls to post additional cash or collateral, and to meet these calls many of them also had to sell. The market was therefore flooded with sellers and many investors who would have suffered little or no loss had they been able to hold these securities until maturity were forced to get out early at fire-sale prices, turning their paper losses into real losses, and propelling the financial spiral down even further and faster. Obviously, these follow-on consequences of the defaults at issue here were risks that should have been taken into account in the initial evaluation of the wisdom of these investments but were not.

Complicating matters further still is the fact that all these swaps were executed and traded privately, rather than on an established market where the nature and extent of such transactions would have been transparent, so the extent of the risk to which those engaged in such transactions were exposed and even their identities were beyond the ability of outsiders to begin to fathom much less estimate with reasonable certainty. Because of this, people became afraid to deal with even the most long-established and substantial firms, for no one knew the extent of the risk to which these firms were exposed and therefore could not determine what the risk of doing business with these firms might be. Economic activity accordingly rapidly ground to a halt. All together then, events that should have resulted in large losses only for those heavily invested in the subprime mortgage market became uncontained and actually caused severe financial repercussions throughout the entire global economy. And without further regulation of these kinds of transactions, there is every reason to believe that such a financial meltdown could easily happen again and sometime soon.[95]

[95] Indeed, one of the impediments to an agreement between Greece and its creditors about the restructuring of its debt was the existence of credit default swaps, which threw a wild card into the debt renegotiation process. Some holders of Greek debt had purchased swaps and were thus unwilling to agree to any restructuring that would not be classified as a "default," thereby triggering coverage of their losses, yet some holders of Greek debt had actually *sold* swaps and therefore did not want to agree to any restructuring that did. And the potential for manipulation of the determination of what constitutes a "default" in these cases is enormous—under current practice, these decisions are not made by the courts, but by a fifteen member committee set up by the private ISDA trade group, and ten members of this committee are themselves major dealers in credit default swaps, making a decision that goes against their interests unlikely to say the least. See Jessie Eisinger, "Swap Market, Like Libor, is Vulnerable to Manipulation," *The New York Times*

The regulations that have been enacted to deal with this so far, however, seem woefully inadequate. The only real progress seems to be in making the swaps market somewhat more transparent.[96] But this is not enough. Even if the swaps market were to become completely transparent, the risk-multiplier effect of speculative swaps and the corresponding danger that such swaps pose and the potential they create for extensive collateral damage to the global economy should be obvious. This danger alone is enough to justify the prohibition of such speculative transactions—that is, swaps that involve risks that are not ones to which the buyer is already exposed. And some governments are finally beginning to realize this, at least for certain kinds of swaps.[97] Germany, for example, has recently banned certain kinds of short-selling, and is advocating "a wide-reaching ban on naked short-selling of stocks, sovereign bonds, and credit default swaps."[98] Unfortunately, however, the potential profits from engaging in such speculative trading of these instruments are enormous, so the lobbying effort against further regulation by those within the financial industry is intense, and this pressure may be impossible for even the most enlightened governments to resist. The financial industry's position seems to be that any future losses resulting from this kind of activity will not spread, and this, in turn, seems to make the case for regulation turn on how convinced we are that the modest changes that have been made to existing practice rules in order to ensure that any future blow-up connected with these investments can be contained will be successful. The best evidence that what has been done so far is not enough, however, is that people

(July 18, 2012). In this case, there was also concern that the number of non-creditor speculators that had purchased swaps on Greek debt could be huge, and that if the swaps were to pay out this could cause yet another worldwide financial collapse. Apparently, those insisting on a payout ultimately prevailed and the market nevertheless survived, although the fact that we could not be sure of this in advance is yet another reason why this market must be made much more transparent and its regulatory body much more independent if it is not going to pose an ongoing risk to the stability of the worldwide financial system. See Peter Evans, "Greek Credit-Default Swaps are Activated," *The New York Times* (March 9, 2012). Moreover, sovereign debt is not the only possible trigger of another financial meltdown. Many home equity loans have until now required payments of interest only but will soon require the payment of both interest and principal. Whether those who are on the hook for these loans will be able to make these dramatically bigger payments, especially if the economy remains as sluggish as it is now and it remains difficult to refinance, and whether this risk has been unwisely multiplied by the sale of credit default swaps to outsiders, remains to be seen. See Gretchen Morgenson, "Here Comes the Catch in Home Equity Loans," *The New York Times* (July 14, 2012).

[96] I say "somewhat" because even now, the exact exposure of our major banking institutions under these instruments is still murky. See Gretchen Morgenson, "17 Countries, but Even More Unknowns," *The New York Times* (October 8, 2011).

[97] See The Associated Press, "EU Adopts Stricter Rules on Short Selling," *The New York Times* (October 18, 2011) (reporting that the European Union has finally agreed to regulate the speculative short-selling of shares and bonds more strictly and to ban entirely the purchase and sale of naked credit default swaps on sovereign debt).

[98] The quote is from Martin Kotthaus, a spokesman for the German (finance ministry. See Christine Hauser and Julia Werdigier, "Stocks Open Higher in U.S.; Europe Up," *The New York Times* (August 11, 2011).

continue to hoard cash—in the absence of effective regulation of these instruments of economic mass destruction far too many people and the businesses they represent are still too afraid that another financial collapse could soon occur, and they are therefore reluctant to lend, borrow, increase production, and invest. Indeed, even if they want to be able to engage in such speculation *themselves*, and are lobbying relentlessly to keep their ability to do so relatively unfettered, they are not comfortable living in a world in which such speculation can also be easily undertaken by everybody else. If the buying of credit default swaps by non-creditors is exploitive, however, we need not worry about whether the risk of such activity is really manageable, or whether we can prove that it is not. All the reason we need to ban such transactions can be found in our theory of exploitation.

To see why, let us consider what is involved when one purchases a more traditional form of insurance. While insurance contracts are not generally thought of as futures contracts, this is what they are—a promise to make a payment at a future time should an uncertain event occur or, to put it more precisely given that some future events (like death) are certain, an insurance contract is a way of managing risk when the nature, timing, or extent of a future event is to some degree uncertain. Suppose, for example, that I buy an insurance policy covering the cost of replacing my house should it be destroyed by fire. For this policy to pay off, I have to incur two different kinds of cost. First, I have to pay whatever premium is due on the policy. Second, and most importantly, I have to suffer the loss of my home, or to put it in strict accounting terms, I have to suffer a loss equivalent to the depreciated cost of my now destroyed home. It is possible that the total of these costs is somewhat less than the home's replacement cost, but once the purchase price is adjusted for inflation, it is unlikely that it will be so much less that the payoff I receive will represent a greater than 100 per cent profit on my home. Accordingly, I may indeed have profited from this transaction in the accounting sense (although not in the economic sense), but there was a purpose to engaging in this transaction beyond the generation of an accounting profit alone. Even if I have earned a profit in the inflation-adjusted accounting sense and the transaction accordingly violates the doctrine of the just price, we nevertheless have good reason to tolerate this violation up to and including the amount of payoff actually received given that it is economically rational and reasonable for me to incur costs to protect my assets from risk and destruction.

But now suppose that instead of buying a fire insurance policy on *my* home, I buy such a policy on *your* home. If your home burns down, I have lost nothing. On the contrary, I have profited a great deal, for my only cost is the cost of the premium I have paid, and perhaps some research expenses involved in determining that your house was particularly susceptible to fire. This is exactly what happens when I enter into a credit default swap for a loan

I do not currently own (if it was for a loan I currently owned the transaction would be effectively the same as insuring my own home). If this other creditor's loan goes bad, I suffer no loss, and therefore the cost of the payout I receive is merely what I paid for the swap itself, plus perhaps some research expenses. Because the payout I receive is equivalent to the amount of principal still owing on the loan, however, and this will usually be substantial, I will profit many, many times over through this transaction. Indeed, even if the payout is not more than 100 per cent of the cost of the CDS and any associated research expenses, we have no reason to tolerate even a penny of profit because the transaction has no purpose other than the generation of profit. It is simply a wager, and as wager, it is going to exploit the seller if it does pay off. And if it does not pay off, it is going to exploit the buyer, for the buyer has not been relieved of any risk in the interim, and therefore has effectively received nothing in return for his premium payment. In other words, the transaction is necessarily exploitive of somebody, the only question up front is who, and therefore under our theory, the entire transaction must be prohibited.

This would still be the case even if we decided that the *ex post* perspective, while the correct one for evaluating the existence or non-existence of a moral hazard, was not the correct one for evaluating the just price of a purely speculative transaction. Under these circumstances, what would matter is not the state of affairs after the bet pays off (or not), but whether the bet is justly priced given its potential payout, the degree of risk involved, and the administrative expenses to be actually incurred by the institution acting as intermediary on the transaction (what would be called the "takeout rate" enjoyed by the house with regard to a more traditional form of gambling). The burdens of judgment would apply to each of these determinations, and therefore excuse some deviation from the just price in some cases, but unless there was good economic reason to allow either party to profit from purely speculative transactions, any deviation that is greater than this would make the transaction exploitive. This would mean that the kind of outsized commissions that were driving the creation and sale of credit default swaps in the past would no longer be available, and the premiums charged would have to be much higher to reflect the true risk involved. And remember, the true risk involved would be enormous if multiple non-creditors could purchase such instruments, for the potential payout would technically be unlimited. So if credit default swaps were to be offered to non-creditors, their price would have to be prohibitive. In other words, no matter how you looked at it, our theory of exploitation would as a practical matter effectively ensure that credit default swaps and similar derivatives would be sold only to the debtor's creditors.

Even if there are no good *private* business reasons for tolerating the sale of credit default swaps to non-creditors and other purely speculative transactions, however, might there not be good business reasons for allowing such transactions from a societal point of view? Could allowing purely speculative transactions have an important positive effect on overall economic activity, one that is important enough to outweigh the private injustice they entail? Indeed, only if there is insufficient justification for tolerating deviations from the just price for such transactions from *both* the individual and the societal point of view are such transactions not only unjust, but intolerably unjust and therefore exploitive.

If you listen to those who support this kind of trading, there are two larger economic reasons offered for tolerating whatever injustice this trading might produce. First, speculative trading, especially trading that is the equivalent of naked shorting, whatever form this may take, acts like a canary in a coal mine, alerting the public when a stock or commodity or bond is overpriced, forcing its price down to more realistic levels and promoting the more efficient allocation of capital. Second, speculative trading, whatever its form, adds liquidity to the market, something that is especially important when it comes to otherwise lightly traded stocks, bonds, or commodities for which a market might not even exist if this kind of trading was not available. And there is some modest empirical support for both these alleged justifications. Unfortunately, however, neither holds up to closer scrutiny.

Let me begin with the claim that this kind of trading acts as a kind of early warning system to alert the public of the existence of corporate fraud and other mal- or misfeasance that the market has not otherwise noted or absorbed. The problem here is that for each case where speculative shorting has alerted the market to problems of overpricing, there is another case where speculative shorting has been used to manipulate the prices of stocks, bonds, commodities, or currencies that were actually correctly priced and to artificially suppress these prices to potentially ruinous levels or otherwise aid and abet the commission of other kinds of fraud. George Soros, for example, claims that the unregulated use of credit default swaps to engage in "speculating on the short side" with regard to bonds, combined with the relentless attack by short-sellers on companies like AIG and Lehman Brothers, subjected the stock of these and other financial institutions to overwhelming downward pressure, pressure that eventually led to their demise.[99] The desire to engage in the speculative shorting of subprime loans was also allegedly behind some of the activities of Goldman Sachs, activities that were subject of fraud charges brought against that firm by the SEC and recently settled.[100] And speculators

[99] See George Soros, "The Game Changer," *Financial Times* (January 28, 2009).

[100] See Louise Story and Gretchen Morgenson, "U.S. Accuses Goldman Sachs of Fraud," *The New York Times* (April 16, 2010); Dealbook, "Goldman Settles with S.E.C. for $550 million," *The New York Times* (July 15, 2012).

on the long side have often been blamed for bidding up the price of wheat and oil.[101] In contrast, prohibiting short-selling, even just temporarily, has seemed to bring price stability and rationality to the market on those few occasions on which it has been tried.[102] So it is hard to say that the availability of this kind of trading on balance and overall really does lead to the more efficient allocation of capital or otherwise make a net positive contribution to the common good. Indeed, at *best* it may be possible to claim that this kind of trading has no effect on price whatsoever, either up or down, given that one recent study suggests that the bulk of speculative trading activity typically follows rather than leads price movements in the underlying instrument or commodity.[103] This makes sense, actually, because the causal process by which speculation is supposed to drive the market is less than clear. For every short-seller, there is someone on the other side manifesting the opposite view of the future of the underlying instrument or commodity—why is the negative view the one that is necessarily going to have the greater impact on the market? It seems more likely that rather than *cause* price movements either up or down, both the volume of this kind of trading activity and the price movements associated with it are often simply joint *effects* of the ebbs and flows of market information and rumor. Finally, even assuming that this kind of trading activity is at least sometimes a cause rather than an effect, it can only be a cause when the trading involved is transparent. When short-selling or its equivalent is done in private, as it was with regard to credit default swaps and other credit derivatives, the canary in the coal mine argument cannot possibly apply.

The claim that this kind of trading adds liquidity to the market is also much weaker than it might initially seem. First, remember that we are not talking about banning all trading in options, swaps, and other derivatives, or even banning all trading on a speculative motive, only trading that is speculative on *both* sides, and it is not at all clear that this marginal reduction in speculative trading will have any liquidity effects whatsoever. Second, even if we were to ban both pure and one-sided speculative trading, the alleged liquidity effects would be at most very modest. One of the few studies to actually attempt to measure this reduction in liquidity puts it at only about 15 per cent.[104] The only circumstances in which such a marginal reduction in

[101] See, e.g. *Report on Excessive Speculation in the Wheat Market*, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, United Sates Senate (June 24, 2009); *Report on The Role of Market Speculation in Rising Oil and Gas Prices,* Subcommittee on Investigations, Committee on Homeland Security, United States Senate (June 27, 2006).

[102] See Louise Story and Stephen Castle, "Seeking Safety in a Perilous Market: 4 European Nations Act to Curtail Stock Short-Selling," *The New York Times* (August 12, 2011).

[103] See Veljko Fotak, Vikas Raman, and Pradeep K. Yadav, "Naked Short Selling: The Emperor's New Clothes?" (May 22, 2009), <http://ssrn.com/abstract=1408493>.

[104] See Anchada Charoenrook and Hazem Daouk, "A Study of Market-Wide Short-Selling Restrictions" (January 2005), 13, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687562>.

liquidity could possibly matter, however, would be in markets where the underlying instrument or commodity was otherwise very lightly traded. For what provides liquidity to a market is not pure speculators, it is market-makers, and there is nothing in a ban on pure speculation that would prevent market-makers from finding this kind of activity attractive and from otherwise doing their job. Market-makers protect themselves from incurring losses when they do not have a counterparty immediately available through which they can close out their position by ensuring that there is a spread between the bid and ask price of the security, commodity, currency, or other good at issue. They can also protect themselves through hedging to ensure that they have time to wait for an appropriate opportunity to close out their position to arise. They do not need the ability to engage in purely speculative trading in order for their market-making to be profitable, for even without this ability it can be very profitable indeed.[105] So there is no reason to assume that those who currently engage in market-making would abandon this activity if they could not engage in purely speculative trading.[106] And if market-makers would not withdraw, why must we allow them to engage in purely speculative trading activity, much less allow this kind of trading by anybody else? Of course, there are no market-makers for some goods, but these goods are already illiquid even though purely speculative trading is possible. So in these cases, the liquidity argument cannot possibly apply. And finally, even assuming there would be some loss in liquidity and the overall effect of allowing purely speculative trading has somewhat positive effects overall, this merely provides an *economic* reason to allow this kind of activity—it does not establish that this economic reason is sufficient to warrant the sacrifice in commutative and distributive justice that would otherwise occur. Once this injustice is considered part of the mix, what was at best an equivocal

[105] See generally Michael Durbin, *All About High-Frequency Trading* (New York: McGraw-Hill, 2010).

[106] Indeed, when a ban on short-selling was enacted in the US in the immediate aftermath of the most recent financial crisis, market-makers were exempted—they could continue to hedge their positions, the only thing they could not do was speculate, see Ekkehart Boehmer, Charles M. Jones, and Xiaoyan Zhang, "Shackling Short Sellers: The 2008 Shorting Ban," EDHC-Risk Institute (September 2009) (discussing exemptions to ban), and no market-makers exited the market as a result. All they did was increase their bid-ask spreads. See Alessandro Bebe and Marco Pagano, "Short-Selling Bans around the World: Evidence from the 2007-09 Crisis," Center for Studies in Economics and Finance, Working Paper No. 241 (September 2011). Which suggests that before the ban, market-makers were using profits from speculating to subsidize their market-making, and this is economically inefficient because it distorts the true cost of market-making. If we have good reasons to subsidize bid-ask spreads then we should do so, but we should not do so by allowing an otherwise pernicious activity; we should instead simply tax those who otherwise benefit from the subsidy provided. On the other hand, there may be good reasons not to close the bid-ask spread too much. The smaller the bid-ask spread, the more we encourage short-term trading, and this seems to be as much of a problem in itself as the extra liquidity it provides is a solution to anything. See Nathaniel Popper, "On Wall Street, the Rising Cost of Faster Trades," *The New York Times* (August 13, 2012).

economic argument in favor of this kind of activity becomes clearly insufficient to justify it. The burden on those who would permit this kind of activity simply cannot be met. And since there is insufficient reason to tolerate purely speculative trading, such trading is not only unjust, it is also exploitive and therefore can and must be prohibited.

