“Euvoluntary” Exchange and the “Difference Principle”

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I returned, and saw under the sun, that the race [is] not to the swift, nor the battle to the strong, neither yet bread to the wise, nor yet riches to men of understanding, nor yet favour to men of skill; but time and chance happeneth to them all. Ecclesiastes 9:11

When under the pretext of fraternity, the legal code imposes mutual sacrifices on the citizens, human nature is not thereby abrogated. Everyone will then direct his efforts toward contributing little to, and taking much from, the common fund of sacrifices. Now, is it the most unfortunate who gains from this struggle? Certainly not, but rather the most influential and calculating. (Frederic Bastiat, *Justice and fraternity*, in *Journal des Économistes*, 15 June 1848, page 324)

I. Introduction

John Rawls was no egalitarian. He explicitly allowed for inequalities consistent with the “Difference Principle” (Rawls, 1971: 60). Allowable inequalities must be “reasonably expected to be to everyone’s advantage, and attached to positions and offices open to all.”[1]

The problem is that any Pareto improvement, or move that makes at least one person better off, and no one strictly worse, might satisfy this restriction. How to choose among the enormous set of Pareto improvements over equality? Must we make interpersonal utility comparisons to select the “best”?

Rawls was also no utilitarian. He advocates “justice as fairness” as the criterion for choosing. Given that citizens (even reasonable citizens committed to reaching agreement) disagree about the good and the nature of the ideal society, the answer is to reach agreement on fair procedures. If procedures are unanimously agreed to in the original position, and the

[1] As students of Rawls will immediately point out, this is not the fully fleshed out difference principle Rawls ultimately settles on. I am asking that we try to capture the underlying goals of the difference principle, rather than the particular form Rawls uses to instantiate that spirit.

distribution of primary goods satisfies the difference principle, then the outcome is just. More simply, Rawls argues that justice is the result of fair procedures for choosing.[2]

The Difference Principle narrows down the set of Pareto improvements. Everyone must be better off than in a state of pure equality, but those *least* well off must enjoy the greatest improvement. To satisfy this condition Rawls (1971) seems to reimport the utilitarianism he claims to have rejected. He says that "...an injustice is tolerable only when it is necessary to avoid an even greater injustice." (p.4). A few pages later, he elaborates:

> …social and economic inequalities, for example inequalities of wealth and authority, are just only if they result in compensating benefits for everyone, and in particular for the least advantaged members of society. (pp.14-15).

How can one make these calculations, without being a utilitarian? The power of his argument comes from finessing direct interpersonal comparisons, and letting each person choose for him or herself. In the final statement of the Difference Principle, Rawls (1971) sets out these requirements:

> Social and economic inequalities are to be arranged so that they are ...(a) to the greatest benefit of the least advantaged; and (b) attached to offices and positions open to all under conditions of fair equality of opportunity. (p. 302).

> An inequality of opportunity must enhance the opportunities of those with the lesser opportunity…*General Conception*: All social primary goods—liberty and opportunity, income and wealth, and all the bases of self-respect—are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored. (p. 303; emphasis original).

The two constraints shape both the procedure for allocating, and the resulting distribution of, what he calls "primary goods."

[2] One argument for this view is Gordon (2008). This is not to say that Rawls himself would accept such a reductionist thesis, since he clearly would not. In fact, the tension between fair procedures and fair final distributions is the key point of disagreement that Nozick (1974) later focused on. If final distributions are the key, one is obliged to rule out some transactions that satisfy procedural fairness.

- The *procedure*, Rawls insists, must be fair, meaning that it is selected in the original position, where all choosers are divested of the taint of self-interest.
- The resulting *distribution*, Rawls requires, must have the property that the greatest improvement is felt by those who are least well of.

Rawls believes this procedure achieves the Benthamite "greatest good for the greatest number" while avoiding what he sees as failing "to take seriously the distinction between persons." (Rawls, 1971; p. 187).

Provided that some side constraints are met (no one can be made worse off, etc.), whatever set of political and economic institutions satisfy both the fair process constraint and the consequentialist distribution constraint is just. Do we know what the "best" institutions are? We probably don't, and in fact reasonable people might disagree about what they are. But we are constrained to choose only from among fair processes that produce just distributions, before we even begin to think about which institutions are best.

Core Claims

Having laid out the constraints, a number of people have asked whether a capitalist system, with state action in key areas yet to be determined, can satisfy Rawls's "justice as fairness" conception. In particular, what transactions, activities, and wealth distributions would be allowed?

It is important to note that the only legitimate arguments for markets are consumer sovereignty and improved employment prospects for society's resources, including labor. That is, it is the material consequences (for consumers, and workers, including the poor) of *allowing* profit and loss, *not the profits and losses themselves*, that form the core justification for markets.

For anyone who wants to implement Rawls's conception of a just society, it is important to recognize that profits are a byproduct, like loud noises from an industrial facility that produces a valuable product. The activity is not undertaken to produce noise. But producing the valuable product is either too expensive or impossible unless the noise is produced as a by-product.

Profits result from redirecting resources toward producing things consumers want and need. *Large* profits are signals that before the entrepreneurial activity there were *substantial* resource misallocations, implying large costs and losses for consumers. We pay the cost of the profits as a way of grasping the far larger societal benefit of greater output, higher quality products, and much lower prices. Confiscating profits,[3] unless it can be done by surprise, eliminates the incentives for entrepreneurship and perpetuates resource waste and misuse.

The remainder of this paper examines the question of whether market processes can satisfy Rawls's "fairness" criteria. One part of the argument addresses Rawls's treatment of markets. The other corrects Nozick's treatment of markets. It is useful to set out some markers outlining the path before I begin the main part of the paper, just so we don't get lost.

The Problem with Rawls: Taking the Original Position Seriously There are only two states or positions to be considered, by the logic of the "veil of ignorance." These are (a) the *original position*, where everyone is equal, and equally ignorant of their positions in the realized society, and (b) the *realized society* that implements the institutions selected behind the veil of ignorance.

[3] "Profit" is a term of art in economics. The return to labor is wage; the return to capital is interest; the return to land is rent. Any return above and beyond "normal" returns is either a transitory, accidental phenomenon or a longer term consequence of some barrier to entry. For capital, this supernormal return is often called "profit." But as a number of authors (see Tollison 1982 for an early survey) have shown, there are also conditions where such returns may be "rents," or supernormal returns that accrue to acquiring protection through government action, or obtaining favorable policy through "investing" in politics, rather than in economic capital. I am assuming that the "profits" discussed here are of the transitory economic type. In any case, profits are never the normal "interest" return to capital, though in fact this is how the term profit is generally used by accountants and the general public.

Further, the reasons to choose (b: realized institutions) over (a: perfect equality) have to be the reasons that Rawls himself gives: Liberty and Difference. It is perfectly justified to use unanimous consent in the original position to include a social safety net, redistributive taxation, social insurance, and assistance to ease the plight of workers trapped in a declining industry. In fact, this is the core of the free-market liberal social compact:

> There are two kinds of security: the certainty of a given minimum of sustenance for all and the security of a given standard of life, of the relative position which one person or group enjoys compared with others. *There is no reason why, in a society which has reached the general level of wealth ours has, the first kind of security should not be guaranteed to all without endangering general freedom; that is: some minimum of food, shelter and clothing, sufficient to preserve health. Nor is there any reason why the state should not help to organize a comprehensive system of social insurance in providing for those common hazards of life against which few can make adequate provision.* It is planning for security of the second kind which has such an insidious effect on liberty. It is planning designed to protect individuals or groups against diminutions of their incomes. (Hayek, 1944/2007; emphasis added.)

Hayek's point is identical to Rawls's, in this respect at least: social insurance and income security to ensure the welfare of the least well off is an obligation of the wealthy society. Hayek does not object to guaranteeing a minimal income for the poor; he protests state preservation of incomes.

So we might (with both Hayek and Rawls) endorse a move from hypothetical institutional state (a: pure equality) to a realized institutional state (b: market system with social safety net to protect the least well off). And the extent of the social safety net would be a matter of public agreement, in a way to be made clear in a moment.

What is *impermissible* is to justify a coerced move to yet a third state of the world (c), where further redistribution and punitive tax policies are undertaken to "fix" the realized society of position (b). The reason this is impermissible in the Rawlsian framework is self-evident: it is *only after we know our status in the realized society* that we wake up one morning and decide that position (b) is not what we (the least well off) wanted after all.