With regard to speculation in options, the apparatus to prohibit this kind of trading is already largely in place, for these instruments are already traded on open and regulated exchanges. In order to enforce this prohibition with regard to credit default swaps and other more exotic derivatives, however, several things are necessary. First, these instruments must be traded on an open market, so their nature and extent can be monitored and those that violate the relevant prohibition can be identified and any prohibited transactions unwound. This means eliminating the exemptions to regulation currently contained in the federal securities and commodities acts and subjecting credit derivatives to the kind of supervisions and regulation that currently applies to more traditional futures contracts.[107] Second, we may want to impose responsible reserve requirements on those who sell such swaps, as we do with those who sell insurance, to ensure that swaps are not exploitive of the buyer, for as has become all too clear, without such reserves the seller of the swap may not be able to honor its commitment to pay off the covered loan should a default occur. This, in turn, means the purchaser of the credit default swap may still feel somewhat insecure, leading him to purchase a credit default swap on the seller of the first swap in order to protect against the possibility of that party's default, and then to purchase another on *that* seller, and so on, thereby intertwining everyone's exposure to everyone else's default and leaving everyone in the market unsure of the credit-worthiness and total exposure of everyone else.

While such an outright prohibition on speculation would be something new, it is not beyond the realm of the politically possible. Putting curbs on speculative trading of oil, natural gas, and other energy products is at least being talked about now.[108] And under the Dodd-Frank reforms, the trading of credit derivatives will be both more transparent and more regulated than in the past, although still permitted. But there is still plenty of reason for concern. The precise scope of the limited regulation imposed by Dodd-Frank

[107] Such reform has been on the horizon in the United States for some time. See David Herszenhorn, "Bill Passed in Senate Broadly Expands Oversight of Wall Street," *The New York Times* (May 20, 2010). It is still not clear, however, the extent to which this will ever become law.

[108] See Edmund L. Andrews, "Call to Curb Speculators in Energy," *New York Times* (July 29, 2009), and "U.S. Considers Curbs on Speculative Trading in Oil," *New York Times* (July 8, 2009); Stephen Castle and Louise Story, "Europe Considers Ban on Short-Selling," *The New York Times* (August 11, 2011).

depends on decisions that have been left to administrators to make.[109] As a result, tremendous pressure is being brought to bear on these administrators to make whatever regulations this process ultimately generates weak, ineffective, and untimely.[110] The budgets of the agencies in charge of promulgating these new regulations are being limited or cut,[111] and more than fifteen months after Dodd-Frank was passed, only about a quarter of the 400 regulations called for by the Act have been written, much less approved.[112] And it now looks like firms which arrange less than $8 billion in swaps (that means 85 per cent of the firms engaged in such business) will not be subject to any further regulation at all.[113] Not surprisingly, similar problems seem to be impeding the promulgation and enactment of the new regulation of the financial services industry by the European Commission,[114] and resistance is

[109] See Edward Wyatt and David M. Herszenhorn, "Senate Approves Tougher Rules on Derivatives," *The New York Times* (April 21, 2010). Unfortunately, however, not everything in the Senate bill actually made it into law. See Gretchen Morgenson, "Strong Enough for Tough Stains?" *The New York Times* (June 25, 2010). Nevertheless, derivatives are at least subject to some regulation now. See Edward Wyatt, "For Securities Industry, Finance Law Could Bring New Light to Derivatives," *The New York Times* (July 15, 2010).

[110] "The financial industry tried to water down Dodd-Frank before it was enacted, has been trying to chip away at it since it became law, and is continuing that effort with this lawsuit [to curb a new rule restricting speculative trading]," according to Senator Carl Levin, Democrat of Michigan. See Ben Protess, "Wall Street Groups Sue Regulator to Challenge New Trading Rule," *The New York Times* (December 2, 2011). See also Edward Wyatt, "Dodd-Frank Under Fire a Year Later," *The New York Times* (July 18, 2011); Ben Protess, "Wall Street Lobbyist Aims to 'Reform the Reform'," *The New York Times* (July 14, 2011) (following intense lobbying by Wall Street, "The Commodity Futures Trading Commission is even reconsidering plans to curb banks' control over derivatives, once seen as a cornerstone of Dodd-Frank"); Louise Story, "Financial Overhaul is Mired in Detail and Dissent," *The New York Times* (June 6, 2011); James B. Stewart, "Volcker Rule, Once Simple, Now Boggles," *The New York Times* (October 21, 2011); Gretchen Morgenson, "Slipping Backwards on Swaps," *The New York Times* (November 26, 2011); Jack Ewing, "A Fight to Make Banks More Prudent," *The New York Times* (December 20, 2011); Ben Protess and Peter Eavis, "At Volker Rule Deadline, a Strong Pushback from Wall St.," *The New York Times* (February 13, 2012); Jesse Eisinger, "The Volker Rule, Made Bloated and Weak," *The New York Times* (February 22, 2012); Gretchen Morgenson, "Barriers to Change, From Wall St. and Geneva," *The New York Times* (March 17, 2012). There is also a strong push to exempt trading in derivatives by American banks if they do so through their foreign units. See Ben Protess, "A Debate Goes Behind Closed Doors," *The New York Times* (June 22, 2012). Some European banks are even electing to give up their "bank holding company" status in order to avoid some of the requirements of Dodd-Frank. See Tom Braithwaite and Shahien Nasiripour, "Deutsche Bank Avoids US Capital Rules," *Financial Times* (March 21, 2012). And European bank regulators are either delaying or resisting efforts to impose new capital rules on their own banks at home. See Floyd Norris, "U.S. Chose Better Path to Recovery," *The New York Times* (May 3, 2012).

[111] See James B. Stewart, "As a Watchdog Starves, Wall Street is Tossed a Bone," *The New York Times* (July 15, 2011).

[112] See Edward Wyatt, "Dodd-Frank Act a Favorite Target for Republicans Laying Blame," *The New York Times* (September 20, 2011); Editorial, "A Long Run to Regulating Derivatives," *The New York Times* (March 24, 2012).

[113] See Ben Protess, "Regulators to Ease Rule on Derivatives Dealers," *The New York Times* (April 17, 2012) and "In New Rules to Shine Light on Derivatives, Regulators Also Allow Exemptions," *The New York Times* (July 10, 2012).

[114] See *Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties, and Trade Repositories* (Brussels: European Commission, 2010); *Proposal for a*

also being offered to the various recommendations issued by an independent banking investigatory commission in the UK.[115]

But while speculation in stock, commodities, and credit derivatives can cause enormous disruption to what would otherwise be the natural workings of the market and there is accordingly good reason to see this kind of economic activity as socially pernicious (indeed, speculative trading in derivatives on sovereign debt and the contagion this can cause is already threatening to reprise the damage done by speculative trading in derivatives on subprime mortgage debt),[116] the fact that such activity can be socially pernicious in particular cases even in a more regulatory conscious environment is not the reason for imposing a prohibition. Or rather it is not the only or even a necessary reason. Regardless of the importance to the economy of the underlying asset involved, or the form that a particular kind of speculative trading may take, the overriding reason to prohibit such transactions is that they necessarily subject one party or the other to exploitation. In other words, we do not have to show that this activity is socially pernicious to prohibit it—those who are in favor of allowing it have to show that it is socially beneficial to explain why we should tolerate it. And in the absence of such an explanation, such transactions must be deemed exploitive, and the principle of reciprocity accordingly requires that we ban them.

How do we tell, however, when a transaction is *purely* speculative—that is, peopled by speculators on both sides, rather than speculative on only one side, as it is when one party is engaged in hedging? Once all the relevant instruments are required to be traded on an established public exchange, this determination should be relatively straightforward. At the time of the purchase or sale, each party would simply be required to identify the purpose of their trade and, if they claim to be hedging, the risk that they are attempting to hedge. After all, most if not all of these parties are already required to submit

Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps (Brussels: European Commission, 2010).

[115] The UK government recently announced it intends to impose much stricter national regulation on banking activities by seeking to enact and implement the recommendations of the Vickers Report. See Julia Werdigier, "Britain Backs Banking Overhaul," *The New York Times* (December 19, 2011). Among other things, the Report (which is by an independent commission led by former Bank of England Chief Economist John Vickers) recommends the separation of retail banking and investment banking operations, which would prevent banks from using customer deposits to finance their investment banking activities. See Independent Commission on Banking, "Final Report," (September 2011). But there is reason to doubt that any of these recommendations will ever become law. The government does not intend to introduce the regulations recommended by the Report until 2015 and may not seek to bring them into effect until 2019, and 2019 is a long way off. A lot of damage to the economy can be done by then, even if these new regulations do not get watered down in the meantime.

[116] See, e.g. Gretchen Morgenson, "Sad Proof of Europe's Fallout," *The New York Times* (November 5, 2011) (discussing the fall of MF Global, the firm run by former New Jersey Governor and Senator Jon Corzine).

financial statements to their creditors, shareholders, and regulators, and in these statements, any party that holds or issues derivatives is also already required by the Financial Accounting Standards Board ("FASB") to disclose its objectives for holding or issuing such instruments, the context needed to understand those objectives, and its strategies for achieving those objectives.[117] Of course, some speculators might try to conceal their true motives, but this problem is nothing new, and the commissions that regulate these exchanges have long experience in monitoring such activity and should be capable of policing the required disclosures. Indeed, the motivation to conceal the true purpose of the trade is somewhat moderated by the fact that announcing a speculative motive does not mean that the trade will not go through. Speculators can trade with hedgers; they are just not permitted to trade with other speculators. And while there are typically not enough hedgers to go around, appropriate non-discrimination rules would ensure that market-makers do not favor certain customers over others by deciding which speculative trades do and which do not go through. Market-makers would be required to match speculators and hedgers on a first-in-time basis, and trades that could not be cleared within the traditional three-day settlement period would be cancelled, ensuring that attempts at speculation in excess of what is necessary to provide hedgers with counterparties would not be allowed to close.[118] While some speculation would be tolerated, this would be no more than the amount necessary to support specific productive economic activities and investments. This kind of speculation might produce profits that were unfair, but at least these profits would not be intolerably unfair. The gains realized would accordingly violate our reconceived notion of the just price, but they would not violate our theory of exploitation.

[117] See FASB, Financial Accounting Standard 133, para. 44 (1998). See also International Accounting Standards Board, International Financial Reporting Standard 7 (2007) and International Accounting Standard 39 (2009).

[118] Note that in applying this rule, "hedging" would have to be narrowly defined. That is, the only form of hedging that would be allowed is trading designed to protect against risks to specific assets, a strategy that is also called "micro-hedging." Macro-hedging—that is, an attempt to hedge the risk of a whole portfolio or one's exposure to an entire industry would not be allowed (or rather not treated as true hedging), for this is really just a disguised form of speculation, and can increase risk rather than reduce it. See, e.g. Floyd Norris, "Lesson from Trades Big and Bad," *The New York Times* (May 17, 2012) (discussing how JPMorgan's recent $3 billion loss (now estimated at $5.8 billion and possibly as much as $7.5 billion or more) arose from an attempted macro-hedge, or at least that is what the bank currently claims). Indeed, anything can be called hedging if you define the risk being hedged broadly enough. This is why, for example, section 619 of Dodd-Frank, also known as "the Volcker rule," bars banks from engaging in proprietary trading but contains exceptions for micro- but not macro-hedging, and also why the financial industry is doing its best to subvert this provision in the ongoing administrative rule-making process. See Jessie Eisinger, "Volcker Rule Gets Murky Treatment," *The New York Times* (April 18, 2012).

6.10 Exploitation and Arbitrage

There is one further kind of trading that I would like to address, and this is the kind of trading known as arbitrage. Technically, arbitrage is the simultaneous purchase and sale of the same or very similar securities, commodities, currencies, or other goods or financial instruments in two different markets for advantageously different prices.[119] In theory, at least, arbitrage requires no capital and entails no risk—arbitrage opportunities are as close to a sure thing as one can get.[120] Indeed, the whole point of arbitrage is to sell something for more than you bought it without incurring any or at least any significant costs of your own. Violating our reconceived notion of the just price is pretty much built into the concept. We accordingly need to consider whether we have reason to tolerate such violations or whether we should treat such "sure-thing" arbitrage opportunities as intolerably unfair and therefore exploitive.

The argument for allowing arbitrage is this: if all investors were completely rational and made their investment decisions solely on predictions about fundamental value, and everyone had access to the same information, then market prices would necessarily reflect fundamental values. There would be no arbitrage opportunities, for all the relevant markets would be, to use the popular term, efficient. But of course not all investors are completely rational, and some are not rational at all. Some investors trade on "noise," not information, or draw irrational conclusions from the information available to them.[121] Nevertheless, if people were irrational in completely idiosyncratic ways, this would not be a problem because irrational trades would be randomly distributed and would therefore cancel each other out. Prices would still reflect fundamental values, and markets would still be efficient. But people are not irrational in completely idiosyncratic ways. On the contrary, they are irrational in very common and predictable ways, ways that we are now coming to better recognize and understand through a series of empirical studies in a field that has come to be known as behavioral finance, or more generally, behavioral economics.[122] Irrational trades are therefore not randomly distributed, and so irrational trades can pull prices away from

[119] See Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford: Oxford University Press, 2000), 28 (quoting William Sharpe and Gordon J. Alexander, *Investments*, 4th edition (Upper Saddle River, NJ: Prentice Hall, 1990)).

[120] See Andrei Shleifer and Robert W. Vishny, "The Limits of Arbitrage," *Journal of Finance* 52 (1997): 35–55, 35.

[121] See generally J. Bradford DeLong, Andrei Shleifer, Lawrence Summers, and Robert J. Waldmann, "Noise Trader Risk in Financial Markets," *Journal of Political Economy* 98 (1990): 703–38.

[122] See generally Nicholas Barberis and Richard H. Thaler, "A Survey of Behavioral Finance," in *Advances in Behavioral Finance Volume II*, ed. Richard H. Thaler (Princeton: Princeton University Press, 2005), 1–75.

fundamental values and make markets inefficient. This, then, is where the reason for tolerating arbitrage comes in. What arbitrageurs do, the theory goes, is recognize the mispricing caused by irrational investors and buy the resulting underpriced or sell the resulting overpriced stocks or other goods, thereby driving prices back toward fundamental values and once again helping to ensure that markets remain efficient.[123]

The first problem with this theory, it should be obvious, is that there has been an equivocation in the use of the term "arbitrage." Investors who try to take advantage of what they see as mispricings are not arbitrageurs in the classical sense—that is, they are not investors who are trying to profit from price differentials for the same or similar goods in two different markets. On the contrary, they are simply value investors. True, they often hedge their bets by selling similar goods short or using other hedging techniques so that their downside is limited if the price of the supposedly mispriced good does not converge on its fundamental value within the time frame they anticipate, and sometimes these hedges are made in different markets, but the profit opportunity here is from movement in the mispriced good, not from differences in prices of similar goods in two different markets. So while these value investors are often referred to as arbitrageurs, they are arbitrageurs in a very different sense, and whatever effect they may have on mispricing, this is not a reason for us to tolerate arbitrage in the classical sense.[124]

Moreover, while it may be true that what I have been calling classical arbitrage does serve to bring prices in different markets into equilibrium, it is hard to see why we should care about this. The fact that the same good sells at two different prices in two different markets is only a problem if people can take advantage of this. If people cannot trans-ship or its equivalent—that is, if they cannot buy the good in one market and resell it in the other, or at least if they cannot buy the good in one market and resell it in another *for more than its just price*, there is no reason to be concerned by such price differentials. In other words, arbitrage in the classical sense only helps to make markets more efficient if arbitrage is possible. So we cannot use the problem that arbitrage both creates and cures as a justification for tolerating its existence.

Finally, it is hard to see why allowing arbitrage is necessary to drive the prices in two different markets toward each other. If such convergence is possible, why would it not occur even in the absence of classical arbitrageurs? Assuming that prices do eventually move toward fundamental values, and the fundamental value of the good at issue does not vary from market to market,

[123] See Shleifer, *Inefficient Markets*, 2–5.
[124] Even the ability of this kind of arbitrage to drive prices toward fundamental values is likely to be limited. See Shleifer and Vishny, "The Limits of Arbitrage."

then the same forces that serve to drive prices toward fundamental values in a single market should work in both markets and eventually drive prices to the same level in both regardless of the lack of any opportunity for arbitrage. And if such convergence is not possible, allowing arbitrage is not going to change that fact. Which is why arbitrageurs in practice have rarely been able to eliminate such inefficiencies.[125] So once again, there seems to be little reason here to tolerate the deviation from the just price that profiting from arbitrage necessarily entails.

On the other hand, there are good reasons for not tolerating this. In the real world, opportunities for pure arbitrage are exceedingly rare. Most arbitrage transactions involve some degree of risk, and often a high degree of risk, given differences in the goods involved, the degree of correlation between the behavior of the markets involved, the sheer size of the transaction necessary to make pursuit of the potential profit opportunity worthwhile, unavoidable discontinuities in the timing of the purchase and sale, the fact that arbitrageurs are generally agents trading for poorly-informed principles who have short-term goals and may be somewhat irrational themselves, and so on. Often, the arbitrage opportunity exists for only a few seconds or less and can be taken advantage of only by those who constantly monitor the markets for such opportunities using sophisticated and highly-complex computer algorithms and are able to execute massive computer-assisted trades in milliseconds. Nevertheless, such "high-frequency" trades today account for a stunningly high percentage of daily trading volume, perhaps more than 50 per cent, even though only a small handful of traders are in a position to follow such a strategy.[126] Unlike classical arbitrage, however, these trades do require access to large amounts of capital, both human (because a great deal of technical expertise is required to engage in this kind of trading) and financial (because the profit to be had here is minuscule unless the trades involved are huge). Like the sale and purchase of credit default swaps, moreover, they involve not the management and reduction of pre-existing risk but the creation of it. And this risk, it turns out, can be very large indeed.[127] In other

[125] See Owen A. Lamont and Richard Thaler, "Can the Market Add and Subtract? Mispricing in Tech Stock Carve-Outs," *Journal of Political Economy* 111 (2003): 227–68.

[126] See Nelson D. Schwartz and Louise Story, "Surge of Computer Selling after Apparent Glitch Sends Stocks Plunging," *The New York Times* (May 6, 2010). Note that these figures include trading by market-makers, who do have a legitimate objective for both buying and selling at the same time, and flash trading, which is in reality a form of front-running, or trading on information a few microseconds before it is released to the general public. The former accounts for only a modest percentage of high-frequency trading, however, and the latter is simply a form of trading on inside information that is or at least should be unlawful already. See Charles Duhigg, "S.E.C. Starts Crackdown on 'Flash' Trading," *The New York Times* (August 5, 2009). Accordingly, neither practice is included in the kind of high-frequency trading I am criticizing here.

[127] Consider, for example, the recent Knight Capital trading debacle, in which a glitch in the company's new high-speed computer trading program caused it to lose $440 million in just forty-five minutes. See Nathaniel Popper, "Knight Capital Says Trading Glitch Cost It $440 Million," *The New York Times* (August 2, 2012).

words, this kind of arbitrage is not something distinct from speculation; it is a form of it. Moreover, to the extent that arbitrageurs take advantage of price separations that exist for only milliseconds, it seems hard to believe that their activity will actually make markets more efficient. Indeed, if anything, arbitrageurs are likely to expend much political and financial capital on *preventing* further increases in market efficiency, for it is the existence of such inefficiencies that give rise to their opportunities for profit. At the very least, it seems that high-frequency trading has greatly increased market volatility, and it may provide those who can engage in it with a new tool for market manipulation.[128] Arbitrage therefore has definite social costs as well as social benefits, assuming such benefits exist, and even if they do, it does not seem that they could possibly outweigh the costs.[129] What this means, in turn, is that arbitrage not only violates our reconceived notion of the just price; it is also exploitive. Indeed, it is the textbook case of the kind of transaction that the Scholastics condemned: the pursuit of profit for its own sake. Like other forms of exploitation, we accordingly have all the reason we need to ban it.

6.11 Exploitation and Climate Change

The final ramification of our theory of exploitation that I want to discuss is with regard to the problem of climate change. The reason that our theory has some implications for the problem of climate change is that it requires the sales price of any good to reflect its social as well as its private cost. To the extent that goods sold now do not reflect the full cost of the environmental damage they will later impose on others, these goods are underpriced, and therefore violate the doctrine of the just price as we have reconceived it. Whether they are exploitive, however, depends on whether there are any reasons for tolerating this downward deviation. What those reasons might be, and the extent to which they might justify a downward deviation in the just price, are the questions I will take up here.

Before I do, however, there is one preliminary point I want to make. Because the environmental costs that we are considering are costs that will be incurred in the future, it may be the case that a large portion or perhaps even everyone who will have to bear these costs are members of future generations—that is,

[128] See Graham Bowley, "Clamping Down on Rapid Trades in Stock Market," *The New York Times* (October 8, 2011); Roger Lowenstein, "A Speed Limit for the Stock Market," *The New York Times* (October 1, 2012).

[129] See E. Glyn Weyl, "Is Arbitrage Socially Beneficial?" (October 15, 2007), <http://ssrn.com/abstract=1324423>. Doubts about this are already leading a number of countries to enact limits on high-speed trading. See Nathaniel Popper, "Beyond Wall St., Curbs on High-Speed Trading Advance," *The New York Times* (September 26, 2012).

people who do not currently exist. Whether people who do not currently exist can hold rights against and be owed duties by people who currently do is controversial, and if we were to conclude that people who do not yet exist cannot hold such rights, then the failure to take account of future environmental costs would not be a breach of duty toward anyone and therefore could not be exploitive.[130] While it might have been necessary to provide a rebuttal to this argument at one time, however, it no longer is. The effects of climate change are now recognized as severe enough and as coming soon enough—indeed, some of them are already here—that at least some of the costs imposed by transactions that do not take their environmental impact into account are going to be costs for people who already exist. Indeed, current models show a potential for disaster by the year 2050, when a large proportion of the people who currently exist will still be alive.[131] To deal with these costs, action will be required, and whatever action is taken, the costs will be the same regardless of whether all of the people who benefit from this action are alive at the time the transactions that made this action necessary take place or only some of them. In other words, addressing climate change is a public good—it is indivisible, non-excludable, and non-rivalrous. So we need not worry about whether and if so to what extent we can owe duties to future generations here. If we have insufficient reason to tolerate the failure to take future environmental costs into account in the present context, then such transactions are exploitive and can and should be prohibited.

For a time, of course (and this is related to the future generations argument) it was perhaps not clear that human conduct was threatening future environmental damage, or what it would cost to address this damage if it occurred, or when such damage would occur if it did. During this period, the burdens of judgment might have provided a reason to tolerate some failure to take account of future environmental costs and a corresponding

[130] For examples of those who take the position that future persons cannot hold rights, see Hillel Steiner, *An Essay on Rights* (Oxford: Blackwell, 1994), 259–61, and John Broome, "Fairness," *Proceedings of the Aristotelian Society* 91 (1990–91): 87–101, 90–3. For examples of those who take the opposing view, see Matthew H. Kramer, "Getting Rights Right," in *Rights, Wrongs, and Responsibilities*, ed. Matthew H. Kramer (Basingstoke: Palgrave, 2001), 28–95, at 52–7, and Axel Gosseries, "On Future Generations' Future Rights," *Journal of Political Philosophy* 16 (2008): 446–74.

[131] The most authoritative statement of the current scientific consensus with regard to the nature, causes, and effects of climate change is contained in Fourth Assessment Report of the Intergovernmental Panel on Climate Change ("IPCC"), joint winner of the Nobel Peace Prize in 2007. See IPCC, *Climate Change 2007: Synthesis Report* (available at <http://www.ipcc.ch/pdf/assessment-report/ar4/syr/ar4_syr.pdf>). For one of the most influential economic assessments of the problem of climate change, see Nicholas Stern et al., *The Economics of Climate Change: The Stern Review* (Cambridge: Cambridge University Press, 2007) ("the Stern Review"). For criticism of the Stern Review, see, e.g. William D. Nordhaus, "A Review of *The Stern Review on the Economics of Climate Change*," *Journal of Economic Literature* 45 (2007): 686–702; and M. L. Weitzman, "The Stern Review of the Economics of Climate Change," *Journal of Economic Literature* 45 (2007): 703–24. For Stern's response to these and various other criticisms, see Nicholas Stern, "The Economics of Climate Change," *American Economic Review: Papers and Proceedings* 98 (2008): 1–37.

downward deviation from the just price, even though we were convinced that those asserting that the existing scientific data was not sufficiently persuasive were in error. But the time when a denial of the science here could be categorized as reasonable under even the most generous interpretation of that word has long since passed. The most recent IPCC report, for example, states that "warming of the climate system is unequivocal, as is now evident from observations of increases in global average and ocean temperatures, widespread melting of snow and ice and rising global average sea level," "global atmospheric concentrations of [greenhouse gasses ("GHG")] have increased markedly as a result of human activities," and "most of the observed increase in global average temperatures since the mid-20th century is *very likely* due to the observed increase in GHG concentrations."[132] While the exact costs of either mitigation of or adaptation to the effects of these changes are not yet known with complete certainty, the causal connection between human activity and climate change is now clear enough (the phrase "very likely" reflects a 90 per cent certainty), the time frame in which this damage will occur is now soon enough, and the potential cost of these changes if they are allowed to continue is now large enough that a failure to take these costs into account cannot be defended as within the burdens of judgment. Indeed, even former climate-change skeptics are now conceding that the IPCC report was not only right, it may have actually *understated* both the extent of the problem and its connection with human activity.[133] If toleration of downward deviations from the just price is going to be justified today, it cannot be justified simply by denying that the problem of man-made climate-change exists.[134]

Perhaps, then, a reason to tolerate some degree of downward deviation can be found in the strains of commitment. The strains of commitment, you may recall, apply whenever human nature makes it difficult for people to abide by ethical commitments made in the abstract once they know that these ethical commitments and their self-interest (or what they perceive as their

[132] IPCC, *Synthesis Report*, 30, 37, and 39 (emphasis in original). For those who wish to review the scientific data on which these statements are based, these are set forth in full in the *Report*.

[133] See, e. g. Richard A. Muller, "The Conversion of a Climate-Change Skeptic," *The New York Times* (July 29, 2012).

[134] Even if the burdens of judgment did justify continued toleration of a downward deviation in the just price, of course, that would not mean it would be improper to do anything about climate change. On the contrary, it would merely mean that the failure to do anything about climate change was not exploitative. Addressing the problem of climate change could still be justified under the precautionary principle, which recommends that action be taken now to prevent what may be very severe future injury even though it is unclear that such injury will indeed occur. Of course, the precautionary principle is itself open to criticism, both as to its coherence and as to when its use is appropriate. But these problems have been extensively discussed elsewhere, see, e.g. Cass Sunstein, *Laws of Fear: Beyond the Precautionary Principle* (Cambridge: Cambridge University Press, 2005), so I shall not engage with them here.

self-interest) are likely to conflict. And there is some reason for concern here, given people's well-known tendency to favor their short-term over their long-term interest—in other words, people's tendency to discount the payoffs of future events not because they may be uncertain, or rather not *only* because they may be uncertain, which is rational, but also because these payoffs will be enjoyed in the future, which is not.[135] This is the reason why many people are willing to buy goods on credit that they know they ultimately cannot, in fact, afford. In light of this tendency, even though it is clear now that the costs of climate change are costs for people who already exist and that these costs will only increase the longer we fail to address their causes, people may still prefer to put off dealing with the problem now if there appear to be benefits available (in the form of the current avoidance of economic sacrifice) from doing so.[136]

But once again, it seems like the time when the strains of commitment would have had some real purchase here has passed. People seem finally to be convinced that if we do not do something now, they face a certain and irremediable degree of loss. In other words, they fear that if we do not do something now, we may not be able to reverse the coming changes or even adequately ameliorate their effects, no matter how much we are prepared to pay later. This, in turn, raises the possibility that the threat of climate change may trigger loss aversion, which encourages people to take risks to avoid losses they would not take to obtain gains.[137] We accordingly may now have one technically irrational tendency in human decision-making effectively counteracting another. Perhaps this will mean that legislation dealing with climate change may now finally have a chance of passing. But at least it means that the political tide against dealing seriously with this issue may have begun to turn. And if it has, the strains of commitment, like the burdens of judgment, no longer provide us with a sufficient reason to tolerate continued downward

[135] Why so many people seem to have such a tendency is unclear. But Robert Nozick has an interesting theory about this. He argues that our tendency to discount future payoffs excessively (that is, more than necessary to account for the uncertainty of future events) results from that uncertainty being counted twice—once because evolution has led us to make anticipatory probabilistic calculations instinctively, since we were at one time incapable of making such calculations consciously, and again because now that we *are* capable of making such calculations consciously, we consciously discount what we have in effect already discounted instinctively. See Robert Nozick, *The Nature of Rationality* (Princeton: Princeton University Press, 1993), 14–15.

[136] For a discussion of the effect of this kind of short-sightedness on perceptions of what we should do about climate change, see the symposium of discounting dilemmas in volume 37 of the *Journal of Risk and Uncertainty* (2008). A useful introduction to these papers is provided in Richard J. Zeckhauser and W. Kip Viscusi, "Discounting Dilemmas: Editors' Introduction," *Journal of Risk and Uncertainty* 37 (2008): 95–106.

[137] Experimental evidence suggests that for even small to moderate sums of money, losses tend to be given roughly twice the decision weight of equivalent gains. See Amos Tversky and Daniel Kahneman, "Loss Aversion in Riskless Choice," *Quarterly Journal of Economics* 106 (1991): 1039–61. Given the size of the potentially unrecoverable sums we are talking about here, however, the decision weight attached to avoiding these losses is potentially huge.

deviations from the just price of transactions that have a recognized environmental impact.[138]

If a justification for such downward deviation is to be found, it must accordingly be found in the presuppositions of capitalism. Given that we are currently experiencing a financial downturn, the argument that capitalism provides for continued toleration of the failure to take future environmental costs into account is this: the economic impact of including these costs in all relevant transactions now will be financially onerous and therefore have a negative effect on economic growth. While this might not be a problem during an economic boom (indeed, it might be exactly the kind of thing we need to do to put the brakes on an over-heating economy), it is exactly the wrong thing to do during an economic downturn. We must accordingly be willing to allow some deviation from the just price now even if this causes more damage later. The argument is that managing the business cycle is part of capitalism, and the last thing we need to do when at the bottom of an economic valley is impose regulations that will raise prices and thereby reduce employment and otherwise hinder economic growth.

Of course, this same argument was made by some during the recent economic boom, when those opposed to dealing with climate change characterized any attempt to address the problems that climate change seemed to create as "a boom killer." But if embarking on such a project is indeed worthwhile, then embarking on it during a boom is exactly the right time to do it, for this is when producers are in the best position to absorb the increased costs without passing these on to the consumer and thereby triggering inflation, so this argument should have had little traction then. Now that we have moved from boom to bust, however, there is some genuine reason to be concerned. It will be difficult now for producers to absorb these costs without passing them on to consumers and contributing to inflation. If the downturn is serious enough, however, *deflation* not *inflation* is our greatest cause for concern, so a little inflationary activity might be helpful rather than hurtful, or at least not very hurtful.[139] In any case, the solution that capitalism recommends for this

[138] It is possible of course, that loss aversion is also working the other way. Some people might view the economic sacrifice required now as a certain loss, and the future effects of climate change as a greater but still uncertain loss, a loss they are willing to risk in order to avoid incurring a certain loss today.

[139] There are three reasons why deflation is bad. First, the expectation of continuously dropping prices causes people to not spend, since why buy something now when you can buy it later for less, so not spending becomes a form of saving, and this in turn creates more deflation, and so on. Second, deflation worsens the position of debtors by increasing the real burden of their debts, and rising real debt can, once again, lead to further deflation. Finally, if prices are falling, wages will need to fall too, but wages are stickier than prices, and the only way to overcome this may be to create mass unemployment. See Paul Krugman, "Why is Deflation Bad," *The New York Times* (August 2, 2010). See also Sewell Chan, "Deflation Concerns Diminish at the Fed," *The New York Times* (January 4, 2011) (justifying the Fed's program of quantitative easing on the grounds that its

problem is not deferral and delay; it is technical innovation. Indeed, technical innovation is not only one of the best ways to address climate change; it is also one of the best ways to address economic malaise. Even though there may be some short-term economic dislocation associated with attacking the problem of climate change now, the innovations that will eventually come as a result of addressing this problem will themselves be highly valuable. And while it is always possible that later innovators may learn from the mistakes of early innovators and therefore have lower costs and higher profits (a form of free-riding), it is no less plausible that the long-term economic return will be greatest for those who engage the problem first and learn by doing, enabling them to develop and patent the relevant technologies and therefore enjoy what are effectively higher than normal (in other words, monopoly) profits. If we have no reason to believe one outcome is more likely than the other, the principle of insufficient reason recommends that we treat each outcome as equally probable, in which case waiting would have no greater expected value than starting *at best*. Yet we actually have reason to believe it has less. This is because unless *someone* is willing to start, waiting cannot possibly generate *any* returns—on a societal basis, starting always produces greater returns than not starting when there are returns to be had and the alternative is that no one does anything at all. Which means that the short-term cost of addressing the problem of climate change now will be more than outweighed by the additional long-term return of starting sooner rather than later even if there are ultimately somewhat greater gains to be had for latecomers.

To put this in game-theoretic terms, the incentives here are *not* the incentives of the Prisoner's Dilemma, for it is not true that each party does better by waiting no matter what the relevant other parties do. Nor do we have a game of Chicken, for it is not true that waiting is *necessarily* best if others start, while starting is best if others wait, for starting may be best even if others are starting too. Nor do we have an assurance game, for even if there is insufficient cooperation now to guarantee that climate change can be successfully combated, at some point there will be, so a market for these technologies will eventually exist. Thus we do *not* have a tragedy of the commons, despite the existence of various motivational impediments to successful cooperation, but

inflationary effect is actually helpful not hurtful when deflation is a danger). In light of all this, central banks typically aim not at maintaining an inflation rate of 0 per cent, for that comes too close to teetering over into deflation, but at something more like 2 per cent. See, e.g. Federal Open Market Committee, *Press Release* (January 25, 2012) (US Federal Reserve). Some economists even argue that allowing inflation to rise to 3 per cent or even 4 per cent should be acceptable if necessary to help bring down unemployment when unemployment levels are high. See, e.g. Paul Krugman, "Not Enough Inflation," *The New York Times* (April 5, 2012); Rich Miller, "U.S. Needs More Inflation to Speed Recovery, Say Mankiw, Rogoff," *Bloomberg* (May 19, 2009).

a game in which the payoffs are uncertain.[140] And the only thing that is certain is that unless widespread and well-funded action by others would create the opportunity for and increase the probability of successful free-riding to greater than 50 per cent, in which case we might do better by waiting rather than tackling climate change now, starting to deal with climate-change now offers at least as good an expected payoff as waiting does, and perhaps a far better one. Under current conditions, then, starting represents the dominant choice, at least for an economy as large as the United States, which is capable of developing the needed technologies on its own even in the absence of contributions from other nation states.