The problem is that if voluntary transactions are to be allowed, income inequalities will recur over time. A continuous process of readjustment (not just (c) but then (d) and before long (e)) would be required, based on information we could not possibly have possessed behind the veil of ignorance. These adjustments would be motivated not by the initial agreement about fairness, but self-interested arguments about redistribution, once knowledge about actual wealth positions are revealed. And that is the reason that people who end up with below-average protest procedurally fair voluntary transactions: they don't actually care about procedural fairness, they just want more money.

This more dynamic version of the Difference Principle is inconsistent with Liberty. And that is just the criticism that Robert Nozick was making when he said:

> To maintain a pattern, one must either must continually interfere to stop people from transferring as they wish to, or continually (or periodically) interfere to take from some persons resources that others for some reason chose to transfer to them. (But if some time is limit is to be set on how long people may keep resources others voluntarily transfer to them, why let them keep these resources for *any* amount of time? Why not have immediate confiscation?) (Nozick 1974, p. 163).

To carry the burden of this argument, I will use the concept of "lotteries." But we must be careful, because a lottery means something very specific to students of utility theory, especially the "expected utility" variant of von Neumann and Morgenstern. For von Neumann and Morgenstern, a lottery is not a $20 scratch-off at the Circle K, or the Euro Lotto.

In expected utility theory a lottery (or gamble) is simply a probability distribution defined with respect to a set of outcomes. The probabilities of each event are known, and the set of outcomes is finite. These "outcomes" should be thought of for our purposes as an allocation of Rawls's "primary goods." The advantage of using lotteries in this way is that it raises serious questions about the plausibility of relying on the maximin principle.

What Rawls asserts is that any reasonable person in the original position, given a choice between two lotteries, must always make a particular kind of choice, the maximin. Consider two lotteries, α and β, in the table below, as well as a variant on β, which I'll call β′.

	Lottery α	Lottery β	Lottery β′
Least Well Off	$1,000 with p=1.0	$800 with p=0.10	$9,800 with p=0.10
Wealthy	n/a	$100,000 with p=0.90	$99,000 with p=0.90
Expected Value of Lottery	$1,000	$90,080	$90,080

Let lottery α be $1,000 for certain (that is, one event, occurring with probability 1.0). Let lottery β result in $800 with probability 10% and $100,000 with probability 90%. Rawls requires that the individual, and society, would choose lottery α. The reason is that it maximizes the minimum payoff received by the least well off: the worst thing that can happen in lottery α is that I get $1,000; the worst that can happen in lottery β is worse, $800.

Others have pointed out that this is, at a minimum, a very special assumption, and may be absurdly false as an empirical matter of preference.[4] After all, the expected value of α is $1,000, while the expected value of lottery β is more than $90,000. Given the choice, one would have to be awfully risk-averse to choose α over β.

But even if we accept Rawls's empirical claim (and it is empirical, not a required part of his formal argument) about risk aversion and maximin choices, we need not restrict our choices to α or β. One of the advantages of lotteries is that they are quite flexible, and convexify the outcome space. It is possible (in the original position, before the uncertainty about actual status is resolved) to agree on a small fix for lottery β, changing it to β′. The gains to the winners from moving to a market system are large, and the winners outnumber the losers 9 to 1 (in my arbitrary example). This means we can use ex ante or planned redistribution, a system of social

[4] See, for example, Frohlich, et al. (1987)

welfare to create a third lottery β'. We'll take $1,000 from each of the wealthy, and give this money to the poor. Since the ratio is 9 to 1, this means each wealthy person loses $1,000 and each poor person gains $9,000.

But that means that even the worst off person will get $9,800 with probability 10% or $99,000 with probability 90%. Obviously, what has been done is use redistributive taxation and social insurance to raise the condition of the one person out of ten who would have been less well off. Since lottery α gives $1,000 to everyone, and lottery β' gives $9,800 to a few and $100,000 to most, lottery β' is clearly preferred to A by everyone.

What would be odd, and in fact quite logically impermissible, is for that one "poor" person, the one who got $9,800, to complain about unfairness. S/he is better off than in the world of perfect equality, and agreed (behind the veil of ignorance) to accept a lottery over incomes. Only now, after the veil of ignorance is raised, is there an objection. And the objection is not that there was no improvement in the welfare of the poorest, but rather than there are other people who have done even better.

In selecting institutions, the question is not how to ensure that there are no rich people, but rather how to ensure that the welfare of the poor is put first. A critic of the market system of institutions is obliged to propose an alternative lottery, call it γ, which people would unanimously prefer to β' behind the veil of ignorance. Otherwise, the choice made in the original position (choose the institution that maximizes total average income, with a generous redistributive policy to help those least well off) is immune from further adjustment based on self-interest, by the very logic of Rawls's original position.

The Problem with Nozick: Taking Exchange Seriously As was discussed above, Robert Nozick recognized an inherent contradiction between the Liberty and Difference Principles in Rawls's scheme. The problem is that one cannot maintain a continuous process of wealth adjustment without violating the liberty of individuals to engage in voluntary transactions.

But Nozick's defense of the minimal state takes the wrong approach for justification (chaining "permissible" moves), and then uses the wrong example (Wilt Chamberlain) as an existence proof. The correct justification is that market systems create large amounts of wealth, thereby allowing an increase in living standards for all. Thus, exchange is not just *permitted*, but *required* for a rational chooser in the original position. The correct example must not be an athlete with supernatural attributes, but rather someone with no abilities except the exchange itself.

To accomplish these two tasks, rehabilitating the justification for markets in a way acceptable to Rawls, and providing a better example of existence in support of Nozick, I discuss here a concept I have developed at greater length in other work (Munger 2011), the idea of "euvoluntary exchange." The better defense is to connect the aggregate consequences of myriad individually euvoluntary exchanges. I introduce two characters, the Itinerant Padre and the Verger of St. Phillips, who I propose to use as replacements for the Chamberlain example.

Outline of the paper: I will proceed as follows: I will take up the difference principle, and what is permissible for someone who wants a society based on the idea of "justice as fairness." Then the concept of "euvoluntary exchange" is introduced. Then the importance of profits and losses in producing growth and prosperity are discussed. This raises the question, in section IV, of whether it is possible, as J.S. Mill argued, to separate production (which must be capitalist) from distribution (which can be calibrated after the fact to satisfy a variety of conceptions of justice, including presumably justice as fairness). Section V tries to answer this question in the negative, arguing that the anticipation of redistribution eliminates profits as a signal capable of animating productive action and losses as a signal capable of disciplining mistaken action or inaction.[5]

Section VI is the key argument in the paper, claiming that the focus on profits in the *ex post* distribution of wealth in the society is mistaken. Profits are not the object of market action; in fact, markets tend to reduce profits if competition is allowed. If markets are allowed to operate, and if profits and losses allowed to accrue to right and wrong actions, respectively, the result is a system where consumers, including the least well off, command resources with an ease and facility possible in no other system. Profits are a by-product of the production of consumer sovereignty, just as loud noises are the by-product of many valuable products. So discussions of how the by-product might be reduced while maintaining justice as fairness are perfectly consistent with the Rawlsian project. Eliminating profits from the ex post distribution in the realized society is not. The result would be a net harm to those who are least well off, which in the Rawlsian project is impermissible. The seventh section concludes.

II. The Difference Principle

[5] Bas van der Vossen made many very useful comments on two separate earlier drafts of this paper. But his useful contribution may be here. By "mistaken" I mean an allocation of resources other than that which maximizes profits. (And the maximum could be zero, where any other action implies a loss, of course). There is no moral sense that attaches to a mistaken or wrong action, however. The idea of error, and its implications, are explored in a brilliant but little-known doctoral thesis by Gilberto Salgado (1999). It should also be pointed out that "mistakes" might only be contingent, rather than objective. Mistakes might be defined as deviations from Pareto optimality, but these might be caused by the institutions and incentives that shape the context of entrepreneurial action, not the actual maximizing choices themselves. North's (1990) distinction between institutions and organizations is important in understanding the difference.

I am going to argue for a form of the difference principle that simplifies Rawls's argument (Rawls, 1971; 75-83). Whether it distorts the argument beyond reason I leave to the reader. There are five steps in the argument.

1. Differences based on status, honor, or heredity have no basis in justice. Large differences in access to resources and ownership of wealth tend to perpetuate themselves through generations; people born into wealthy or prestigious situations don't morally deserve them. The real problem may be immobility, however, so that birth fully determines status. Serfs and peasants are always servile and poor, regardless of their merit.