It is also important to keep in mind that ensuring an externality is taken into account can be done in a number of ways. First, there is simple regulation, which would require that a producer take the environmental costs of his products into account when calculating their just price, although the adjusted prices that would result may have to be phased in rather than put in place all at once in order to avoid an untoward shock to the economy. While this would ensure the proper allocation of resources, however, it would not solve the exploitation problem by itself, even once this adjustment period is complete, unless something additional is done to ensure that the costs collected will indeed be used to address the environmental problems that the particular transaction may create. To accomplish this, the costs collected would have to be turned over to a trust fund or to the government, which would then assume the burden of paying these costs when they come due. Second, there is taxation, which forces the producer to internalize the cost that the government will ultimately have to bear, thereby accomplishing the same thing as in the first approach but somewhat more directly, although in this case it would be the government who would make the necessary calculations and provide the necessary assistance to those affected. Third, there are government loans or grants for research and innovation, grants designed to help offset increased taxation and provide additional incentives for those in the best position to address these problems to attempt to do so. Fourth, there is implementation of a system of carbon trading, where limits are imposed on the quantity of greenhouse gasses that can be released by each producer, but producers are allowed to buy and sell the allocated limits.

Each of these approaches has something to recommend it, but I will not take the time to argue for one approach over the others here, for my objective is not to show how the problem of climate change should ultimately be solved but simply to show that our theory of exploitation establishes that the failure to

[140] For a discussion of the tragedy of the commons and the various game-theoretic structures that capture the motivational impediments it involves, see my *Punishment, Compensation, and Law* (Cambridge: Cambridge University Press, 2005), 58–61.

pursue a solution would be a violation of at least the affected members of the current generation's rights.[141] With regard to the details of how best to protect these rights, suffice it to say that some combination of all four methods of addressing the problem will probably be required. Indeed, if the problem is addressed correctly—in other words, if instead of merely requiring producers to raise their prices to reflect their true environmental costs we also provide government subsidies for the innovations that are required to reduce these costs or find better, cheaper substitutes, addressing the problem can be combined with a government stimulus program that is fully in line with a Keynesian approach to managing a downturn in the economy.[142] We would not only benefit from getting a head start on the technical innovation that is likely to bring both heightened environmental and financial returns in the near future, we would also benefit from the net economic stimulus that a properly designed government incentive program would provide to the economy. In any case, whatever weight the economic downturn-based argument for continued toleration has, it is not sufficient to justify the continued failure to take these environmental costs into account.

What this means is that the failure to account for the cost of the environmental impact of current transactions in those transactions themselves is indeed an act of exploitation. While our theory of exploitation does not prescribe any particular solution to this problem, it does require that the problem be solved. And this, I submit, gives our theory of exploitation an advantage that other liberal theories of economic justice lack. Economists and scientists alike all recognize that the problem of climate change has an ethical dimension, and admit that it cannot be adequately described much less addressed until some preliminary moral decisions have been made, such as how to divide the costs not only between emitters from nations in various stages of development but also between present and future generations.[143] The first issue has to do with the fact that the already developed nations are richer and therefore their economies are better able to absorb the cost of imposing limits on emissions than the developing nations, plus they have already enjoyed the economic benefits of imposing these externalities on other nations for many years, while the developing nations have not. The second has to do with what is called the social discount rate—the claim that to some extent, at least, it is appropriate to shift the burden of the cost of environmental damage to future generations because future generations will

[141] For a discussion of how best to approach dealing with the problem and the assumptions that should underlie any such approach, see *The Stern Review* as well as Stern, "The Economics of Climate Change."

[142] See generally John Maynard Keynes, "The Means to Prosperity," in *Essays in Persuasion,* (London: Palgrave Macmillan, 1931, 1972, 2010), 335–66.

[143] See, e.g. Stern, "The Economics of Climate Change," at 12–17.

presumably be richer than we are now and will therefore feel the burden less.[144]

Notice that both issues are global albeit in different ways—the first cuts across geographic boundaries; the second across time. Despite the recent popularity of thinking about issues of distributive justice on a global scale, however, philosophers were slow to address these issues until relatively recently.[145] One reason for this may be that the standard liberal approaches to addressing questions of economic justice do not seem to work well here. To analyze climate change using the difference principle, for example, we would have to ask whether the life chances of the least advantaged are better if we ignore the problem now or better if we try to solve it. The problem is that it may be the case, as William Nordhaus argues, that instead of devoting something like 2 per cent of global gross domestic product ("GDP") to addressing the problem of climate change (the figure the Stern Review suggests), everyone (and especially the currently least advantaged) would be better off if we simply spent nothing on climate change now and used a portion of the funds saved to improve the economic position of the least advantaged through direct investments in reproducible and human capital, thereby building up the productive base of the economy, especially in poor nations, and providing all concerned with greater resources to deal with the various ramifications of climate change when these ramifications eventually arise.[146] There are substantial political impediments to accomplishing this no doubt (how do we get people in rich nations to support increased foreign aid and aid to their own poor when they are so reluctant to give aid at the much lower levels in place now), but if Nordhaus is right about this, it seems that the difference principle would recommend against devoting substantial funds to addressing climate change

[144] Note that the social discount rate is to be distinguished from the pure time discount rate—the amount of discount necessary to convert future dollars into units of the same value as current dollars given the real rate of interest, the amount that a dollar today can be expected to earn in a riskless investment over inflation. For further discussion of this distinction, see Stern, "The Economics of Climate Change," 11–17.

[145] See Stephen M. Gardiner, "Ethics and Global Climate Change," *Ethics* 114 (2004): 555–600, at 555 (finding it "puzzling" that "very few moral philosophers have written on climate change"). Only in the last few years has the issue of climate change attracted a large amount of attention within applied philosophy.

[146] See William D. Nordhaus, *Managing the Global Commons: The Economics of Climate Change* (Cambridge, MA: MIT Press, 1994). Note that Nordhaus's argument is much more sophisticated and much more compatible with the thinking behind the difference principle than the one considered and rejected by Peter Singer in *One World: The Ethics of Globalization* (New Haven: Yale University Press, 2002), 36–40. Singer argues that contrary to some assertions by the most recent Bush administration, simply allowing things to go on as they have been is not consistent with the difference principle because this does not make the poor in other countries better off. But Nordhaus does not argue that we should simply continue doing what we have been doing; he argues that instead of devoting similar or even greater funds to addressing the problem of climate change now, we should invest in the poor directly. This is a much stronger argument than the one Singer attacks, for it is much more in keeping with the spirit of the difference principle and it is much harder to show that the empirical assumptions underlying it are wrong.

now. And while it is not clear that Nordhaus *is* right, it is difficult to know one way or the other for sure. The fact that the difference principle makes this a critical issue therefore makes it an unfortunately equivocal source of advice when it comes to climate change.

There is also an added complication here. Those who are the worse off now and who would therefore be the beneficiaries of the capital and other investments that Nordhaus contemplates are not necessarily the same people who would be the worse off later if we do not begin addressing climate change now. There is accordingly a potential conflict between these two groups—those who would be worse off later if we do nothing to address climate change now, and those who are the worse off now if we do. This, it seems, is how the question of the appropriate social discount rate would arise under the difference principle. And once again, the difference principle could be read to support the Nordhaus argument, in that it might require a very high social discount rate. Indeed, if we assume that future generations will be better off, then we are the worse off group, and thus anything that makes us worse off should be eschewed even if it makes our better-off descendants worse off than they would otherwise be.[147] Now Rawls himself casts doubt on whether the difference principle should be used like this—he says "the appropriate expectation in applying the difference principle is that of the long-term prospects of the least favored extending over future generations"; he elsewhere says "the principle of just savings holds between generations, while the difference principle holds within generations."[148] The just savings principle, in turn, does require the current generation to take account of the effect of their actions on the next.[149] But I am not going to attempt to resolve this potential conflict in Rawls's work here. The only point I am trying to make is that the advice offered by the difference principle for addressing climate change is conflicting and unclear, making it at best a controversial and at worst an unhelpful source of guidance for dealing with the problem.

Under our theory of exploitation, in contrast, it is clear how these ethical issues are to be dealt with—they have nothing to do with whether the price charged by current producers is just, but rather are to be addressed as potential reasons for toleration. Obviously, the fact that the developed nations have been the greatest producers of GHG in the past is not a reason for toleration of

[147] For a discussion of this possible interpretation of the difference principle by someone who rejects it, see Samuel Freeman, *Rawls* (London: Routledge, 2007), 136–9. Among economists, however, the argument that we should favor the current generation over the next and the next and so on seems to hold much sway. A similar argument to the one made by Nordhaus is also made by Partha Dasgupta, who unlike Nordhaus, ties it to the difference principle explicitly. See Partha Dasgupta, "Commentary: The Stern Review's Economics of Climate Change," *National Institute Economic Review* 199 (2007): 1–7, at 6.

[148] Compare Rawls, *A Theory of Justice* (rev. ed.), 252, with Rawls, *Justice as Fairness*, 159.

[149] See Rawls, *A Theory of Justice* (rev. ed.), sec. 44, pp. 251–8.

any present violations of the doctrine of the just price by them now. It might be a reason for some toleration for a downward deviation from the just price by producers of GHG in developing nations if we decide that our theory of exploitation can apply to such nations, or it might not, but the answer to this question is not relevant to deciding whether we can continue such emissions ourselves. If we decide that developing nations do have sufficient reason to tolerate some downward deviation from the just price, this simply means that we may have to do more now than merely cease our continuing violations if we are to adequately address the problems created by climate change, but this is a matter that goes beyond the question of continuing exploitation and into the realm of our remedial obligations for past violations, and requires the application of other, more general principles of distributive justice, and is thus beyond the scope of what I am attempting to address here.

With regard to whether the poor would be better or worse off if we do or do not begin to address the problem of climate change now, and which poor should be the focus of our concern, these issues become academic if we apply our theory of exploitation rather than the difference principle. Even if the poor would be better off one way or the other, this is not a reason for tolerating continuing violations of the doctrine of the just price, for making the poor better off is simply not something with which our theory of exploitation in particular or capitalism in general is concerned, even though preventing exploitation and otherwise promoting capitalism may often or at least sometimes have this effect. And this is true *even if we have reason to provide the poor with special assistance* to ameliorate some of the effects of capitalism or the prohibition of exploitation under more general principles of distributive justice. Thus, our theory of exploitation requires us to prohibit any downward deviations from the just price now and the contributions to climate change these would otherwise present regardless of what effect this might have on certain segments of present or future generations.

Finally, we come to the issue of the appropriate social rate of discount, and whether the fact that future generations will be wealthier than we are now—assuming this is a fact—is a reason to tolerate our imposition of externalities on them. Frankly, I do not see how a reason for toleration can arise out of the presumed greater wealth of future generations despite what Nordhaus and certain others seem to assume and despite what one interpretation of the difference principle might suggest. At least some of those who will be seriously injured if we do nothing about climate change now are already alive. The fact that preventing the injury of people who are now alive will also benefit people who are not yet alive is not a reason to allow the injury of existing people to occur. On the contrary, it is simply irrelevant that future people will also benefit. The fact that these benefits are non-rivalrous, meaning that the enjoyment of them by some does not reduce the enjoyment of them by others is no reason not to create them.[150] The social discount rate that our theory of exploitation suggests we use is therefore one, which, parenthetically, is the figure used in the Stern Review. And while many of the Report's critics object to this figure on the grounds that it would require huge transfers of wealth from the current generation to the next and from the next to the next and so on and so forth despite the fact that these generations would (allegedly) already be better off even without such transfers, this would only be the case if achieving intergenerational distributive justice was a positive obligation, rather than merely a potential reason for the toleration of a certain kind of commutative injustice, as it is under our theory of exploitation. In other words, we can still use a positive social rate of discount for deciding whether there is some general obligation arising out of pure distributive justice to assist future generations without being committed to use this same rate when it comes to the question of whether we should tolerate the commission of a specific kind of distributive injustice by people who exist now. Thus, the problem that Stern's critics see in Stern's use of one as the social rate of discount does not arise if we use our theory of exploitation. While the difference principle walks head-on into the problem of the social rate of discount, our theory of exploitation manages to side-step it. Under the difference principle, what we should do now about the problem of climate change is at best uncertain. Under our theory of exploitation, however, it is clear that we must do something now, regardless of what less developed nations do and whether future generations will be better or worse off. Only the question of whether we must also provide further assistance to the poor is up for continuing discussion.

Luck egalitarianism, I should also note, seems to be even less helpful here than the difference principle. It provides no structure for dealing with the problem of climate change *ex ante* at all. All it allows us to do is to argue *ex post* for financial support for those who have been disadvantaged by climate change through no fault of their own. But some and perhaps even the vast majority of those disadvantaged by climate change may have knowingly contributed to its formation, not only by leaving unnecessarily large carbon footprints, but also by voting for projects and politicians that trade future harm to the environment for short-term economic gain. When these people begin to suffer the effects of these actions and decisions they might accordingly plausibly be characterized as suffering because of their own choices, not bad luck. In this case, luck egalitarianism would suggest that we simply let the chips fall where they may, and indeed, this is exactly what Nordhaus recommends we do. But recommending that we do nothing to head off climate

[150] For further discussion of and argument against the social discount rate, see Derek Parfit, *Reasons and Persons* (Oxford: Oxford University Press, 1984), 480–6.

change before it occurs and that we should not even compensate those disadvantaged by this does not make luck egalitarianism a very attractive policy on this issue. And while I do not claim that luck egalitarians cannot find resources within their theory to develop a more proactive attitude toward climate change, it is troubling that luck egalitarianism seems to deal with the problem rather awkwardly. Under our theory of exploitation, in contrast, it is not necessary to "get creative" in order to grapple with the problem of climate change. Our theory of exploitation allows us to take on the problem of climate change directly, and to directly address both the concerns that seem to be driving it and the concerns that are driving resistance to its solution.

As I bring this chapter to a close, I want to make some general comments on the areas in which implementation and enforcement of our theory of exploitation may have some substantial ramifications. Besides supporting the imposition of both a minimum and maximum wage, prohibiting excessive profits and (in some cases) sales below cost, justifying the imposition of both an estate and gift tax on the very wealthiest individuals, prohibiting acts of pure speculation and arbitrage, and requiring us to take serious steps toward addressing the problem of climate change, there will no doubt be other public policies our theory of exploitation will support, and some of these will also be politically controversial. In some cases, the ramifications of implementation and enforcement of our theory may even be unclear. I do not pretend to have provided an exhaustive survey of every effect that implementation and enforcement of the theory will have on our daily lives. Instead, I have simply focused on some of the most important and controversial issues that are currently topics of public debate and shown how our theory of exploitation would suggest we deal with them. But for any theory to have an impact, it must have supporters. The extent to which our theory of exploitation can draw support from the adherents of a wide range of more comprehensive theories of distributive justice is accordingly the topic we turn to next.

7

The Prospects for an Overlapping Consensus

The purpose of this final chapter is to place our theory of exploitation in a wider context by comparing it to its most popular competitors: prioritarianism, luck egalitarianism, and libertarianism. The purpose of this comparison is not to develop a critique of these other theories, but rather to see what they have in common and, more importantly, to see what they have in common with our theory of exploitation, for we need to consider whether and if so to what extent our theory might be the object of what Rawls calls an overlapping consensus—a theory that a variety of different traditions can all support without in any way compromising their fundamental values.[1] Only such a theory can be politically stable in a society characterized by reasonable pluralism—that is, a society in which people embrace a wide variety of reasonable although largely incompatible comprehensive moral, religious, and philosophical doctrines—and it is essential that our theory be politically stable if it is to have a reasonable chance of reducing economic inequality in the United States and other liberal capitalist democracies.

Before I begin these head-to-head comparisons, however, let me point out three general features of our theory of exploitation that make it a good candidate for being the object of an overlapping consensus. First, our theory is very limited, in that it focuses on specific transactions, rather than on the broad consequences of certain underlying socio-economic conditions and institutions, and therefore it is going to feel substantially less intrusive to those subject to its prohibitions than the more broad attempts at social engineering embodied in the first two of our theory's principal competitors. Second, its overall aim—that of reducing economic inequality from today's high levels, is widely shared, not only by at least two and a half of our theory's

[1] See John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: Harvard University Press, 2001), 32–8.

principal competitors (right-libertarianism may be a special case but I will get to this in a moment), but also by many of the comprehensive doctrines of which our theory's principal competitors are part. And finally, our theory of exploitation is built upon fundamental notions (reciprocity and tolerance) that have a long history of wide acceptance among the family of theories that comprise political liberalism, notions that are also consistent with the fundamental presuppositions of modern capitalism, presuppositions that a vast majority of society also already accept. So there is already good reason to be optimistic regarding our theory's potential for being the focus of an overlapping consensus, even before we begin our head-to-head comparisons. It is to that more detailed endeavor, however, that we now turn.