2. The liberty principle requires that social mobility be based on merit and a capacity to fully realize human potential. This principle actually has two parts. The first is based on a freedom from restriction to realize potential. The other is a personal autonomy claim that makes (with some exceptions) the individual the best judge of what that potential is and how to value alternative feasible outcomes.

3. Free market capitalism has more opportunity and rewards to merit than feudalism, but it is still unjust. Differences in wealth are loosely related to "merit" (defined as contribution to the society), but much of where you end up still depends on where you started. Being born to a wealthy family and being educated at expensive schools still explain much of the differences in income and wealth, and these are unjust for the same reasons that feudal distinctions are unjust. Career opportunities should be open to those who would be best able to perform in those careers. But many poor people never know how they might perform because they never have a real chance. The poor lack education, connections, and accessible role models.

4. Even a pure meritocracy, if such a society could be constructed, would still be unjust. Many of the qualities that allow some people to advance while others fail are themselves morally arbitrary. "Character" is something you inherit from your parents, or are taught by the people who raised you. There is no intrinsic moral desert that accrues to good character and hard work, because these are qualities that were acquired through a complex random process of genetics and environment, which the child did not control and cannot be responsible for, either for harm or benefit.[6]

A metaphor commonly used to describe the problem of discerning merit is running a race. In a pure meritocracy the race goes to the swift, and the swift therefore achieve high status in the society. But what if swiftness is at least partly an inherited property? And what if other differences in swiftness can be explained largely as consequences of morally arbitrary features of history or genetics? A man who lost his leg in an accident, or was born without legs, is not swift, but why is a race then a fair test of his merit?

So the difference principle divides the primary goods that (a) come to the individual as intrinsically deserved from those (b) earned as rewards or sanctions. It may be that in the just society, where the difference principle guides division of primary goods, that the neuro-surgeon has a reliable, luxurious new Mercedes. But this is because that society has a stake in ensuring that surgeon arrive reliably and well-rested at the hospital to begin his work fixing the brains of those less able and more sick.

5. *Justice is defined as fairness, and fairness is defined as the distributional rule that reasonable people would choose in the "original position*." This is just tying up the loose ends of the argument, and being clear about the definition. Rawls argues that the distributional rule that

[6] In its starkest form, this argument is related to the problem of "free will." Even if we believe that people have free will, and therefore their choices are morally blameworthy or praiseworthy, they didn't make a choice about the kind of preferences and character they use to make choices.

would be selected must consist of two principles: the liberty principle and the difference principle. Rawls's initial statement[7] of these principles is succinct.

"First: Each person is to have an equal right to the most extensive basic liberty compatible with similar liberty for others.

Second: Social and economic inequalities are to be arranged so that they are both: *a)* reasonably expected to be to everyone's advantage and *b)* attached to positions and offices open to all." (60)

The reading of Rawls that I am advocating is not so very controversial. What I am emphasizing is that we should take the Rawlsian logic seriously, and actually enforce the temporal priority it rests on. One must first (in the original position) choose institutions in a way that denies information about self-interested choice. After the veil of ignorance is lifted, no one can then use information about the realized distribution of primary goods to argue for an additional redistributive step.

The reason this is important is that further interference with *voluntary* actions after we enter the world of the realized distribution of primary goods violates the liberty principle. But what is "voluntary;" what does it mean? We turn now to the problem of exchange, and what makes exchange truly voluntary, so that we can connect up with Robert Nozick's concerns about "capitalist acts between consenting adults."

III. Euvoluntary Exchange

Robert Nozick (1974) famously responded to Rawls by focusing on the justice of voluntary exchange and a different kind of (un)fairness. Nozick objected that institutions in the realized "just" state would not be just after all, but would require further, perhaps continuous,

[7] Again, to be fair, this is NOT the final form of the difference principle Rawls arrives at, but rather a statement of his goals for what the correct difference principle will accomplish. I am trying to argue that the goals can be satisfied in another way.

redistribution of income. He was willing to accept, for the sake of argument, that Rawls's justification for redistributing wealth was that otherwise the realized distribution was *not fair*.

But Nozick responded that such redistributions could not be *just*. First, voluntary transactions would over time have cumulative effects of creating inequalities that Rawls would deem unfair. Paradoxically, each of the individual transactions that led away from a fair distribution was, *by itself*, just and beneficial to both parties. Why punish a transactor who had actually provided benefits to each partner in each transaction?[8]

Second, the possessors of wealth holdings have property rights in that wealth. These rights include the right to have and to use the property, and the rights to transfer the property. Rawls would either violate the right to possess property, by taking it, or else would violate the right freely to transfer the property, taking the fruits of those transfers. I will call such fruits "profits," as is common in the economics literature.

As an illustration, Nozick famously used a particular person, professional basketball star Wilt Chamberlain.[9] As the example is well known, I will not describe it at length here. But the

[8] One could object if the transactions were coerced, or fraudulent, of course. But the force of Nozick's objection is that Rawls would redistribute even if none of the transactions were coerced or fraudulent. And that violates a certain kind of moral intuition some people have about fairness.

[9] For readers younger than 50, and those for whom basketball is obscure, an explanation is useful. The difference between Wilt Chamberlain and his average competitor was perhaps the largest in the history of all of professional sports. On 2-2-68 in a game against the Detroit Pistons, Mr. Chamberlain recorded a "double triple double," putting up 22 points, 25 rebounds, and 21 assists. A "double double" is a good single game; over the course of his long career, Mr. Chamberlain averaged a "double double double," with 30 points per game and 23 rebounds per game. He was not the best team player (Oscar Robertson was a better team player.) But Mr. Chamberlain was utterly dominant for more than decade, 1959 through 1971. The only comparable sports figures are Babe Ruth in the 1920s in baseball, and Tiger Woods in golf in the 2000s. One might protest that Michael Jordan was a better all-around player. Indeed. My claim for dominance for Mr. Chamberlain is based on the *difference* between his performance and that of his peers, at the same time. Basketball had gotten a lot better by the time Mr. Jordan played. So, though Jordan was better overall, Chamberlain was more individually dominant in his era.

point was that many people, even relatively poor people, might be willing to pay an additional \$0.25 to the alpine Mr. Chamberlain to see him play. They are happy to pay the money, and are happy with the result, walking out of the arena feeling the extra quarter was well spent.

The question is whether the "new" distribution, after allowing people to pay Mr. Chamberlain is unjust. If one answers yes, then one must believe either that the citizens who paid extra are not competent judges of their own welfare or that the transactions themselves are unjust in ways the state must overrule. Either way, a state that would force redistribution to return to the initial fair distribution is "outlawing capitalist acts between consenting adults." (Nozick, 1974; p. 163). That might be a violation of Rawls's own Liberty Principle, and it certainly would violate the moral intuition of many people about an important side constraint on what government can regulate.

This is an important point. It means that the internally coherent Rawlsian must outlaw transactions that would benefit both parties, or else must reverse transactions after the fact, returning the money spent by the buyer after taking it by force from the seller.

Nozick's summary is worth quoting at some length:

> No end-state principle or distributional patterned principle of justice can be continuously realized without continuous interference with peoples' lives. Any favored pattern [starting point] would be transformed into one unfavored by the principle, by people choosing to act in various [morally acceptable, mutually beneficial] ways…To maintain a pattern one must either continually interfere to stop people from transferring [even giving away] resources as they wish to, or continually (or periodically) interfere to take some persons' resources that others for some reason choose to transfer to them. (P. 163)

The argument is powerful, but I have always wondered that Nozick chose such an odd and narrow example. Wilt Chamberlain was nearly supernatural. Yes, the example serves as an existence proof, but one that invites only de minimus concessions: Some tiny set of voluntary transactions might be allowed, but the claim that most transactions should either be prevented or reversed by a state committed to justice is left untouched.

A much more useful example, at least in my opinion, is the fable of the "Itinerant Padre," described in Radford (1945). Since this example is not well known (see also Munger, 2011), I will cover it at a bit more length. The point, lest it be obscured, is this: since voluntary exchanges make both parties better off, allowing those who are least well off to have access to exchange improves their welfare. Access to voluntary exchange may well be, for the least well off, the difference between death and survival. By that logic, access to markets improves the welfare of the least well, by more, satisfying Rawls's principle. Now, the example.