7.1 Exploitation and Libertarianism

Given libertarians' traditional hostility to most forms of redistribution, the inclusion of libertarianism on the list of theories to which our theory of exploitation will be compared may seem surprising. But the line between liberalism and certain forms of libertarianism is not always clear and, as we shall see, our theory can fit very comfortably into the schema libertarians use to analyze questions of economic justice. Indeed, Hillel Steiner, the only contemporary theorist to have offered a liberal theory of exploitation, is a left-libertarian, and by looking at left-libertarianism as including any theory that has a libertarian structure but still has the tools to combat extreme economic inequality, our theory of exploitation could be classified as left-libertarian too. But even if it cannot, it is important to note the relationship between our theory and libertarianism. Not only because right- and left-libertarianism both offer popular competing visions of how to think about the redistribution of wealth and income, but also because luck egalitarianism, one of our theory's principal liberal competitors, has borrowed and incorporated some powerful libertarian ideas. In assessing Ronald Dworkin's version of luck egalitarianism, for example, G. A. Cohen notes that

> Dworkin has, in effect, performed for egalitarianism the considerable service of incorporating within it the most powerful idea in the arsenal of the anti-egalitarian right: the idea of choice and responsibility.[2]

If we are to determine whether our theory of exploitation might be the subject of an overlapping consensus, it is accordingly important that we examine how our theory might fit into the libertarian tradition.

[2] G. A. Cohen, "On the Currency of Egalitarian Justice," *Ethics* 99 (1989): 906–44, 933.

7.1.1 *The Place of the Just Price in the Structure of Libertarian Thought*

To begin this examination, I will start with the libertarianism of Robert Nozick, for even though he is neither the first nor the only theorist to articulate a libertarian position, it is beyond dispute that his vision of libertarianism has had enormous influence, and no contemporary discussion of libertarianism can proceed without taking his views into account. What he argued was that everything that is justly acquired can be justly transferred.[3] He then went on to articulate a principle of just initial acquisition and a principle of justice in transfer, and argued that if these two principles were consistently followed, then no matter what pattern of distribution might result it would necessarily be just. His reasoning went as follows: suppose we believe that the existing distribution of wealth and income is just only if it follows a certain pattern. Whatever pattern we select, this would quickly be disrupted as soon as people start to trade, and this new pattern would then be quickly disrupted by further trades, and so on and so forth. The only way to maintain any particular pattern would be to have the government constantly re-arranging people's holdings. But if one *started* with a pattern that was just, and changed it merely by engaging in *voluntary* transfers, how could the resulting pattern be anything other than just? It therefore cannot be the actual pattern of distribution itself that matters when trying to determine if existing holdings are distributively just, but how this pattern came about.

Because of this focus on how things came about rather than on what they are, Nozick called his theory of distributive justice "an historical entitlement theory." Theories like the Rawlsian difference principle, in contrast, he called "end-state" or "patterned" theories because they focused on the nature of the existing pattern of distribution (the difference principle, recall, provided that social and economic inequalities were unjust unless the least advantaged members of society would be worse off under some lesser degree of inequality), and therefore required constant government-directed redistribution to maintain.[4] But for Nozick, redistribution was anathema except as a *remedy* for unjust acquisition or unjust transfer, which is why Nozick's historical entitlement theory of distributive justice had not just two principles but *three*, with the third designed to remedy violations of the first two, a principle Nozick called a principle of rectification.

Various aspects of Nozick's historical entitlement theory have been extensively criticized, and I have no desire to reprise or rebut any of these criticisms here. What I do want to do is focus exclusively on the second of his principles—his principle of justice in transfer, the one that provides that as long as

[3] See Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), 150–3.
[4] Nozick, *Anarchy, State, and Utopia*, 153–60.

a holding is justly acquired and voluntarily transferred, there would be a disruption of the previously obtaining pattern of distribution but this disruption could not possibly be unjust. Many theorists have challenged this claim, arguing that as a result of market-failures or defects in our concept of voluntariness or the presence of inherently coercive background conditions or negative externalities, the pattern of distribution resulting from a series of supposedly voluntary transfers could indeed be in some sense coercive and therefore unjust.[5] To this we could add Aquinas's concern that one cannot justly sell what one does not own, and it is impossible to own the need or want of another man. And what this means, in turn, is that an exchange at the market price can indeed be unjust even though it may be entirely voluntary if it includes compensation for something the seller has no right to sell.

To see how this last concern operates, let us use an example that Nozick himself developed. Nozick was a fan of professional basketball, and one of the most dominant players in the league at the time was Wilt Chamberlain, who played center for the Philadelphia 76ers. Many people came to see Chamberlain play, and as a result of his prowess on the court and his popular appeal, he was richly compensated. Nozick argued that as a result of the increased ticket sales that Chamberlain produced, which in turn increased the revenue generated by the games in which Chamberlain played, which in turn underwrote Chamberlain's salary, what we effectively had was a series of monetary transfers from these fans to Chamberlain. No matter what pattern of distribution held before, Nozick correctly pointed out, after these transfers, Chamberlain would have more money and his fans less. Income would have been redistributed from his predominately poor fans to his undeniably rich self. But as long as these transfers were voluntary, Nozick reasoned, there could not possibly be anything unjust about this. There could accordingly be nothing unjust about the pattern of distribution these transfers produced, or so Nozick thought.

But Aquinas would say that Chamberlain was in part being compensated for selling something he did not own. Chamberlain was highly compensated because there was such a thing as the game of basketball, which created a demand for his services that would not otherwise exist. After all, who would have thought that the ability to throw a big orange ball into a little yellow net could demand such high economic rent? There are many possible worlds in which this could easily have not been the case. And basketball was so popular because there had been a history of great players and great teams that had been fun to watch and had played in a league that was well managed and effectively marketed through the relatively new medium of television, which

[5] See, e.g. G. A. Cohen, *Self-Ownership, Freedom, and Equality* (Cambridge: Cambridge University Press, 1995); Robert Hale, "Coercion and Distribution in a Supposedly Non-Coercive State," *Political Science Quarterly* 38 (1923): 470–94.

in another world also might not exist. The demand for Chamberlain's services was not something that Chamberlain could own—indeed, it is incoherent to think that one could own the need or want of another man—and it was therefore not something that he could justly sell. And while *some* of the reasons behind this demand are reasons that Chamberlain incurred costs to produce (the degree of his own skill), the cost of producing a great many of the reasons behind this demand were incurred by someone else. Yet it was all these reasons taken together that made the demand for his services so high, and it is this total demand and not merely its cost of production that set what for him was his market price. For Aquinas then, even if every transaction that produced Chamberlain's salary was entirely voluntary, Chamberlain was (in part) selling something he did own and did not incur costs to produce. A portion of the compensation he received (the amount above the actual cost of production of his services) was therefore unjust even if it was the result of transfers that were entirely voluntary, notwithstanding what Nozick thought.

But all these concerns—that is, both the concerns of Aquinas (concerns that also, remember, were expressed by Scotus and by Luther) and the concerns of Nozick's more contemporary critics—melt away if we amend Nozick's theory as follows. Instead of providing that all voluntary transfers of justly acquired holdings are just, we recognize that voluntary transfers of justly acquired holdings are just *if and only if* the transfer is at a just price or intended as a gift. In other words, the mere fact that a transfer is voluntary does not mean that it is not a violation of someone's right, for this also depends on the transaction's terms or, more precisely, on the transaction's price term. Even voluntary transfers can be unjust and produce an unjust pattern of distribution if the just price is not paid. Only if all holdings were justly acquired, and all subsequent transfers are either intended as a gift or made for a just price, must the resulting pattern of distribution, whatever it might be, necessarily be just.

Of course, even if this were the case, it would not mean that everyone would enjoy an equal share of income or wealth or resources or primary goods or whatever else we might want to equalize. If some people labor, or put other forms of consideration besides resources into producing goods and services, while others simply buy and sell resources—in other words, if people make different *choices*—eventually those who provide labor and other forms of consideration will come to have more wealth than those who engage purely in mercantile activity. Luck might also produce inequalities, for some of those who assumed risks taken by others would be called on to make good on their agreements and some would not. Like all of its competitors, enforcement of the doctrine of just price would accordingly not preclude inequalities from arising. It would merely regulate those inequalities. But it would not do so by looking at the pattern of distribution that obtains. On the contrary, like libertarianism, and for that matter luck egalitarianism too, the doctrine of just price is an historical theory, for what matters is not the effect of an inequality or its extent, but how that inequality came about.

While luck egalitarianism and the doctrine of the just price are both historical theories, however, neither is historical in quite the same way as Nozick's libertarian theory, for neither looks very far back into the pedigree of an inequality, and certainly not all the way back to the state of nature. On the contrary, both theories look only at an inequality's most immediate cause. Under the doctrine of the just price, we look back only to the immediately prior state of affairs, and it does not matter whether either party was *entitled* to his holdings in that state of affairs, or in any other prior state of affairs for that matter, but merely whether the inequality obtaining between the parties has changed as a result of the transaction at issue. If there is an increase in inequality, that increase is unjust unless the party who benefited from it received the amount of this increase as a gift. Under luck egalitarianism, in contrast, we don't look back at all, but rather compare the current state of affairs with the hypothetical state of affairs that would have existed had those who are disadvantaged by inequality in the current state of affairs not suffered from brute bad luck. To the extent that any of the inequalities here can be traced back to the luck of the people disadvantaged by them rather than their choices, then the inequality is unjust. So both the doctrine of the just price and luck egalitarianism are "historical" only in a limited sense.[6] But given that they are clearly not end-state patterned theories, unless we want to invent a third category of theories to capture these variations, the historical entitlement category will have to do.

Remember also that not all violations of the doctrine of the just price are instances of exploitation under the terms of our theory. Only violations of the doctrine that are intolerably unfair constitute acts of exploitation under our theory. Given its tolerance for some violations of the doctrine of the just price, our theory of exploitation would accordingly *not* produce a pattern of distribution that was by definition just, even if we began in a state of just initial acquisition. But the same reasoning that ensures that the resulting pattern of distribution would be just if we began with a just initial distribution and all subsequent transfers were voluntary and made at a just price or intended as a gift also ensures that if all subsequent transfers were not exploitive, then the resulting pattern of distribution would not be intolerably unjust. And this, I contend, is all a liberal theory of distributive justice can possibly require.

[6] My thanks to Michael Davis for bringing this point to my attention.

At least that is all a liberal theory of justice can possibly require if we begin with a state of just initial acquisition. No one, however, contends that this is the case for any society in which anyone actually lives. Herbert Spencer's dramatic description of our historical position is typical: "The course of nature," he says, "is red in tooth and claw."

> Through "blood and iron" small clusters of men have been consolidated into larger ones, and these again into still larger ones, until nations have been formed. This process, carried on everywhere and always by brute force, has resulted in a history of wrongs upon wrongs: savage tribes have been slowly welded together by savage means. We could not, if we tried, trace back the acts of unscrupulous violence committed during these thousands of years; and could we trace them back we could not rectify their evil results.[7]

We all live in societies in which the initial distribution of resources was *not* just, and because of this, we need to consider carefully whether and to what extent this should have an impact on what a theory of economic justice designed to apply to a real society should require. We need to consider, for example, what compliance with our reconceived doctrine of the just price and our new, non-Marxist, liberal theory of exploitation would mean for the kind of society in which we actually live. Would we still end up with a pattern of distribution that was just in the first case and not intolerably unjust in the latter? Or would a substantial amount of rectification need to be done, no matter how hopeless it might be to try, and if so, what principle of rectification would justice require that we apply?

Despite noting that a principle of rectification would be a necessary component of any historical entitlement theory, Nozick, you may recall, had little to say about what this principle should require. He did note, however, that something very much like the difference principle, while it would not be acceptable as a self-contained principle of justice, might be acceptable as a principle of rectification.[8] Whatever principle we use as our principle of rectification, however, this is going to be a critical part of our historical entitlement theory, given the amount of rectification that is going to have to be done. Indeed, rather than prohibiting most government interference with existing holdings, any historical entitlement theory is actually going to have to authorize a wholesale rearrangement of whatever holdings people currently enjoy, at least if we are to take the idea of a principle of rectification seriously. Nozick's concession that the difference principle might work well as a principle of rectification accordingly seems like the kind of exception that could swallow the rule, turning what started out as an alternative to the

[7] Herbert Spencer, *The Principles of Ethics* (New York: D. Appleton and Company, 1898), vol. 2, p. 440.

[8] See Nozick, *Anarchy, State and Utopia*, 230–1.

difference principle into what is effectively another version of it, at least with regard to what his principles actually advise us to do.

But given the amendments we have enacted to Nozick's principles, I do not think that much active rectification would be required, at least with regard to correcting for violations of the principle of just initial acquisition, whatever these might be. Because our theory of exploitation limits the extent to which concentrations of wealth may be passed on and requires that the proceeds from hugely profitable activities be widely shared and provides for significant improvements in the minimum wage, any pre-existing intolerably unjust inequalities should eventually work their way out of the present income distribution and disappear. In other words, our liberal theory of exploitation does not require any massive and highly impracticable rearrangement of existing holdings in order to produce a pattern of distribution that is just, or rather no such rearrangement is required to produce a pattern that is not intolerably unjust. If our liberal theory of exploitation were generally accepted and effectively enforced, the current pattern of distribution would begin to change, and after a few generations the resulting pattern of distribution should eventually come to meet the requirements of tolerable fairness no matter what pattern of distribution was in place when we began. With the addition of our theory of exploitation, the libertarian principle of transfer effectively becomes a complete, self-contained principle of economic justice all on its own.

Given this affinity between our theory of exploitation and the general form of libertarian thought, we should perhaps consider whether our theory of exploitation could be characterized as left-libertarian as well as liberal. Indeed, as amended by our theory of exploitation, we might even ask whether our new more comprehensive principle of transfer renders the traditional distinction between left- and right-libertarianism no longer significant. This distinction, you may recall, is usually drawn by the status one ascribes to resources in the state of nature, that is, before these resources have been appropriated by anyone. If one treats these resources as un-owned, and therefore subject to individual appropriation, this generates the anti-egalitarian right-libertarian conclusion that any attempt at the redistribution of wealth generated by resources that were legitimately appropriated is a violation of people's rights.[9] If one treats these resources as in some sense jointly-owned instead of un-owned, on the other hand, then these resources are not subject to individual appropriation unless compensation is paid to all other joint owners.[10] This

[9] See, e.g. Nozick, *Anarchy, State, and Utopia*.

[10] Exactly how the idea of joint ownership is cashed out varies among left libertarians, and some left libertarians get to the same point via a slightly different route, but the nuances of these views have no bearing on the point I am making in the text.

compensation, in turn, might *look* like a series of redistributive payments, but because these payments would in fact be remedial rather than redistributive, they would not be a violation of anyone's rights. Indeed, it would be a violation of the rights of those who were the victims of unjust appropriation *not* to make them. And because the issuance of such remedial payments would produce a far more egalitarian society than the one in which we live now, this version of libertarianism is as egalitarian as any other theory on the moderate left.[11] But if we amend Nozick's principle of transfer to ensure that all voluntary exchanges comply with our theory of exploitation, the pattern of distribution that results would also be just (or not intolerably unjust) in a few generations without the payment of compensation despite any violations of the principle of just acquisition. Libertarianism would in effect be a liberal egalitarian theory regardless of which libertarian tradition one happened to embrace.

To see this, imagine an island on which one person (let us call him "the first man") has appropriated, justly or unjustly, everything on the island that currently exists, including the land and all the natural resources it contains, the surrounding sea and all the natural resources it contains, and even the atmosphere itself. Perhaps he was the only person on the island for some time, and managed to mix his labor with everything that exists, thereby making it his own, or perhaps he arrived as a conqueror, and killed all those then living on the island so he could claim all their property for himself. Now a shipwreck off the coast brings a new group of people to the island. Suppose, as in the television show Lost, the island is incorrectly marked on the existing charts, and the prospect of rescue for the survivors is exceedingly small. The new arrivals on the island now face a choice—they can labor for the first man and use whatever wages he provides to purchase from him the means of their subsistence, or starve. The first man can survive—that is, produce the means of his own subsistence—without anybody's help, but he can improve his well-being by purchasing the labor power of others, for other people have various natural talents and abilities that he lacks, or have natural talents and abilities that he has but in greater abundance, or can simply create more and better goods for him to consume than he can create all by himself. Let us further suppose that all the new arrivals on the island embrace, accept, and generally respect a ban on the use of force or violence against those who have not violated or threatened to violate their rights, that they understand this ban to encompass all those activities that would constitute the threat or use of

[11] For further discussion of the difference between the left- and right-wing versions of libertarianism, see Peter Vallentyne, Hillel Steiner, and Michael Otsuka, "Why Left-Libertarianism is Not Incoherent, Indeterminate, or Irrelevant: A Reply to Fried," *Philosophy and Public Affairs* 33 (2005): 201–15; *Left-Libertarianism and its Critics: The Contemporary Debate*, ed. Peter Vallentyne and Hillel Steiner (New York: Palgrave, 2000).

force or violence in a typical liberal capitalist state, that they have no right to welfare, and that it would therefore be within the first man's rights to allow any or even all the new arrivals on the island to starve if they were unwilling to enter into labor contracts with him and thereby acquire the wherewithal to purchase the means of their subsistence. Finally, let us suppose that there is one constraint on what the first man may do: while he may choose not to hire others to labor for him, he may not enslave them; that is, if he does choose to enter into labor contracts with any of them he must do so at a just price. The man has one heir, who has one heir, who has one heir, and so on. What would the distribution of wealth look like among those living on this island after say, ten generations?[12]

Given that the first man has only one heir, who has only one heir, and so on, you might think that the state of affairs in which the inhabitants of the island find themselves would continue indefinitely: one man would always own everything, and everyone else would be at his mercy, forced to either accept whatever charity he deigned to throw their way or starve. He would indeed support some inhabitants of the island, for he needs partners to reproduce, and he might even enjoy the company and society of others and therefore support others besides his sexual partners and children, but why should he agree to hire anyone to labor at a just price? Remember, the just price of labor is more than mere subsistence—it includes sufficient compensation to cover contextual basic needs, plus the average total cost of developing one's natural talents and abilities and of forming and supporting a family both now and in retirement, which means that the wages paid would have to be sufficient to provide each laborer with some ability to accumulate capital should he choose to do so rather than use everything he earns to satisfy his current wants and desires and those of his family. In other words, if the first man hired others on the island to labor for him, the first man could not keep all the surplus value that such labor would produce for himself—he would have to share some of this surplus with the laborers themselves, providing them with the ability to accumulate capital, and he would thereby weaken his position of having total control of all the capital on the island.