During World War II, British economist R.A. Radford was captured and placed in a German P.O.W. camp. Radford noticed the universality of exchange in various camps, and (as an economist) he knew that exchange, in the presence of full information and in the absence of coercion or fraud, always makes both parties to the exchange better off. The interesting thing about the prison camp setting is that each prisoner had precisely the same endowment or total wealth. The reason that we know this for certain is that each prisoner received (a) identical (and often scanty) daily rations from what Radford delicately calls "the detaining power"; and (b) sporadically, but regularly enough to be relied upon, the contents of a Red Cross packet: tinned milk, jam, butter, biscuits, tinned beef, tinned carrots, chocolate, sugar, treacle (molasses), and cigarettes.

What I mean by "makes both parties better off" is this. If I like two carrots more than one milk, and you like one milk more than two carrots, we can trade. This is actually quite important: There is no increase in the total amount of food in the area, but the total welfare of the group is improved. In fact, any law or restriction requiring that we all have the same distribution

would be quite harmful. And such a restriction would harm most those who have least, because the first few trades yield the highest marginal utility. Since the least well off start with such a low base of utility, even small increases represent a dramatic increase in their welfare.

The poor, the bereft….they recognize this quickly. As Radford puts it, "Very soon after capture people realized that it was both undesirable and unnecessary, in view of the limited size and the equality of supplies, to give away or to accept gifts.... 'Goodwill' developed into trading as a more equitable means of maximizing individual satisfaction." In other words, these desperate people realized exchange is more equitable than relying on gifts or charity. The reason is that voluntary trades always leave both parties better off. Forcing one party to give gifts, using guilt or guns, makes one party worse off. One would need a very good reason indeed.

Still, even if trade and exchange are good actions on one's own behalf, what about middlemen? Aren't *they* a problem? After all, in Nozick's example, the exchange was direct: the fans paid, Chamberlain received, and both were better off. Suppose someone specialized in such activities, profiting by creating exchanges without producing new value. Would that deviation from the "fair" distribution be defensible?

Radford mentions describes a priest with a sharp eye for exchanges: "Stories circulated of a padre who started off round the camp with a tin of cheese and five cigarettes and returned to his bed with a complete [Red Cross] parcel in addition to his original cheese and cigarettes."

Interestingly, the prisoners in Radford's camp thought the that the resulting distribution (padre gets a full Red Cross packet) was unjust. They had no quarrel with any of individual transactions, but only with the consequent wealth differences. This is the paradox Nozick was getting at: how can an unjust aggregate result come from many individually just transactions?

Now we see why the example of Wilt Chamberlain was a *cul de sac*, a distraction.[10] Wilt profited by being a unique showman, so why not pay him extra? Middlemen such as the itinerant padre produce nothing, *nothing*, except value. Middlemen, and other traders, earn profits by making other people better off. The padre never made a fraudulent claim or misrepresented what he was offering to trade.[11] The commodities were standardized and interchangeable (one tin of cheese is just like any other; cigarettes are machine-made, and indistinguishable; a tin of jam is always the same). At each and every step, in every transaction, the exchange with the padre made the other party better off. *And yet,* the padre accumulated "profit" of a full Red Cross parcel, a small fortune in the setting of the camp.

If every exchange makes both parties better, how can the padre or any other trader produce any profit? Truly voluntary transactions create value for buyers and sellers, and profits are the reward for facilitating transactions. Of course, it might seem that the wandering padre only *took* value, buying cheap, selling dear, and changing or improving none of the products he exchanged. But in fact the padre created value at every step in the process. He did this by finding Allan, who would pay six (or fewer) cigarettes for a tin of beef, and then finding Barry, who would sell a tin of beef for three (or more) cigarettes. Of course, if these two traders had *happened* to meet each other, they would have exchanged directly. But finding just the right person to trade with is time-consuming at best, and may not happen except by chance. The padre, by searching across trades, *arbitraged* the difference: He could sell the beef to Allan for five cigarettes after buying it from Barry for four cigarettes. Thus, both Allan and Barry are

[10] Remember, Radford was published in 1945, and was available as an example. The parable is well-known among economists, by the way.
[11] Of course, one could allege fraud or coercion, but just as with the example of Wilt Chamberlain the point is to suppose that those things are not true, to see what happens. Fraud and coercion are problems with transactions being unjust; Nozick's challenge is about the aggregate consequences of many just transactions being deemed unjust.

better off by at least one cigarette and the padre "profits" one cigarette by finding the voluntary exchange opportunity.

Truly voluntary exchange: The idea of "truly voluntary" exchange comes up often enough that in an earlier paper I tried to formalize both the concept and its definition. I used (Munger 2011) a neologism, coining the word "euvoluntary" borrowing the Greek prefix "eu" meaning well or truly. For example, among the so-called "social insects" there are some that stand out as truly social, or *eusocial*. These are the ants and the bees, creatures so social that it is not clear if the organism is the bee or the hive, the ant or the next.

In any case, let us define what it means for an exchange to be euvoluntary. *Euvoluntary* exchange requires:

(1) conventional ownership of items, services, or currency by both parties

(2) conventional capacity to transfer and assign this ownership to the other party

(3) the absence of regret, for both parties, after the exchange, in the sense that both receive value at least as great as was anticipated at the time of the agreement to exchange

(4) no large scale or dangerous uncompensated externalities, or costs imposed on third parties without their consent.[12] (And consent would have to be explicit, and elicited under circumstances that themselves otherwise approximate euvoluntary exchange.)

(5) that neither party is coerced in the sense of being forced to exchange by threat ("If you don't trade I will shoot you!")

(6) neither party is coerced in the alternative sense of being harmed by failing to exchange ("If I don't trade I will starve!").

[12] In a private property regime with small numbers, this assumption is easily met by Coasian bargaining (Coase 1960). If property is common and numbers are large, however, state action may be required. However, this is more a problem with the property rights regime than with the exchange itself.

Categories 1-4 are standard requirements for a valid contract in the common law.[13] Likewise, categories 5 and 6 could be summarized as "no duress," also a requirement for valid contracts under the common law.[14] The fifth requirement is a routine aspect of "voluntary" acts for political scientists. In the political world, "power" means a person (group) can impose his (its) will on others through the threat of violence.[15] That is the sense of "coercion" in number 5 above.

In the economic world, power and even duress are different. This difference is captured in category 6: harm caused by an inability to exchange. Most of us have a sense that monopoly is not only economically inefficient, but immoral. Of course, the decision by a consumer whether to purchase a product marketed by a monopoly is not coercive in the same sense as political power is coercive. But if the product is desperately needed, the choices of the consumer faced with a monopoly do not seem euvoluntary.

Fortunately, there is a way of making this notion of power in an economic setting precise. Imagine Jane and Matt are considering an exchange of a product for a sum of money. Jane has power over Matt if Matt suffers more from a failure to exchange than Jane. In some sense, each has a voluntary choice to make: Jane can sell or not sell, and Matt can buy or not buy. But if the consequences of failing to transact differ enormously, then the exchange is not euvoluntary.

[13] Henry C. Black, *A Treatise on the Rescission of Contracts and Cancellation of Written Instruments*, Kansas City: Vernon Law Book Co., 1916.
[14] Ibid.
[15] Hobbes argued that coercion must be relegated to government, not to private bargaining, because "covenants being but words, and breath, have no force to oblige, contain, constrain, or protect any man, but what it has from the public sword..." Thomas Hobbes, *Leviathan*, Part Two, Chapter XVIII

Economists call the state of the individual in the absence of an exchange the "Best Alternative To a Negotiated Agreement," or BATNA for short.[16] One might think of the value of the BATNA as the level of welfare of the person without access to exchange. So, formally, Jane has *power* over Matt, and Matts's exchange decision is *not euvoluntary*, if:

$$\text{Value}\ (\text{BATNA}_{\text{JANE}}) - \text{Value}\ (\text{BATNA}_{\text{MATT}}) \geq \text{Disparity Threshold}$$

The exact level of the "disparity threshold" that dictates which exchanges are not euvoluntary is not obvious. But at some level, if Jane is (nearly) indifferent between exchanging and not exchanging, but Bill must either exchange or suffer great harm, then Jane has power over Bill.

Euvoluntary exchange is actually the concept that Nozick was looking for. He comes close to defining it as he closes the Wilt Chamberlain example:

There is no question about whether each of the people was entitled to the control over the resources they held. Each of these persons chose to give twenty-five cents of their money to Wilt Chamberlain. They could have spent it on going to the movies, or on candy bars.... But they all, or at least one million of them, converged on giving it to Wilt Chamberlain in exchange for watching him play basketball. (Nozick, 1974: 161).

That is, they owned the money, they had alternatives, no one was holding a gun to their heads, and the alternative to a night out at the basketball game was not starvation. This was a euvoluntary exchange.

In the following section, I will flesh out the importance of giving people access to exchange. In particular, I will try to carry the argument to a point where it makes sense to think of access to euvoluntary? exchange, with all the consequent disparities in income that result, as the most important means of improving the welfare of those who are least well off. Remember, I am arguing that the only relevant comparison is between the original position, where all incomes

[16] This concept of BATNA comes from Roger Fisher and William L. Ury. *Getting to Yes: Negotiating Agreement Without Giving In* (Boston, MA: Penguin Books, 1981).

are equal, and the real world of realized institutions, where income disparities are allowed to exist.

IV. Voluntary Exchange, Prices, and the Benefits of Using Markets

In "Wall Street," Gordon Gecko delivers an iconic speech:

Greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures, the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge, has marked the upward surge of mankind.

But few defenders of free markets have actually claimed greed is good. Perhaps Ayn Rand or Mandeville can be read that way, but even then one has to be careful.

It is more accurate to say that greed is simply a fact. Given this fact, human institutions can usefully be arranged to make the clash of self-interest a benefit, rather than a harm, to the society. And that is just what market exchange can do, under a limited set of circumstances: Markets can make human interaction mutually beneficial, *even if* those humans are sometimes greedy.

The best argument for free markets is based on individual liberty and consumer sovereignty. That is, an individual left to his or her own devices has better information and clearer incentives to act. A system based on consumer sovereignty ensures that consumers direct the production decisions of entrepreneurs, though consumers themselves need expend no effort in performing this directive function.

What, then, of profits and the income disparities associated with market processes? Is not the pursuit of profit the goal of capitalism?

Absolutely not, and to say that is to fundamentally misread the argument for capitalism. Capitalism is that system that best ensures consumer sovereignty. Profits, and income inequality,

are waste products, byproducts of the attempts by entrepreneurs to serve consumers. And like by-products in any other context, the idea that the world would be better if the level of external effects were reduced to zero is quite mistaken. We need to ask the key questions: what is it that the system of profits and losses is producing? And would the system continue to produce whatever value we care about if the accumulation of profits were to be curtailed?

It seems tempting to think the answer is "yes." John Stuart Mill certainly thought so. As he famously put it, there is a crystal clear distinction between production decisions and distribution decisions.

The laws and conditions of the Production of wealth partake of the character of physical truths. There is nothing optional or arbitrary in them. Whatever mankind produce, must be produced in the modes, and under the conditions, imposed by the constitution of external things, and by the inherent properties of their own bodily and mental structure….

It is not so with the Distribution of wealth. That is a matter of human institution solely. The things once there, mankind, individually or collectively, can do with them as they like. They can place them at the disposal of whomsoever they please, and on whatever terms. Further, in the social state, in every state except total solitude, any disposal whatever of them can only take place by the consent of society, or rather of those who dispose of its active force. Even what a person has produced by his individual toil, unaided by any one, he cannot keep, unless by the permission of society. Not only can society take it from him, but individuals could and would take it from him, if society only remained passive; if it did not either interfere *en masse,* or employ and pay people for the purpose of preventing him from being disturbed in the possession. (p. 199)

In other words, perhaps something like a capitalist system is necessary for efficient production of goods and services. But it is perfectly plausible to insist that decisions about distribution of the increased prosperity that results are well within the boundaries of state competence. In fact, Mill makes a radical claim: The distribution of property that results from leaving market processes to work without interference is still contingent on state action. Therefore, that so-called "free-market" distribution is just as arbitrary as any other distribution the state might select. The state not only can but must choose the best distribution from the perspective of the society as a whole.[17]

This separation of economic production and distribution is quite similar to the separation envisioned later by Rawls.

"These principles [Liberty and Difference] presuppose that the social structure can be divided into two more or less distinct parts, the first principle applying to the one, the second to the other. They distinguish between those aspects of the social system that define and secure the equal liberties of citizenship and those that specify and establish social and economic inequalities. The basic liberties of citizens are, roughly speaking, political liberty (the right to vote and to be eligible for public office) together with freedom of speech and assembly; liberty of conscience and freedom of thought; freedom of the person along with the right to hold (personal) property; and freedom from arbitrary arrest and seizure as defined by the concept of the rule of law. These liberties are all required to be equal by the first principle, since citizens of a just society are to have the same basic rights.

The second principle applies, in the first approximation, to the distribution of income and wealth
and to the design of organizations that make use of differences in authority and responsibility, or
chains of command. While the distribution of wealth and income need not be equal, it must be to
everyone's advantage, and at the same time, positions of authority and offices of command must
be accessible to all. One applies the second principle by holding positions open, and then, subject
to this constraint, arranges social and economic inequalities so that everyone benefits. (Rawls, 1971: 61)

Rawls envisions a sphere where government action is primarily focused on *protecting* liberty, and another where government action should focus on *effecting* a just distribution of income. In the first instance, liberties are assumed to exist, and the job of government is to protect justice. In the second instance, the distribution of wealth is assumed to be flawed, and the job of government is to effect justice.

[17] This distinction may explain why Mill called himself, and in retrospect might still be called, both a liberal and a socialist.

The key problem with this formulation is visible clearly in Mill's formulation, and is strongly implicit in Rawls. The problem is a question-begging premise: In Mill's words, "The things once there, mankind, individually or collectively, can do with them as they like."

The things once there? Really? And economists get mocked for their facile question-begging assumptions! (The reader has likely heard the famous, "Assume a can opener" joke, for example).[18] We have no basis for assuming that "the things" will be there, unless prices and profits can perform their directive functions. Without the promise of profit, *the things are not there*. In fact, the things are not even things, but rather ideas that no one has ever thought about.

V. Profits as a Way of Ensuring "the Things" Are There

Creating profits is not the objective of market economies; indeed, competitive markets drive profits downward. It could be argued that, since many companies consistently make profits year after year, this competitive force is weak.

The problem with this viewpoint is that it takes an odd benchmark, the world of perfect competition, as a description of how actual markets work. Profits, large or shrinking, are a means to an end. The pursuit of investment in high profit ventures directs resources toward those activities that *consumers* value most.

This point is very important, and for some reason most critics of markets are greatly confused by it, perhaps willfully. Profits, and greed, are not inherently good. Rather, given the right context, the greed-driven pursuit of selfishness can be useful to consumers, as more, better, and cheaper products are produced. In a simple economy, profits would likely be quite limited, because choices are few and information is easily obtained.

[18] Three scholars are marooned on a desert island. They have nothing but a case of canned beans. The chemist describes how focused heat from the sun can open the can. The physicist explains how the application of force using a fulcrum and lever can do the job. The economist shrugs and says, "Assume we have a can opener…"

But given the dynamic and constantly changing nature of a modern economy, choices are many and the consequences of those choices are hard to foresee. In a complex economy, both benefits to consumers (the primary objective) and profits (a byproduct of consumer sovereignty) are likely to be produced in great abundance.

As I said, it is easy to become confused about this. There are three core confusions I want to address in this section.

- First, it is a mistake to assume that the amount of wealth, and the quality and variety of consumer goods, is a fixed pie that can be redistributed according to a conception of justice. The way the pie is expected to be cut sharply affects the size of the pie.
- Second, the people who make profits do not deserve them, in any important moral sense. The only reason we would allow people to keep profits is if the consequence of using a system that produces profits does more social good than harm.
- Finally, I will argue that allowing the pursuit of profits improves the welfare of the least well off better than any alternative. What that means is that anyone sympathetic to the general goals of Difference Principle (though not Rawls statement of the realized form of that principle) should choose the institution of markets, though with the kind of welfare safety net that Hayek describes. Markets uniquely satisfy the Liberty Principle, provided that the continuous politically motivated redistribution process can be avoided.

Cutting the Pie Affects the Size of the Pie:

The idea that the anticipated division of the pie might affect the size of the pie is often denigrated as “supply side” or “voodoo economics.” Ronald Reagan was roundly mocked for his folksy story about high taxes when he was an actor in Hollywood after World War II.