Nevertheless, it is reasonable to believe he would enter into labor contracts with others on the island. There are utility gains to be had from purchasing the labor of others, utility gains that could be achieved in no other way, and some of these would no doubt seem substantial enough that the first man would be willing to enter into labor contracts at a just price even if this meant he would no longer own and control all the island's capital. Besides, the incremental

[12] Island examples are of course familiar ones in both philosophy and economics, but this particular one is inspired by Henry George. See Henry George, *The Complete Works of Henry George: Volume II: Social Problems* (New York: Doubleday, 1911), 197–201.

loss of control on each occasion would seem paltry indeed. Not only do we all tend to give greater weight to short-term gains than to long-term costs, we also tend to evaluate long-term costs on an incremental rather than a sum total basis.[13] So unless the first man was exceptionally self-disciplined and far-sighted, we could indeed expect him to hire various inhabitants of the island to labor on his behalf, and to share some of the surplus value that this labor creates with those whom he employs. The most enterprising amongst this group will save some of the wages they receive over and above the amount necessary to finance their subsistence to acquire capital and even purchase the labor of others and thereby capture further surplus value for themselves. And when the first man dies, at least some and possibly a good deal of his estate will constitute leftover profits from exchange transactions (let's say that gifts in anticipation of death are treated as part of his estate precisely so he can't dispose of his assets by gift just before he is about to die). If there are such profits left they must have been obtained unjustly, for there should be nothing left from the proceeds of just transactions after the first man's debts are paid in full. These assets are therefore subject to being redistributed to all those who entered into exchanges with him or, if such persons cannot be readily identified, to all the inhabitants of the island equally. Eventually, and probably relatively quickly—that is, in just a few generations, the capital on the island would be relatively equally distributed, with any variations due primarily to the degree to which each inhabitant differed in their willingness to save and then invest (either in the labor of others and what they create or whatever the first man is willing to sell shares in) rather than consume whatever surplus value they managed to acquire. There would be inequality, but whatever inequality existed would be the same regardless of whether the first man had initially acquired everything on the island justly or unjustly, that is, regardless of whether the assets on the island were initially un-owned, jointly owned, or owned by someone else, for everything anyone currently actually possessed would have passed through the filter of the just price, and the same pattern of distribution would result no matter what.

Note that our hypothetical thought experiment not only gives us a way of uniting left- and right-libertarianism, for the issue currently dividing them would no longer have much significance, it also shows that there is an alternative approach to that suggested by the second fundamental theorem of welfare economics. The first fundamental theorem says that under conditions of perfect competition, an economy is always Pareto efficient—that is,

[13] On our preference for short-term gains over long-term losses, see again Robert Nozick, *The Nature of Rationality* (Princeton: Princeton University Press, 1993), 14–15. On mental accounting, see Richard H. Thaler, "Mental Accounting Matters," *Journal of Behavioral Decision Making* 12 (1999): 183–206.

no one can be made better off without at least one person being made worse off. The second fundamental theorem says that while there are multiple possible Pareto efficient outcomes, one can achieve any particular one by conducting a lump-sum redistribution and then letting the market take over.[14] The effect of the second theorem, which is more far-reaching than the first, is to suggest that the enterprise of economics can be conducted entirely free from the concerns of morality. It is up to political theorists, not economists, to sort out any moral problems in the existing allocation; economists are simply there to ensure that markets work once whatever re-allocation that is deemed appropriate to establish justice is put in place. Of course there are substantial reasons to question whether the second theorem is correct.[15] But what our hypothetical shows is that regardless of whether the second theorem is correct—in other words, regardless of whether an otherwise unregulated market would produce both a just and a Pareto efficient outcome if we could conduct a lump-sum redistribution and correct for conditions of imperfect competition, which as a practical if not a theoretical matter we in all probability cannot, we can nevertheless achieve this precise result by simply ignoring the problems arising out of an unjust initial distribution and enforcing the doctrine of the just price or, in a capitalist system, where our objective is not justice but tolerable unfairness, by enforcing not the doctrine of the just price but the theory of exploitation we have built thereon. Instead of having to decide what precise pattern of distribution is uniquely morally required all in one go, we will be able to close in on that solution incrementally, using our prohibition of exploitation to slowly but surely wash the injustices of the past away. Instead of having to focus on these injustices, injustices that are buried under centuries of murky and contested history, we can focus on preventing further injustices in the present, allowing old wounds to slowly heal of their own accord regardless of their cause. The pattern of distribution we can count on our theory to eventually produce would be one that is distributively just, or at least one that is not intolerably unjust, and we would not have to remake the entire modern world to do it.

7.1.2 *Self-Ownership, Equal Liberty, and Negative Liberty*

There is, however, one difference between our theory of exploitation and libertarianism that I do want to further discuss, because we must consider whether this difference might pose an impediment to an overlapping

[14] For a description and discussion of both fundamental theorems, see Joseph E. Stiglitz, "The Invisible Hand and Modern Welfare Economics," *National Bureau of Economic Research, Working Paper No. 3641* (March 1991), especially 2–4.

[15] Stiglitz, "The Invisible Hand and Modern Welfare Economics."

consensus. All libertarians, whether on the left or the right, believe that the principle of self-ownership is fundamental and draw their respective theories of distributive justice largely from this. Our theory of exploitation, in contrast, begins by accepting the presuppositions of modern capitalism as moderated by the presuppositions of political liberalism, and then derives a theory of exploitation from the principles of reciprocity and toleration. But while our theory of exploitation is not based on the principle of self-ownership, it is not inconsistent with it either. The heart of the concept of self-ownership, remember, is that we own ourselves fully and completely, and therefore no one has rights in our own bodies and we have no rights over the body of anyone else. A necessary corollary (or at least a standard extension) of this principle is that we also own our own labor fully and completely. We accordingly have no right to appropriate the labor of others, and others, in turn, have no right to appropriate our labor for themselves. Redistributing income and wealth to meet some preconceived pattern of "just" distribution is therefore objectionable to libertarians because it would violate this extended principle of self-ownership—it would in effect require some parties to contribute to the well-being of others by laboring for them, which would be tantamount to requiring a kind of slavery.[16]

But that is not what enforcing our theory of exploitation seeks to do. On the contrary, what it attempts to do is ensure that there is reciprocity in exchange—that each party receives value equivalent to the value transferred to another. This is exactly the recipe that self-ownership requires, for if there has been an unreciprocated transfer of value from one party to another, the party who benefits from this has necessarily appropriated the labor of the other, at least in part. Indeed, if taxing people's earnings for purposes of redistribution is tantamount to appropriating a portion of their labor, as libertarians commonly suggest, it is hard to see why paying less than the just price in an exchange is not also. Only when there is a transfer of value for equivalent value is the principle of reciprocity fully satisfied, and only when this principle is satisfied has our right of self-ownership not been violated.

Some libertarians, no doubt, would deny this, especially although perhaps not exclusively those who are on the right. As long as the appropriation arises out of a voluntary transaction, they would say, the appropriation cannot be a violation of self-ownership. This is because, in their view, libertarianism is not derived from a general right of self-ownership, but rather from a general right to negative liberty, or even if it is derived from a general right of self-ownership, this in turn entails a commitment to a general right to negative liberty,

[16] See Nozick, *Anarchy, State, and Utopia*, 172. For a similar definition, see Cohen, *Self-Ownership, Freedom, and Equality*, at 68.

and this means, of course, that all government interference with voluntary transactions is indeed strictly prohibited.[17] But despite the fact that this view is quite common among those members of the public who consider themselves libertarians as well as a few theorists, this view is not actually defensible. As we have seen, Nozick does not derive his version of libertarianism from a general right to negative liberty, but from self-ownership, and while he does suggest that anything voluntarily transferred is justly transferred, he never argues that a general right to negative liberty can be derived from self-ownership or from any other foundational principle. And there is good reason for this. If libertarianism were derived from a general right to negative liberty rather than from the principle of self-ownership, it would be completely arbitrary, for why begin with a general right to negative liberty rather than with some other right, such as a right to welfare?[18] And no general right to negative liberty can be derived from the principle of self-ownership or any other foundational principle because, as Ronald Dworkin has shown, this would require libertarians to embrace some very implausible conclusions about the nature of rights and how they work in our moral reasoning.

Dworkin's argument, for those who are unfamiliar with it, goes like this: If we are committed to the idea that rights are side-constraints, as Nozick and other libertarians claim they are, then rights are peremptory and indefeasible—they represent an inviolable sphere of personal autonomy that cannot be overcome by balancing the countervailing interests of other people against them, no matter how compelling these competing interests might be. But we interfere with negative liberty all the time—indeed, all government regulation does this. And when we do so, we do so by balancing any infringement of negative liberty against whatever interests we think would be furthered by such regulation. But if we had a general *right* to negative liberty rather than simply an interest in it, such balancing would be ruled out. We therefore cannot have a general right to negative liberty, but only an *interest* in it, one that can be overcome by important enough countervailing concerns.[19]

Where, then, does the (mistaken) idea that libertarians *qua* libertarians must embrace a general right to negative liberty—the kind of right that would protect everything voluntary from government interference—come from? This is not clear, for even Jan Narveson, one of the most vociferous asserters

[17] See Jan Narveson, "Libertarianism vs. Marxism: Reflections on G. A. Cohen's Self-Ownership, Freedom and Equality," *Journal of Ethics* 2 (1998): 1–26, especially 3–4.

[18] For further discussion of this point, see N. E. Simmonds, *Central Issues in Jurisprudence* (London: Sweet & Maxwell, 2008), 93–5.

[19] See Ronald Dworkin, "What Rights Do We Have?" in *Taking Rights Seriously* (Cambridge, MA: Harvard University Press, 1977), 266–78. For further discussion of this issue, see Will Kymlicka, *Contemporary Political Philosophy* (Oxford: Oxford University Press, 2002), 138–53.

of such a right, does not explain how the right is to be derived.[20] Indeed, as best as I can determine, the idea that voluntariness should protect economic transactions from government interference is not a product of a political theory at all but of an *economic* one. It is a tenet of economic liberalism, sometimes called economic neoliberalism, which (and here is where things get confusing) is currently part of the economic program of political neoconservatives, not political liberals. It is the idea that the market is fully self-correcting, and that any interference with its workings no matter how well intentioned will inevitably be counterproductive for overall economic prosperity, even if some individuals might be made better or worse off along the way.[21] This economic view then gets politicized by using a slippery slope argument—interfering with the market is a form of central economic planning, and central economic planning requires a strong central government, and a government that is strong enough to engage in this kind of microeconomic management is unlikely to be willing and able to resist the urge to micromanage all sorts of aspects of our lives. In short, there lies "the road to serfdom," for any government that opts for central economic planning is necessarily going to be perfectionist (which in this case probably means communist) and therefore totalitarian or authoritarian or at least anti-democratic, interfering not just with our economic freedoms but with our political freedoms too.[22] But this all or nothing view is very crude—it gives us no way of distinguishing appropriate exercises of governmental power from inappropriate. So even though government may have a general role to play in establishing and regulating markets, economic neoliberals are unable to recognize this—when faced with almost any specific proposal for regulation, they are against it, and when given the opportunity to deregulate some aspect of the market, they are in favor of it, for no matter what the downside risk of enacting weak or dismantling strong governmental regulation might be, this pales in comparison to the dark cloud of political oppression that the slippery slope argument warns them is gathering just beyond the horizon. The only reason why this view is sometimes associated with libertarianism, then, is that a significant number of libertarians also happen to be economic neoliberals.

[20] For a particularly helpful discussion of these issues, see Serena Olsaretti, *Liberty, Desert, and the Market* (Cambridge: Cambridge University Press, 2004), 101–8; and G. A. Cohen, "Once More into the Breach of Self-Ownership: A Reply to Narveson and Brenkert," *Journal of Ethics* 2 (1997): 57–96.

[21] See Frank Knight, "Laissez-Faire: Pro and Con," *Journal of Political Economy* 75 (1967): 782–95, at 782.

[22] See F. A. Hayek, *The Road to Serfdom* (London: Routledge, 1944), especially ch. 7. For later expressions of this same view, see Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), especially ch. 1; and Milton Friedman and Rose Friedman, *Free to Choose* (Orlando, FL: Harcourt, Inc, 1980). The argument made here goes all the way back to J. S. Mill, although Mill actually rejected the idea that this alone provided a sufficient reason against government interference in all circumstances. See J. S. Mill, *Principles of Political Economy* (New York: D. Appleton, 1864), bk. 5, ch. 11, sec. 3.

There is simply nothing in libertarianism that suggests this view is entailed by libertarianism itself.

But this tendency of libertarians *qua* economic neoliberals to interpret every attempt at economic regulation as a first step toward outright and irreversible political oppression represents a gross overreaction to what is at most a cause for modest concern. As the current financial crisis has made all too clear, there is quite a difference between central economic planning and sensible market regulation.[23] A few steps toward the latter is not going to leave us hurtling down the slippery slope of political oppression, for the move from limits on economic freedom to limits on political freedom requires a *wholesale* loss of economic freedom. Up to that point, an incremental loss in economic freedom is unlikely to produce *any* loss in political freedom, for a government that engages in sensible economic regulation need not dominate or have the potential to dominate every aspect of people's lives in the way that those who politicize economic neoliberalism fear. The political liberty that economic neoliberalism protects (to the extent it is properly understood as protecting political liberty at all) is therefore not *negative* liberty at all, but *republican* liberty—not freedom as *non-interference*, but freedom as *non-domination*, the kind of liberty that was central to the political thought of the Romans and the civic republicans of the Renaissance.[24] This kind of liberty is a good step—one that is not continuously subject to small incremental fluctuations but rather remains relatively stable until a certain line is crossed,

[23] Not that I expect many economic neoliberals to recognize this or, even if they do, to remember this lesson very far into the future, for if history is any guide their memory is likely to be short. Indeed, one would have thought that after the Great Depression, which was caused at least in large part by a lack of sensible economic regulation, the relentless push by economic neoliberals (who are mostly although not entirely political neoconservatives) for more and more market deregulation over the last thirty years would have been indefensible. But as Karl Polanyi noted many years ago, despite the experience of the Great Depression the fact that some regulation is not only necessary but also beneficial if we are to enjoy a stable and orderly financial market system is incomprehensible to many neoliberals "whose minds [seem to] habitually miss the true characteristics of the world they are living in." See Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944, 1957, 2001), 211.

[24] See Philip Pettit, "Freedom in the Market," *Politics, Philosophy, and Economics* 5 (2006): 131–49, and Philip Pettit, "Liberty as Non-domination," in *Republicanism: A Theory of Freedom and Government* (Oxford: Oxford University Press, 1997), 51–79. For an interesting discussion of Pettit's view and some of its historical antecedents, see Charles Larmore, *The Autonomy of Morality* (Cambridge: Cambridge University Press, 2008), 168–74. A great deal of important work developing the idea of republican liberty has also been done by Quentin Skinner. See, e.g. Quentin Skinner, *Liberty before Liberalism* (Cambridge: Cambridge University Press, 1998); Quentin Skinner, "Classical Liberty and the Coming of the English Civil War," in *Republicanism: A Shared European Heritage*, ed. Martin van Gelderen and Quentin Skinner (Cambridge: Cambridge University Press, 2002), vol. 2, pp. 9–28. Skinner originally labeled his version of this concept "neo-Roman" liberty, but has since conceded that the term "republican liberty" is the one that has caught on. See Quentin Skinner, *Hobbes and Republican Liberty* (Cambridge: Cambridge University Press, 2008), viii.

or at least that is how I shall conceive of it here.[25] Sensible market regulation simply does not even approach let alone cross this line.

Nor did Adam Smith ever argue that it does, the claims of many economic neoliberals to the contrary notwithstanding. Remember, the kind of counter-productive economic regulations that Smith attacked were the anti-competitive and protectionist restraints of mercantilism and the associated guild system that so limited the movement of both capital and labor and seriously impeded individual commercial initiative, not regulation designed to ensure the integrity and orderliness of the market.[26] Indeed, not only Smith but also many of the early economists whom neoliberals typically associate with pro-*laissez faire* attitudes actually supported a wide variety of government intervention in the market.[27] And there really should be nothing surprising about this, for the various markets that economic neoliberals are so determined to protect could not even *exist* if our negative liberty to engage in fraud and otherwise break our promises and contracts were not curtailed by law. At least there could be no such markets that operate on the basis of non-simultaneous exchange, as all contemporary economic markets do. If there was any real danger to democracy posed by sensible market regulation, surely we would have seen this danger step out of the shadows and actually devour democracy somewhere in the world, but we have not. On the contrary, the kind of strict non-interference in the market that economic neoliberals claim is constitutive of true economic *laissez faire* has never even been tried in any nation we would consider a liberal democracy in the history of the world, yet democracy and political freedom continues to thrive. As Keynes noted many years ago, the presuppositions underlying the neoliberal conception of *laissez faire* are not truths, they're myths:

> It is *not* true that individuals possess a prescriptive 'natural liberty' in their economic activities. There is *no* 'compact' conferring perpetual rights on those who Have or on those who Acquire. The world is *not* so governed from above that private and social interest always coincide. It is *not* so managed from below that in practice they coincide. It is *not* a correct deduction from the principles of

[25] I recognize that some republican liberty theorists may find this statement of the nature of republican liberty somewhat controversial, but I do not intend to engage this potential issue here. There may be other conceptions of republican liberty that are more comprehensive, and there may be situations in which it becomes important to decide whether a narrow or broad conception of republican liberty should be embraced, but this is not one of them. If we are looking for the kind of political liberty that economic neoliberalism protects, the narrow conception of republican liberty best fits the bill.