Reagan claimed that he (in effect) rationed his effort, working on no more than four films a year, because income from the fifth film would have bumped him up into the 91% tax bracket, then the highest bracket charged under the tax law.

I have never been able to see why many people think Reagan was obviously, laughably wrong about this. Sure, some of the claims made for the “supply side” approach, or “trickle down” economics, or the “Laffer curve,” are indeed absurd. But the idea that the anticipated division of the rewards of work will affect the intensity and effectiveness of work is both commonsensical and borne out by economic evidence.[19]

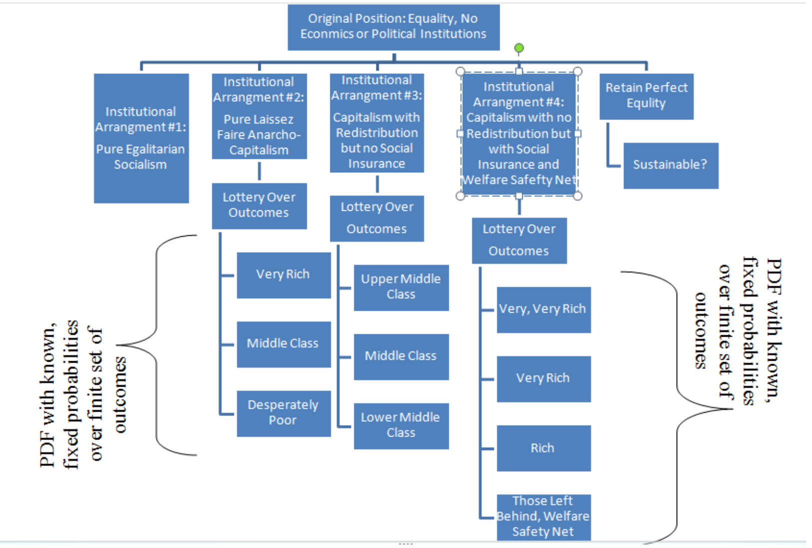
The approach Rawls advocates would appear to say that any differences in income must be justified by an improvement in the condition of those who are least well off. But an improvement compared to which benchmark? The answer has to be the condition under the original condition, behind the veil of ignorance, and assuming pure equality of income.

To claim otherwise is to assert that we can use information about the actual distribution of income, with full knowledge of our position in society, to advocate redistribution. Knowing that I am poor, I will certainly find it in my interest to insist on redistribution. But it is precisely this motivation that the veil of ignorance is conjured to rule out. In the original position, I might well choose a system that produces increased welfare for all, with an expected utility lottery provision that will give me a significant chance at great wealth. The idea of institutions, or states of the world, as lotteries, is an important tool in public economics. (See Fishburn 1981 for a review).

[19] See, for example, Prescott (2004) and the empirical evidence he reviews.

This idea of steps or sequence is best illustrated with a diagram. In the diagram, note that "PDF" stands for "probability distribution function," or a function that maps probabilities of occurrence into the events those probabilities are defined over.

Figure 1: The Choice of Institutions in the Original Position



The gedanken experiment proposed by Rawls relies on understanding of the mapping from institutions into outcomes. That is, Rawls judges whether institutions are just based on whether they have the consequence of satisfying the liberty principle and the difference principle.

The figure lists some different broad categories of institutions; the list is not exhaustive, or even representative.[20] The basis for choosing among different institutions in the original position is clear, even unequivocal: choose the institution that maximizes the difference between the status of the poor in the original position and the status of the poor in the realized world of institutions. More simply, in the Pareto improvement terms discussed earlier, choose the

[20] For a discussion of the meaning of "institutions," see Hodgson (2006); Ostrom (2005); or North (1990).

institutional arrangement that creates the greatest improvement for those who are least well off.

It is useful to give a brief summary of the examples of institutions I have selected (and the selections are entirely arbitrary, as I'm sure is obvious to the reader. In fact, the selections are all satirical, not illustrations of what "real" institutions might look like at all).

- Egalitarian Socialism: State ownership of the means of production, equal incomes for all citizens. Collective action and other incentive problems prevent GDP from growing very large.
- Pure Laissez-Faire Anarcho-Capitalism: Winner takes all, bare-knuckled markets. No government, and security is provided privately. The very poor cannot afford either to feed or defend themselves, and don't live very long. But average income is much higher than under pure state socialism, so there is a 60% chance a selected citizen will be better off, at least monetarily.
- Capitalism with Redistribution: Tax rates for higher income levels are confiscatory, so that incentives for great wealth are attenuated. But even the bottom 20% are better off than under socialism, and much better off than being dead under pure anarcho-capitalism.
- Capitalism with Social Safety Net/Welfare: The bottom 20% are slightly worse off than under socialism, and the next 20% can expect $20,000, the same as under capitalism with redistribution. But every other level of income class is much better off. The very wealthy would be better off under anarcho-capitalism, but the chances of being in some other income category make capitalism with social welfare an attractive alternative.

Table 1: An Arbitrary Example of Incomes Under Alternative Institutional Choices

	Egalitarian Socialism	Pure Laissez-Faire Anarcho-Capitalism	Capitalism with Redistribution	Capitalism with Social Safety Net/ Welfare
Bottom 20%	$10,000	subsistence or less	$15,000	$8,000
Next 20%	$10,000	$10,000	$20,000	$20,000
Middle 20%	$10,000	$20,000	$30,000	$50,000
Upper 20%	$10,000	$30,000	$50,000	$100,000
Top 20%	$10,000	$1,000,000	$100,000	$500,000
GDP:	$50,000	$1,060,000	$215,000	$678,000
Expected Income	$10,000	$212,000	$43,000	$140,000

A decision rule that said "maximize GDP" would select Anarcho-Capitalism, but such a rule is quite foreign to the Rawlsian project. On the other hand, it is by no means clear that the institution implied by maximin (in this case, Capitalism with Redistribution) would actually be selected in the Original Position, given the attractiveness of Capitalism with Social Welfare. GDP and average income are much higher, and a person with even moderate risk aversion might well select Capitalism with Social Welfare because the expected payoffs in all income categories but one are greater than or equal to Capitalism with Redistribution.

Rawls claimed that it was self-evident, as an empirical matter, that people would choose according to the maximin principle in the Original Position. But this is an additional premise to his argument, and not a key part of the logic he uses. The fact is that a considerable literature in experimental psychology and political economy has grown up around this question. If one looks at this literature[21] , there is essentially no evidence in favor of Rawls' empirical claim. Probably the fairest assessment is that reached in the review article by Konow (2003), where the problem is acknowledged but the difficulties are pointed out also.

[21] See, for example, Herne and Suojanen 2004; Oleson 2001; de la Cruz-Dona and Martina 2000; Jackson and Hill 1995; Frohlich and Oppenheimer 1992; Bond and Park 1991; Lissowski, Tyska, and Okrasa 1991; Frohlich and Oppenheimer 1990; Frohlich, Oppenheimer, and Eavey 1987.

The experimental evidence on Rawlsian justice seems to constitute a near-categorical rejection of its crucial premise. Nevertheless, legitimate questions can be raised about the efficacy of the experimental design. Passing through the laboratory door is not necessarily equivalent to passing through a veil of ignorance, and previously formed knowledge and expectations might taint subjects' reasoning. (P. 1196).

The most useful thing at this point is likely to be an acceptance of Rawls's claim about extreme risk-aversion, though perhaps not quite as far as his maximin principle.

A Simple Experiment As An Example To illustrate the problem of temporal priority, and the original position, I performed some classroom experiments, along with my Duke colleague Alex Rosenberg.[22] We gave each student one "scratch off" lottery ticket, from the North Carolina Education Lottery. We asked that the students not scratch off the cover until we decided how we might divide the winnings.

The students were presented with two choices: Each person keep his or her own ticket, and accept the profits, recognizing they were due to chance alone, or pool all the winnings and divide them evenly. After discussing this for a few minutes, we had the vote. Having done this now in several classes, I can say for sure the result is always the same: a large majority favor keeping whatever their ticket gives them.

Students then were asked to scratch off their tickets. We asked for a show of hands, on how many winners there were. Then we asked for amounts. In one class, one young woman had won $200. Summing this and the rest of the winnings, the total for that class was about $235, in a class of 40.