[26] See Wesley C. Mitchell, *Lecture Notes on Types of Economic Theory* (New York: Augustus M. Kelly, 1949), 15–81. A similar observation is made by John Maynard Keynes in "The End of Laissez Faire," in *Essays in Persuasion* (London: Palgrave Macmillan, 1931, 1972, 2010), 272–94, at 278–87.

[27] See Lawrence H. White, *The Clash of Economic Ideas: The Great Policy Debates and Experiments of the Last Hundred Years* (Cambridge: Cambridge University Press, 2012), 21–6.

> economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally *is* enlightened; more often individuals acting separately to promote their own ends are too ignorant or too weak to attain even these. Experience does *not* show that individuals, when they make up a social group, are always less clear-sighted than when they act separately.[28]

Frankly, it is not sensible market regulation that poses a threat to liberal democracy throughout the world; it is the kind of super-strict *laissez faire* called for by economic neoliberals that actually presents such a threat, for this would seem to require the establishment and maintenance of a system that could only be characterized as a form of anarchism.[29] Even Frank Knight, one of the founders of the so-called "Chicago School" of economics, recognized this: "*Laissez-Faire*, that is, economic freedom, if taken in anything like an absolute sense, means anarchism and is indefensible."[30] Some government interference with the market is always necessary. "The issue lies in the amount of freedom, or of control, and the kinds, which depend on the circumstances."[31] So even if there were sound economic reasons for opposing some or perhaps even many attempts to regulate economic interaction if one believed in economic neoliberalism, there would be no *political* reasons for doing so, despite what politically neoconservative supporters of economic neoliberalism so vociferously claim. In any event, there is no basis for doing so that can be found in libertarianism.

Of course, even the more limited claim that there are sound *economic* reasons for resisting government attempts to regulate the marketplace is highly controversial. Capitalism says that things will go economically better if a society employs a decentralized market system of production and distribution and provides incentives for individuals to engage in economically productive activities—it does not say that society should provide incentives to engage in economically *destructive* behavior, or refuse to intervene when incentives for economically destructive behavior naturally arise. That's not capitalism; it's suicide. For capitalism to even exist, a society must take steps to establish and maintain competitive markets. And while economic neoliberals stubbornly insist that unregulated markets are perfectly competitive and therefore can be safely left alone, most serious economists and political theorists alike recognize that perfect competition arises naturally only rarely, and

[28] Keynes, "The End of Laissez Faire," at 287–8.

[29] See Peter Kropotkin, "Modern Science and Anarchism," in *Anarchism: A Collection of Revolutionary Writings* (Mineola, NY: Dover Publications, 2002), 145–94, at 183.

[30] Knight, "Laissez-Faire: Pro and Con," *Journal of Political Economy* 75 (1967): 782–95, at 783.

[31] Knight, "Laissez-Faire: Pro and Con," at 782. A similar view was also expressed by Alfred Marshall, once a fierce advocate of laissez-faire, who by the end of the nineteenth century ultimately recognized the need to bring "free enterprise somewhat under control, to diminish its power of doing evil and increase its power of doing good." Marshall, *Principles of Economics*, 8th edition (London: Macmillan, 1936), bk. 1, ch. 7, sec. 1, p. 113.

that in most cases substantial government regulation is required if we are to achieve even a rough approximation of perfectly competitive conditions and otherwise counteract whatever economically destructive incentives happen to be in play.[32] Even the right-libertarian Michael Oakeshott, one of the fathers of modern traditional (as opposed to neo) conservatism, accepted this:

> As every schoolboy used to know, if effective competition is to exist it can do so only by virtue of a legal system which promotes it, and that monopoly has established itself only because the legal system has not prevented it. To know that unregulated competition is a chimera, to know that to regulate competition is not the same thing as to interfere with the operation of competitive markets, and to know the difference between these two activities, is the beginning of the political economy of freedom.[33]

So the claim that adherence to the economic presuppositions of modern capitalism requires us to oppose all forms of government regulation of the market is simply without foundation.

Finally, even if there were sound economic arguments to be made in favor of economic neoliberalism, these arguments would at best supply only *pro tanto* reasons against regulation, and these reasons would be outweighed by our concerns for justice, as our discussion of the principle of toleration and how it serves to moderate the doctrine of the just price under political liberalism makes clear. Indeed, given the consistent failure of economic liberalism in either its original or neoliberal form to deliver an economically stable and at least tolerably unjust if not just society,[34] the most likely effect of following the kind of super-strict *laissez faire* economic policy neoliberals recommend is to create the kind of political and economic climate that leads to the ascension of either communism or fascism, at least if the history of the twentieth century is to be taken as a guide.[35] Even before this, Adam Smith recognized the potential danger here, and warned that a commitment to economic liberty was no excuse for overriding the laws of natural justice.[36] The approach that economic neoliberals would have us take is accordingly ruled out by political liberalism itself.

[32] See, e.g. Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper Perennial Modern Thought Edition, 2008), especially 87–106.

[33] Michael Oakeshott, "The Political Economy of Freedom," in *Rationalism in Politics and Other Essays* (Indianapolis, IN: Liberty Fund, new and expanded ed., 1991, 1962), 384–406, at 403.

[34] For a discussion of why economic neoliberalism is inherently unstable and unjust, see David Harvey, *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2005), especially 79–81.

[35] See Polanyi, *The Great Transformation*, especially part 3 and the forward by Joseph Stiglitz.

[36] See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Oxford: Oxford University Press, 1976), vol. 2, bk. 4, ch. 9, pp. 687–8. For further and extended argument against those who advocate the implementation of super-strict *laissez faire*, see Henry Sidgwick, *The Principles of Political Economy* (London: Macmillan, 1883), bk. 3, ch. 2–4, pp. 405–84.

In any event, given that there is no plausible basis for thinking that there is a general right to negative liberty to be found in libertarianism, there is no reason for libertarians to believe that mere voluntariness protects a transaction from government interference—the general voluntariness of the exchange transaction is simply irrelevant. What matters (or what should matter) to libertarians is whether there has been a violation of the principle of self-ownership, and to determine that, we need to apply the principle reciprocity, for it is reciprocity, not strict negative liberty, that in most cases tells us if there has been a violation of self-ownership. Indeed, there is only one circumstance in which an unreciprocated transfer of value from one party to another is *not* a violation of the principle of reciprocity—when the transfer is intended as a gift. Absent the intent to make a gift, if an unbalanced transaction has occurred, one party has effectively sold the need or want of another, which as Aquinas (and Scotus and Luther) says, is not something that is his to sell. In such a case, one man has appropriated the property of another, property that is part of that other man's self, just as his labor is. Trading on the need or want of another is accordingly a violation of self-ownership, and when there is a violation of self-ownership, the government violates no one's rights by stepping in to take corrective action. Rather than prohibiting such interference with the workings of the market, under these circumstances the principle of self-ownership actually provides a justification for the government to do so.

Under our theory of exploitation, of course, enforcement of the principle of self-ownership is moderated by the principle of toleration, and this is something to which libertarians might object, for in light of our application of this principle we are not fully protecting everyone from violations of their right to self-ownership by others. But unlike traditional end-state patterned theories of distributive justice, we are also not promoting the commission of such violations by the government. There is no *redistribution* going on; there is simply *remediation* of violations of the principle of self-ownership, and then only to the extent necessary to rectify the violation. The general thrust of our theory of exploitation is to prevent such violations from occurring, and accordingly to protect self-ownership, not impede it. The difference between our liberal theory of exploitation and what would be a libertarian one can accordingly be seen as merely technical, not meaningful. Whether they consider themselves on the left or right, libertarians who base their views on a fundamental right to self-ownership should be willing to embrace our theory of exploitation and, as far as they are concerned, make it the focus of an overlapping consensus.

The same should be true for libertarians who base their libertarianism not only on a right to self-ownership but also on a Kantian right to equal liberty, as some libertarians (for example, Hillel Steiner) do.[37] But while these libertarians also conceive of liberty in the negative sense, they do so for analytical purposes only, meaning they use the concept of negative liberty to determine when there has been an interference with liberty but not to determine whether this interference is impermissible—that determination requires the application of some other theory. In other words, an infringement of negative liberty is not necessarily an infringement of a general, fundamental right, for a general right to *equal* liberty and a general right to *negative* liberty are not equivalent. On the contrary, like the right of self-ownership, the Kantian right to equal liberty is best delineated not as a right to freedom from interference, but rather as a right to freedom from domination. This right to freedom from domination, in turn, like the kind of political freedom protected by economic neoliberalism, is best delineated by the idea of republican liberty, not negative liberty. Indeed, Arthur Ripstein, in describing Kant's concept of equal liberty, opines as follows:

> This familiar Kantian theme is explained in terms of the classic distinction, from Roman law, between persons and things. A person is a being capable of setting its own purposes. A thing is something that can be used in pursuit of whatever purposes the person who has it might have. The classic example of being treated as a mere thing is the slave, for a slave is entirely at the disposal of his or her master. The slave's problem is that he is subject to the master's choice: the master gets to decide what to do with the slave and what the slave will do. The slave does not set his own ends, but is merely a means for ends set by someone else. To call it "the" problem is not too strong: if the other problems the slave has—low welfare, limited options, and so on—were addressed by a benevolent master, the *relationship* of slavery would perhaps be less bad, but it would not thereby be any less wrong. The right to be your own master is neither a right to have things go well for you nor a right to have a wide range of options. Instead, it is explicitly contrastive and interpersonal: to be your own master is to have no *other* master. It is not a claim

[37] See Hillel Steiner, "Sharing Mother Nature's Gifts: A Reply to Quong and Miller," *Journal of Political Philosophy* 19 (2011): 110–23, 111 and n. 5. In accepting a right to equal liberty as foundational, Steiner follows (among others) Locke, Kant, Herbert Spencer, Henry George, Henry Sidgwick, H. L. A. Hart, Rawls (see Rawls's first principle), and certain passages in Nozick, although only Nozick, Spencer (usually), and Henry George (occasionally) are classified as libertarians. See Steiner, *An Essay on Rights* (Oxford: Blackwell, 1994), 216–17 n. 27; Hillel Steiner, "Land, Liberty, and Early Herbert Spencer," *History of Political Thought* (1982): 515–33; Hillel Steiner; "Capitalism, Justice and Equal Starts," *Social Philosophy and Policy* 5 (1987): 49–71. See also John Locke, *Two Treatises on Government*, ed. Peter Laslett (Cambridge: Cambridge University Press, 1960), 287–9; Immanuel Kant, *The Metaphysics of Morals*, ed. Mary Gregor (Cambridge: Cambridge University Press, 1996), 30–1; Henry Sidgwick, *The Methods of Ethics*, 7th edition (Indianapolis: Hackett, 1981), 274–8; Herbert Spencer, *Social Statics* (London: John Chapman, 1851), ch. 4–6; Henry George, *Social Problems* (London: Kegan Paul, 1884), ch. 9, pp. 80–1; Rawls, *A Theory of Justice*, ch. 11; and H. L. A. Hart, "Are There Any Natural Rights?" *The Philosophical Review* 64 (1955): 175–91.

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> about your relation to yourself, only about your relation to others. The right to equal freedom, then, is just the right that no person be the master of another.[38]

What follows from this is that as with the foundational right of self-ownership, it is *reciprocity*, not absolute negative liberty, which is protected by the Kantian right to equal freedom. And while an infringement of negative liberty may or may not be a form of domination, depending on the nature and degree of the liberty infringed, a violation of the principle of reciprocity always is—at least, if not especially, in the economic sphere.

To see this, consider what happens when a voluntary exchange takes place: the means used by one man to create the goods he exchanges with another are effectively devoted to the ends of the other. Each party, in effect, becomes the servant of the other. But when the goods exchanged have unequal value, at least using the definition of value I have employed here, there has *by definition* been an unequal degree of subjugation by one party to the other. One party has employed means of production to serve the ends of the other that cost more than the means employed by that other. In that way and to that extent, one party has *dominated* the other. Prohibiting one man from violating the principle of reciprocity in his economic relations with another is accordingly consistent with, not an infringement of, the Kantian right to equal liberty.[39] There is thus nothing to prevent libertarians who consider such a right foundational from embracing our theory of exploitation too.

Understanding what is meant by the Kantian right of equal freedom is also helpful if we are to put the claims of those libertarians who stubbornly claim that freedom rather than *equal* freedom or self-ownership is fundamental—that is, those who seem to attach a fundamental importance to negative liberty—in their proper context. If we return to the claims of these libertarians, we can see that even they (or at least the more thoughtful among them) do not actually conceive of the right to negative liberty as an *absolute* right to negative liberty. In this case, take F. A. Hayek, generally considered to be a paradigmatic example of a right-libertarian and economic neoliberal. While Hayek speaks simply of freedom rather than of equal freedom as being fundamental, the conception of freedom he has in mind is remarkably similar to Kant's conception of equal freedom. For Hayek, as for Kant, freedom is "a relation of men to other men," one that "does not depend on the range of choice" available to a man, but rather on "whether somebody else has power to so manipulate the conditions [under which he lives] as to make him act according to the other person's will rather than his own."[40] In other words, what Hayek describes as

[38] Arthur Ripstein, *Force and Freedom: Kant's Legal and Political Philosophy* (Cambridge, MA: Harvard University Press, 2009), 36.
[39] See Ripstein, *Force and Freedom*, 162–3.
[40] F. A. Hayek, *The Constitution of Liberty* (London: Routledge, 1960), 12–13.

the fundamental right to freedom is built upon but greater than its atomistic negative liberty component. For Hayek, as for Kant, any constraint may be thought of as an infringement of negative liberty for analytical purposes, but these constraints amount to a violation of a more fundamental right to freedom (what Kant calls equal freedom but Hayek simply calls freedom) only in certain combinations and in certain circumstances, when one person becomes the servant not of his own ends but the ends of another.[41] So while Hayek's economic neoliberalism may lead him to oppose a broader range of government interference with the marketplace for (misguided) economic reasons, that opposition is not (or at least should not be) generated by his libertarianism. To that extent, then, even Hayek and those like him who despite the problems with such a view see themselves as defenders of freedom full stop should be willing to accept our theory of exploitation too.

7.2 Exploitation and Luck Egalitarianism

Luck egalitarians, you may recall, believe that inequalities are not justified if they result from luck, but are if they result from choice, and those who are disadvantaged by their own choices rather than bad luck have no claim on us for intervention.[42] As we have already seen, however, luck egalitarians have a problem cashing their central distinction out. Under a broad interpretation of choice, luck egalitarianism would effectively permit all inequalities, and luck egalitarianism would look hardly egalitarian at all. Under a broad interpretation of luck, in contrast, luck egalitarianism would effectively prohibit all inequalities and the theory would lose its liberal pedigree, becoming instead simply another way of expressing the central claim of the strict egalitarian left. To be a *liberal egalitarian* theory, then, the kind of theory against which our theory of exploitation would indeed compete, luck egalitarianism must allow some inequalities but not others. It must include a principle that allows us to tell the extent to which a state of affairs should be described as the result of choice and the extent to which it should be described as the result of luck. Because almost any state of affairs can be meaningfully described as to some extent the product of *both* luck *and* choice, however, coming up with a

[41] See Hayek, *The Constitution of Liberty*, 20. For a similar interpretation of Hayek, see Raymond Plant, *The Neo-Liberal State* (Oxford: Oxford University Press, 2010), 68, 202; Chandran Kukathas, *Hayek and Modern Liberalism* (Oxford: Oxford University Press, 1989), 141–2.

[42] For an extensive discussion of luck egalitarianism and the variety of forms it can take, see Elizabeth Anderson, "What is the Point of Equality?" *Ethics* 109 (1999): 287–337.

convincing yet principled way of drawing the line required here has proven to be a remarkably elusive task.[43]

One way of viewing our theory of exploitation, however, is as a way of limiting the effects of luck, both good and bad, and respecting the effects of choice. Our theory does not reward anyone for the mere *possession* of natural talents and abilities, which almost everyone concedes is the result of luck. But it does reward those who seek to *develop* their natural talents and abilities, an effort that almost everyone agrees is to an important extent a result of choice. Our theory does not allow unlimited inheritance of wealth, another means of acquiring wealth that almost everyone attributes to luck, but it does respect the acquisition of wealth through the sale of labor and other goods, a means of acquiring wealth that almost everyone again attributes to the effects of choice. Moreover, while luck egalitarians tend to focus on the least advantaged and look for disadvantages that result from luck, our theory of exploitation allows us to focus on the most advantaged too, and therefore allows us to regulate inequalities from the top down as well as from the bottom up, a technique that luck egalitarians typically ignore but which is consistent with luck egalitarianism nonetheless. And while our theory of exploitation does require that we interfere with certain voluntary transactions, and this *looks* like a prescription for undoing the effects of choice, on closer inspection we can see that this is not usually the case. People rarely *choose* to buy a good for an unjust price—at least they rarely choose to do so when they know the asking price is unjust, *even if they cannot purchase the same good for a better price somewhere else*. When they do purchase a good at an unjust price, it is accordingly most likely the result of circumstances that we would typically ascribe to luck, circumstances that limit the buyer's ability to see he is being exploited or to avoid being exploited even when he does manage to see it coming. Regardless of which theory we apply, we have reason to ensure that inequalities arising from such circumstances are suppressed. So even though our theory of exploitation does not turn on the distinction between luck and choice, it is likely to produce results that track the luck egalitarian's intuitions rather well.