After a moment of silence, one of the students asked, "Can we vote again?" I nodded, and vote again we did. Of the 40 students present that day, 38 voted for equal sharing, *after they knew they had lost*. Of course, as I noted above, almost all of these students had voted that each should keep his or her own winnings, before the values of the lottery were revealed. The only two votes for each to keep her own tickets after they were scratched off were the young woman who had won big, and a woman sitting beside her (perhaps a friend, or an aspiring friend?)

[22] Alex also paid for half of the cost of the lottery tickets! So I acknowledge the financial assistance of the Rosenberg Trust in supporting this research.

Following the second vote, I invoked professorial privilege as Leviathan to protect the original property rights we had agreed on, and the students all laughed. All of them left, and the young woman who had won later cashed in her ticket and kept the money. (I'm not sure if her ally got any, of course!)

There are two lessons here. First, it is by no means obvious that being behind the veil of ignorance will result in an equal sharing rule. People might well choose to go with what they get, out of optimism or a sense of being special. One could argue that the stakes were not high here, and losing didn't mean that you die. On the other hand, the probabilities here are quite low. In the "institutions" lottery described earlier, your probability of out-performing equal division was 60%. Here, the probability was about 25%, at best, and your chances at a significant prize are negligible. Yet given the chance a large majority voted to go with their own endowment.

I did an extension in class, to test more directly the proposition that expectations about the distribution of the pie affect the size of the pie. In one class, I had lottery tickets for sale, $1 each. Students could buy as many as they wanted, with the distribution condition in two different classes (with random assignment) being either "all share" or "each keep." In the "all share" condition almost no one bought lottery tickets. In the "each keep" condition more than three quarters of the students bought at least one.

As it turned out, none of the few tickets in the "all share" class had any winnings at all. The "each keep" condition had a few winners of small amounts, but only two students made more than the cost of the tickets they had purchased.

Nonetheless, the point is clear. If it is true that ability is a lottery, then I still have a choice about how much effort I am going to devote to producing products and services that other people need or want. If I expect the rewards of my effort to be evenly distributed, I am likely to work less hard and less long than if I am allowed to keep some or all of the profits. Again, my abilities may be due to chance. But my willingness to devote effort to producing goods for the public is contingent on earning extra for myself. And if that "extra" improves the lot of the least well off, the income difference must be approved by the Rawlsian observer.

The difference between my lottery example—where "effort" produces no public goods except for winnings—and the real world of profits and markets is that profits result from making things other people want to buy. I may not "deserve" those profits any more than a lottery winner deserves her winnings. But that does not mean that choosing a system where wealth is partly determined by chance is ruled out in the original condition. In fact, since markets serve both the liberty principle and the difference principle, only markets can ultimately accomplish the goals Rawls sets out.

People Who Make Profits May Not Deserve Them:

Somerset Maugham wrote a famous short story, "The Verger."[23] In the story, the church verger, Mr. Foreman has been working as a verger at the church for more than 15 years, and been a servant in some capacity since he was a child. He works hard, and well, but the new vicar

[23] I had read the story years ago, but was reminded of its use for present purposes by Klein (2011).

is shocked to learn that the verger cannot read or write. The vicar demands that Mr. Foreman become literate, or leave the church's employ.

Mr. Foreman doubts he can learn, and is sacked. He wanders, looking for a cigarette. But there is no tobacconist anywhere on all the long street of shops. Mr. Foreman opens a shop, and makes considerable profits. Before long, he opens another, and then several more, in every case using the simple strategy of finding an area that has many shops but no tobacconist. Nothing could be more obvious, but no one else seems to have thought of this.

After amassing a considerable fortune, Mr. Foreman is told by an executive at his bank that he should invest in something with a greater return than a bank account. Mr. Foreman demurs, saying he is not confident he can manage other investments, since he cannot read or write. The banker is amazed, and notes that it is truly remarkable that an illiterate man could have become so very wealthy. The banker muses about how things would be different, if only Mr. Foreman could read and write.

"'I can tell you that sir,' said Mr. Foreman, a little smile on his still aristocratic features. 'I'd be verger of St. Peter's, Neville Square.'"

This parable illustrates the three points I am trying to make in this section quite well. First, the overall level of economic activity is increased by opening the new shops (for tobacco haters, just pretend it was a hardware store). The demand for tobacco products was in this era routine, and local. Mr. Foreman was increasing the size of the pie by seeking profits. Second, Mr. Foreman is quite unremarkable. He invented nothing, and brought no new products into the country. All he did was improve the lot of the working class (the third point) in all of the neighborhoods where he opened his shops. People were able to buy a product they wanted, at a lower price (counting travel) than had been possible before.

Mises (1952, p. 121) himself is quite honest about this feature of the profit and loss system.

> The entrepreneurs are neither perfect nor good in any metaphysical sense. They owe their position exclusively to the fact that they are better fit for the performance of the functions incumbent upon them than other people are. They earn profit not because they are clever in performing their tasks, but because they are more clever or less clumsy than other people are. … If the grumbler knew better, why did he not himself fill the gap and seize the opportunity to earn profits? It is easy indeed to display foresight after the event. In retrospect all fools become wise.

But Allowing People To Make and Keep Profits Helps the Least Well Off:

The fascinating thing about this argument is that it turns the standard Rawlsian argument on its head. Rawls objects to the differences in wealth produced by profits because the things that produce profits seem random. He was right in a sense, because our illiterate verger, like other entrepreneurs, was "neither perfect nor good." In truth, it is difficult to make any argument that claims the entrepreneur deserves the extra wealth. He was just lucky to have noticed something that would improve the welfare of many people.

But it is for that reason that we must tolerate profits and disparities in income. Profits can only accrue to entrepreneurship if resources are misallocated; profits are the result of improvements in the allocation of resources. Mr. Foreman noticed that he could improve the welfare of the city's citizens by opening shops in areas that were underserved. In doing so, he improved the lot of all consumers, including those who are least well off, precisely the group whose welfare Rawls claims can be invoked as a justification for differences in income.

Well, that's what profits are, by definition: increases in income differences that reward successful efforts (not efforts; *successful* efforts) to serve consumers better. By putting consumers in charge and using systems of markets where profits and losses attach themselves to decisions on how consumers might best be served, it is true that the society creates an unequal

distribution of income. Further, it is also true that the recipients of these profit bonuses do not deserve the extra income, in any sense save one. But that one sense, the increased benefits to the least well off in the society, is precisely the one that Rawls privileges as justifications for differences in wealth.

Of course, one might object we can't let consumers decide what they want, especially those who are least well off. Rather than letting ignorant consumers decide what they want, we should perhaps have some board of experts decide what the poorest consumers *should* want. But that would be a wrong reading. Rawls is very serious about claiming that the only condition on choice required to produce fairness is ignorance of one's position in the realized society. He wants to endow even the poorest citizens with the liberty to make their own choices; all he requires is that the differences in wealth in that realized society have the consequence of improving the lot of the least well off.

So who is to decide if the least well off are in fact better off? Rawls discusses two principles one might use: (1) Paternalism, or the imperative to choose for others as we believe they would choose for themselves if they were of age, competent, and reasonable. (2) Liberty, or (following Mill) the claim that one activity is better than another if it is preferred by those who are capable of both and who have experienced each of them under circumstances of liberty. (Rawls, 1971: 209-210).

In the absence of robust markets, liberty would not be available as a principle because there would be far fewer choices and little experience of the consequences of choices. That is fine for the paternalist, of course, because if poor people choose many of their choices will be bad. Drug use, gambling, no saving, borrowing from loan sharks, and other awful things will happen if we let people make their own choices. To be fair, the paternalist would claim that these are not really "choices" at all, in a free-standing euvoluntary sense, because several of the restrictions for ensuring that choices are euvoluntary are not met. The heroin addict or crack prostitute are not making a euvoluntary choice, because their addiction robs them of volition and the capacity to choose reasonably.

Rawls is careful here (Rawls, 1971: 210-211). He argues that we cannot opt for paternalism, for many of the reasons that Mill himself argues. This kind of paternalism is simply a brand of utilitarianism, where the welfare of all, or the welfare of the state, is easily traded off against harms to a few. In fact, Rawls makes a statement that comes quite close to certain elements of Hayek: "The suppression of liberty is always likely to be irrational. Even if the general capacities of mankind were known (as they are not), each person has still to find himself, and for this freedom is a prerequisite." (p. 210). He returns to the themes of liberty and autonomy for the least well off later, in restating the difference principle and how we might judge if it is satisfied.