This is true even if we give content to the central distinction between luck and choice by focusing on the reasonableness of the risk incurred, as some luck egalitarians do. For these luck egalitarians, what matters is not whether this particular individual could have avoided the disadvantage from which he now suffers simply by making different choices, but whether the risk of suffering this disadvantage was a risk that a reasonable person in like circumstances would have chosen to avoid. I take a walk outside in the rain knowing there is a slight chance I might be hit by lightning, but most luck egalitarians

[43] For some reflections on these difficulties, see G. A. Cohen, "The Currency of Egalitarian Justice," *Ethics* 99 (1989): 906–44, at 934.

do not think I should be denied medical care at public expense if this unlikely event should turn out to occur. On the other hand, if I choose to take a walk in the middle of a thunderstorm while holding a tall metal pole and stop to rest on the top of a hill where there are no trees or buildings of any sort and I stand there with my pole held high and my bare feet in a pool of water while lightning flashes all around me, we have a completely different attitude toward the risk I am encountering. In this case, my actions seem unreasonable, and so I should not be entitled to call on others to help pay for my medical care if I happen to be struck by lightning now. The central distinction on which this form of luck egalitarianism relies is accordingly not strictly between luck and choice but between brute luck, understood as "the result of risks reasonably encountered," and option luck, understood as "the result of risks *un*reasonably encountered."[44] We still have to cash out what "reasonably" means, of course, but this does seem to be at least intuitively easier than the more basic distinction between luck and choice, for the distinction between the reasonable and the unreasonable is something we have to be able to recognize every day. Easier or not, however, this is also a distinction on which our theory of exploitation relies, for while we will tolerate a seller earning a reasonable profit over the just price, neither unreasonable profits nor unexpected windfalls are permitted. These are also, however, the kinds of profits that almost everyone would ascribe to luck. So given the way reasonable profits are defined by our theory, luck egalitarians who focus on the reasonableness of the risk incurred should find nothing to object to here. There is accordingly every reason for these luck egalitarians to be as willing to embrace our theory of exploitation as their more strict pure luck egalitarian cousins.

Indeed, our theory of exploitation should be especially appealing to luck egalitarians because it not only accomplishes much of what luck egalitarianism seeks to do, it does so without causing some of the deleterious and potentially self-defeating side effects that have been associated with luck egalitarianism. Jonathan Wolff, for example, has argued that what is driving the distinction that luck egalitarians and certain others seek to make between choice and luck is an obsession with cheaters—an almost pathological desire to prevent the indolent from taking unfair advantage of the rest of us through government assistance. To accomplish this, luck egalitarians would require people to provide all sorts of information about why they are disadvantaged. In other words, as a condition of obtaining assistance, luck egalitarians would require people to engage in what Wolff calls "shameful revelation" to prove

[44] For more on this type of luck egalitarianism and some of the problems holding such a view entails, see Peter Vallentyne, "Brute Luck, Option Luck, and Equality of Initial Opportunities," *Ethics* 112 (2002): 529–57, especially 533–4.

that they suffer from some legitimate disadvantage, whether in their natural talents or in their upbringing or in other circumstances. The inevitable result of this is to erode rather than strengthen the bonds of solidarity and mutual concern and respect among citizens, and to undermine the self-respect of those who find themselves disadvantaged. Yet while requiring the poor to explain themselves, luck egalitarians do not require the same from the rich—while the poor must show that they are the victims of circumstance to get assistance, the rich need not show they are the beneficiaries of choice in order to keep their wealth. So according to Wolff, while it may eliminate some economic inequalities, luck egalitarianism actually undermines the "egalitarian ethos" that luck egalitarians purport to accept, the idea that every person should be treated with equal concern and respect.[45]

But no such shameful revelation is required under our theory of exploitation. Rich and poor are treated alike—both must defend the extent to which they profit from transactions, and both most disgorge these profits to the extent they are intolerably unjust. Determining whether these profits are intolerably unjust, moreover, does not require an inquiry into the upbringing, education, or lack of bargaining power of the parties; it merely requires an examination of the terms of the transaction and the cost of production of the goods exchanged, an inquiry that does not threaten either party's self-respect or otherwise undermine the egalitarian ethos. And to the extent that there may be some cases in which this does not produce satisfactory results from the luck egalitarian's point of view, the transaction at issue can still be subjected to further inquiry along the lines that luck egalitarians suggest.

Even our moderation of the effects of the doctrine of the just price through application of the principle of tolerable unfairness is something to which luck egalitarians should not object. One problem with basing a principle of justice on the distinction between luck and choice is that every state of affairs is to some extent the product of both, so we feel uncomfortable with the idea that there could be a line between the two that is so bright and unforgiving, that it suggests we do nothing contrary to justice if we leave those injured by their own unreasonable choices to lie there bleeding in the street.[46] The line our theory of exploitation draws, however, can be seen as a way of balancing the effects of luck against the effects of choice more carefully and incrementally. True, it does this without using luck or choice as a criterion, but that is why

45 See Jonathan Wolff, "Fairness, Respect, and the Egalitarian Ethos," *Philosophy and Public Affairs* 27 (1998): 97–122 and "Fairness, Respect, and the Egalitarian Ethos Revisited," *Journal of Ethics* 14 (2010): 335-50, at 343-46.

46 See Anderson, "What is the Point of Equality?" *Ethics* 109 at 295; Samuel Scheffler, "Choice, Circumstance, and the Value of Equality," *Politics, Philosophy, and Economics* 4 (2005): 5–28, 15; Timothy Hinton, "Choice and Luck in Recent Egalitarian Thought," *Philosophical Papers* 31 (2002): 145–67, 163.

it does not suffer from the same indeterminacies that luck egalitarianism must face. It nevertheless gives both criteria room to operate. Accordingly, our theory can be seen as a sort of proxy for luck egalitarianism—an imperfect one, no doubt, but one that nevertheless captures enough of the intuitions underlying luck egalitarianism (and does so while avoiding most if not all of its pitfalls) for luck egalitarians to embrace its ambitions too. At least there is enough within our theory of exploitation to satisfy luck egalitarians that they should be willing to give it their support.

Finally, remember that our theory of exploitation and luck egalitarianism focus on different things. Our theory of exploitation focuses on transactions; luck egalitarianism focuses on inequalities. While our theory of exploitation would dramatically reduce inequalities, some inequalities would remain. If any of these inequalities were troubling to luck egalitarians, there is nothing in our theory of exploitation that would prevent them from taking whatever corrective action they deemed appropriate. And the opposite is also true: those who reject luck egalitarianism would not be forced to do anything more, for one can accept our theory of exploitation without embracing luck egalitarianism too. In other words, while our theory is consistent with luck egalitarianism and would accomplish many of its aims in a more direct and effective manner, it does not entail an embrace of those aims. If there was work left for luck egalitarianism to do, it could still be done. Luck egalitarians accordingly have nothing to lose and much to gain by embracing our theory of exploitation.

7.3 Exploitation and the Difference Principle

There is much within our theory for Rawlsians to support too, although once again, there is nothing in our theory of exploitation that would *require* the acceptance of the difference principle as a measure of the justness of any remaining inequalities. But there is nothing inconsistent with such acceptance either. Indeed, while it is impossible to prove this claim with anything close to empirical certainty, it is at least reasonable to expect that prohibiting exploitation as we have defined it will make the least advantaged better off than not doing so, or at least leave them no worse off, for it seems reasonable to expect that the least advantaged are going to be in a position to exploit the rich far less often than the rich are going to be in a position to exploit the poor, and the gains to the poor in the former case are almost certainly going to be less than the losses that would result in the latter. Of course, our theory of exploitation does not *directly* address the plight of the least advantaged, or even address inequalities that result from something other than transactions. It is therefore incomplete in important ways. But this is not a weakness; it is a source of strength, for it leaves room for an overlapping consensus to develop. To the extent that inequalities result from luck, or from wrongdoing, or from gifts, our theory leaves these for some other theory to address. There is no reason why this could not be the difference principle if that is what our political community thinks is best. Similarly, while our theory of exploitation does not tell us that we must assist the unemployed, the ill and injured, and the handicapped, it is not *inconsistent* with providing such assistance either, as luck egalitarianism is sometimes said to be.[47] If we want a social minimum that "maximizes the life-prospects of the least advantaged over time," as the difference principle says we should,[48] nothing in our theory prevents us from establishing one to ensure that the least advantaged enjoy an acceptable quality of life. If we think this injunction is too vague, as even some Rawlsians seem to do, we can rely on something like Dworkin's hypothetical insurance market to set the social minimum and provide for national health insurance and government assistance to the handicapped, all at government expense.[49] Indeed, we may finally come to realize that the lack of a national health insurance program has put American industry at a competitive disadvantage, and that the cost of maintaining such a program is simply part of the cost of maintaining a liberal capitalist economy, and therefore demanded by capitalism itself. On the other hand, if we feel that those who are unemployed as the result of their bad choices rather than their bad luck should be left to fend for themselves, then our theory of exploitation would allow this too. Whatever conclusion we might come to in this regard, however, what is important is that embracing our theory of exploitation would not commit us to one solution or another. Whether the failure to provide such assistance would be intolerably unjust is simply a question that must be answered by some other theory.

Our theory of exploitation also covers situations that the difference principle fails to address, situations that the difference principle has been criticized for ignoring. For example, Nozick complains that the difference principle ignores the middle class, or even worse, puts them in competition with the poor.[50] In contrast, our theory of exploitation focuses on the middle class, or rather all members of society who are working, regardless of where they fall on the income distribution, and therefore provides a way of regulating inequality among all groups in society and not just between the two extremes. Our theory also regulates inheritance, as the difference principle

[47] See, e.g. Anderson, "What is the Point of Equality?"

[48] See John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: Harvard University Press, 2001), sec. 38.4, p. 129.

[49] See Ronald Dworkin, "What is Equality? Part II," *Philosophy and Public Affairs* 10:4 (1981): 283–345.

[50] See Nozick, *Anarchy, State, and Utopia*, 209.

would do, but as we have already seen it provides an arguably much stricter standard for regulating the inheritance of wealth while ensuring that the standard is at least no lower.

Finally, our theory is a much more reliable tool for instantiating our liberal egalitarian intuitions than the difference principle has turned out to be. Unlike the difference principle, our theory does not require us to make counterfactual comparisons or predict the future economic effect of current policies in order to tell whether its principal injunction has been satisfied. Indeed, as I have argued at length elsewhere, because it is impossible to tell with certainty whether a policy will help or hurt the poor, the difference principle is amenable to being hijacked by either the anti-egalitarian right or the strict egalitarian left, and to being interpreted so as to prohibit all inequalities or none or anything in between.[51] There is even some reason to believe that contrary to what Rawls hoped and perhaps even expected when the difference principle was introduced, the principle or at least the ethos it represents—that government economic policy should be designed to improve the position of the poor—has actually and unintentionally partially contributed to the dramatic rise in inequality we have recently experienced.[52]

But even if the difference principle is in no way to blame for this, it is impossible to deny that it has not been an effective deterrent to the vast increases in inequality that have occurred over the last thirty years. For those Rawlsians who continue to believe that economic inequality is too high, then, our theory of exploitation offers a way of reducing inequality that is much more difficult to evade or co-opt. And while it is impossible to predict with certainty exactly how much inequality would remain in place in a society in which our theory of exploitation was accepted and enforced, it is possible to make some broad predictions. A great deal of the current rise in inequality in our society has been fueled by the increasing spread between the salary and other compensation that is provided to highly-compensated individuals and the wages provided to the average worker. Under our theory of exploitation, this would stop. A maximum wage would be instituted, the minimum wage would increase substantially for both unskilled and skilled workers, and the profits generated by unusually profitable activities would be widely shared. While it is impossible to predict the exact amount of inequality that would then obtain without addressing how we would deal with the handicapped, the ill and injured, and the unemployed, problems our theory of exploitation leaves to other theories to address, it seems safe to say the spread between the rich and at least the working poor would be substantially

[51] See Reiff, "The Difference Principle, Rising Inequality, and Supply-Side Economics," *Revue de Philosophie Économique/Review of Economic Philosophy* 13: 2 (2012) (forthcoming).

[52] See Reiff, "The Difference Principle, Rising Inequality, and Supply-Side Economics."

less than the degree of inequality present in the US today, and perhaps even less than the degree that characterized American society from the post-war era through 1970, when the income distribution was relatively (although not literally) flat. And this would go some way toward alleviating economic inequality in both the US and any other liberal capitalist society that chooses to have our theory of exploitation implemented and enforced. So once again, as the possible focus of an overlapping consensus, it is our theory of exploitation, not the difference principle or luck egalitarianism or libertarianism that is most likely to fit the bill.

7.4 Exploitation, Equality of Opportunity, and the Demographics of Inequality

Before I close, I would like to make a few brief comments about theories of economic justice that rely on conceptions of equality of opportunity as their central moral premise. I consider such theories to be within the family of political liberalism, but not to be expressions of liberal egalitarianism. The reason for this is that while such theories might limit or even prohibit economic inequality, as, for example, Brian Barry's conception of equality of opportunity would clearly do,[53] they do not care directly about the level of economic inequality or the distributional pattern of income and wealth obtaining in the society at hand. Whatever effect such theories would have on these aspects of economic inequality would arise only as a side effect, not as a direct response to any moral features of economic inequality *qua* economic inequality. Indeed, depending on the particular conception of equality of opportunity that we choose to embrace, it is quite possible for a theory of equality of opportunity to have *no* effect on the level or distributional pattern of economic inequality at all, but merely to result in changes (although possibly very dramatic changes) in the *demographics* of inequality—that is, in the identity of the types of individuals and thus of course in the identity of the individuals themselves who occupy the various slots in the existing income distribution.[54] In other words, instead of white men with certain religious, social, and cultural affiliations at the top on the income distribution and (for example) black men at the bottom, percentiles in the income distribution could no longer be characterized by irrelevant factors such as race, sex, religious affiliation, parental income, and so on but would simply reflect the

[53] See, e.g. Brian Barry, *Why Social Justice Matters* (Cambridge: Polity, 2005).

[54] For a discussion of this possibility, see Larry Temkin, *Inequality* (Oxford: Oxford University Press, 1993), 237 n. 9 and 300–3; John Schaar, "Equality of Opportunity and Beyond," in *Nomos IX: Equality*, ed. Roland Pennock and John W. Chapman (New York: Atherton Press, 1967), 228–49, especially 231–2.

degree of developed natural talent and ability of each individual and the effort each expended. The identity of the occupants of each percentile would change, but the overall pattern of distribution and the number of individuals at each level of the income distribution could remain the same.

There is of course nothing wrong with being concerned about the demographics of inequality, and indeed, nothing in our theory of exploitation would prevent a society from embracing such a concern and enforcing whatever remedial measures seem necessary and appropriate to deal with this. On the contrary, our theory presupposes a society that has embraced political liberalism, and any society that has embraced political liberalism will necessarily have some conception of equality of opportunity that it desires to put in force. Even if it does not, however, our theory would go some way to eliminating two aspects of economic inequality that can have dramatic effects on equality of opportunity all on their own. First, it would limit the transfer of and therefore the advantage of inherited wealth, something almost everyone thinks should have no bearing on where one ultimately falls on the income distribution. Second, it would limit the degree to which wealthy individuals or entities can take advantage of the inequality in bargaining power that wealth creates; again, something that most people who embrace equality of opportunity would also be likely to support. Because of these effects, our theory of exploitation should be attractive to those who embrace the concept of equality of opportunity too, whatever their individual conception of equality of opportunity turns out to be.

As for the profile of those at each level of the income distribution if the conception of equality of opportunity that our society chooses to embrace is no more demanding than what we currently find in force in most liberal capitalist societies, it is likely to be this. At the top of the income distribution would be the lucky risk-takers, as well as those who are able to produce goods with high utility in industries with high barriers to entry and who are therefore able to demand the maximum allowable level of profit. Those with the greatest share of natural talents and abilities might be members of this group, but they might not. Remember, the mere possession of natural talents and abilities, even though these may generate goods with high utility, does not necessarily generate goods with high value, and therefore does not necessarily guarantee the holder entry into the upper echelon of the income distribution. Those at the bottom of the income distribution would be the long-term unemployed and those who were unable to generate sufficient profits in the past to supply a comfortable living for them now, for the social minimum would have to fall substantially below the living generated by the minimum wage in order to avoid any potential moral hazard.

While we might find something morally troubling about this, if we do, what is troubling us is capitalism itself. Those who take the most risks, work the hardest, and have more than their share of good luck, do the best under capitalism, or at least should do. This is simply what the demographics of income inequality that capitalism, even when moderated by political liberalism, necessarily entails. There are moral objections that could be raised to this, and these are not insignificant objections, but they are objections that are beyond the scope of a liberal theory of exploitation to address. For any conception of equality of opportunity that does rest comfortably within political liberalism rather than require a radical rethinking of it, however, the demographics of inequality resulting from implementation of our theory of exploitation should be something the adherents of such a conception are willing to embrace. Even those who would opt for a more robust conception of equality of opportunity should have no trouble making our theory of exploitation the focus of an overlapping consensus, for despite any demographic objection to the society our theory of exploitation would produce, it seems fair to say that such a society would still be preferable to the one we are living in now. After all, those at the lowest end of the income distribution—those who would otherwise be the most vulnerable to exploitation—would at least be protected from further acts of this kind. This might be small comfort to the least advantaged and those most concerned with how the least advantaged fare, but it should be some comfort to them nonetheless.

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