> [P]aternalistic intervention must be justified by the evident failure or absence of reason and will; and it must be guided by the principles of justice and what is known about the subject's more permanent aims and preferences, or by the account of primary goods. These restrictions on the initiation and direction of paternalistic measures follow from the assumptions of the original position. The parties want to guarantee the integrity of their person and their final ends and beliefs whatever these are. Paternalistic principles are a protection against our own irrationality, and must not be interpreted to license assaults on one's convictions and character by any means so long as these offer the prospect of securing consent later on. More generally, methods of education must likewise honor these constraints (Rawls, 1971: 250)

To close a loop that I hope has already become obvious to the reader, I read Rawls as allowing, even encouraging, all transactions that are euvoluntary. Even among exchanges that are not euvoluntary, the test for whether the transaction should be allowed is the one that Rawls proposes, allowing for rewording to make it consistent with the problem we are examining here. We might pose it as an answer to a question:

Question: In a "justice as fairness" world, what transactions would be permitted?

Answer 1: All euvoluntary transactions would be allowed, because by definition they make both parties to the exchange better off.

Answer 2: Even exchanges that are not euvoluntary would be allowed if the violation of the conditions of euvoluntaryness is the "disparity in BATNAs" condition. The reason is that denying the least well off access to market transactions preserves their unacceptably abject position.

Answer 3: If allowing profits, and guaranteeing profits as property, makes the least well off better off, the accidental by-product of arbitrary or undeserved extra profits for entrepreneurs may be permitted. In fact, it may be required if the real concern is for the greatest net improvement in the welfare of the least well off. More simply, just the fact of the existence of a newly created rich class cannot by itself justify confiscation, if that confiscation would harm the incentives for consumer sovereignty that benefit the poor.

"Answer 3" is the most difficult and controversial of these answers. The reason is that it requires a complex judgment about the consequences of attempts at redistribution. The claim rests on the idea that profits are an accidental consequence of the fundamental social good, viz., placing consumers in charge of directing resources to their highest valued use. If that claim is accepted, then any attempt to redistribute profit, while achieving an increase in fundamental *ex post* fairness of the income distribution, will have very bad consequences for the least well off, who were helped most by the improved efficiency of resource use. The "resource use" I have in mind, of course, is employment. Employment is higher in a society with fully employed resources, and profits are necessary (as for the verger) to encourage entrepreneurs to focus on improving employment.

More simply, employment is better than state-sponsored "welfare" payment based on intrusive and restrictive criteria for eligibility. In terms of income, self-esteem, and the fully realized self, autonomy makes people happier and better off.[24] Attempts to redistribute profits are worse, for the least well off (though, again, it may make the society more equal!), compared to accepting morally arbitrary differences in wealth that dramatically improve the welfare of the least well off.

Loren Lomasky proposed, perhaps tongue-in-cheek (who can tell, with Loren?) that one could in fact read "twin" Rawls as an argument for markets. Lomasky says: "It is not paradoxical hyperbole to maintain that the prospects of the poor are enhanced by disallowing all special pleading in legislatures and regulatory bodies on behalf of the poor. Impartial enforcement of a regime of strong property rights and binding contracts almost certainly will better serve them." (Lomasky, 2005: 191-2).

The observation is a common one, and I'm not sure why Rawls and other political theorists ignore the fundamental public choice insight that self-interest pervades government action just as much as market action. And in the case of government, one has no alternative. As Frederic Bastiat recognized in the quote that begins this paper, it is by no means obvious that an attempt to redistribute, even if motivated by right reasons, either can (as a matter of economic physics) or will (as a matter of political incentives) have anything like the result Rawls intends.

VI. Profits and Losses

This is not an economics lecture, so I will give something much less than a full account of the nature of profits and losses in a capitalist economy. But there are several points that are

24 This argument is made at greater length in Munger (2012).

usefully summarized at this point in the argument. I will name them as principles that I would attribute to Rawls's own analysis, though a Rawlsian might state them differently, and perhaps attach different relative weights to their importance.

Autonomy/Non-Paternalism—What makes the least well off "better off"? That judgment could be made by a kind of philosopher king, whose concern for the poor would lead to requirements of study of classical music and a vegetarian diet. This kind of "better off" is always the stuff of revolutions.

There is the old joke about the firebrand revolutionary standing on a soap box in the square, fulminating on the benefits of rising up against tyranny. He shouts, with a messianic joy, "Come the revolution, you will all be eating milk and honey!"

There is a small disturbance on the fringe of the crowd. A small timid man is thrust forward, against his will. "What? What did you say?" roars the firebrand.

"I… I said… I said I don't like milk and honey…" stammers the small man.

"HA!" bellows the firebrand. "Come the revolution, you'll LIKE milk and honey!"

Rawls seems to disavow this view of paternalistic, imposed changes in institutions that purport to benefit the least well off. If he means it, then only an institutional arrangement that expands freedom and variety of choices for the least well off would satisfy his desiderata.

Mises (1952) has an interesting view on the problem.

> The consumer's preference for definite articles may be open to condemnation from the point of view of a philosopher's judgment. But judgments of value are necessarily always personal and subjective. The consumer chooses what, as he thinks, satisfies him best. Nobody is called upon to determine what could make another man happier or less unhappy. The popularity of motor cars, television sets and nylon stockings[25] may be criticized from a "higher" point of view. But these are the things that people are asking for. They cast their ballots for those entrepreneurs who offer them this merchandise of the best quality at the cheapest price.

25 Nylon stockings? Really? Philosophers have a problem with nylon stockings? I don't want to know….

The advantage of markets is that they make each consumer the boss of his or her consumption decisions, with an ability to use subjective judgments to decide whether that consumer is "better off." Can any other institution make such a claim?

Rawls does not appear to have thought this through. There are few institutional details in the idea of "justice as fairness." This is actually to Rawls' credit, because he focuses on the definitions as constraints on what any just system can look like. But this means that Rawls make only a claim that the fair system, whatever it is, must produce liberty and improve most the lot of those least well off. Could a democratic, *non-market* system conceivably carry out this function?

I would argue it could not, at least not without considerable additional assumptions about the nature of social capital and voluntary private organizations within the democratic structure. Consider Tocqueville's famous formulation:

> Aristocratic communities always contain, among a multitude of persons who by themselves are powerless, a small number of powerful and wealthy citizens, each of whom can achieve great undertakings single-handed. … Every wealthy and powerful citizen constitutes the head of a permanent and compulsory association, composed of all those who are dependent upon him or whom he makes subservient to the execution of his designs.
>
> Among democratic nations, on the contrary, all the citizens are independent and feeble; they can do hardly anything by themselves, and none of them can oblige his fellow men to lend him their assistance. They all, therefore, become powerless if they do not learn voluntarily to help one another. (v. II, Section 2, Chapter 5, "Public Associations in Civil Life.")

Again, I am taking this quote out of context both of time and meaning, but it raises an important question, one that I will present in the form of a conjecture. Given the sort of society Rawls seems to envision, one that now falls well short of the ideal of justice as fairness, what specific changes could be made to move closer to justice as fairness?

I think Tocqueville has it right: imposing democracy, if the nation is not a democracy, is not likely to improve much the lot of the least well off. In an aristocratic or totalitarian nation,

the imposition of democracy will enfeeble the citizens who are least well off. They will not be able to secure the sort of benefits from a new democracy that Rawls has in mind for them.

But if the nation is not a market economy, and moves toward a market system, the prospects are better. At a minimum, it is undoubtedly true that the individual consumer in a new market economy will be able to make his views known more forcefully than will the individual voter in a new democracy. More simply, I am claiming that is much easier and more effective to build supermarkets in ghettoes than to try to build social capital. And if you asked the residents of a ghetto which they would prefer, (1) a conveniently located Kroger with low prices and a variety of merchandise, or (2) a visit from activists trying to increase voter registration, then #1 will win by a large margin.

Consumer Sovereignty is the Goal; Profits are the Byproduct

In a capitalist economy, resources are directed by prices toward their highest valued use. "Value" means the values voted on by consumers, aggregated through the system of supply and delivery. The self-interest of the owners of factors of production, and of finished products, leads them to direct these articles toward the highest price (value) activity they can discover.

This process of discovery (remember the Verger from St. Phillips!) operates imperfectly. But that is because the informational requirements of matching production and delivery to an enormously complex set of consumer demands, demands that are constantly changing and being updated, is difficult in the extreme. Much of this information is local, or "impacted," in the sense that it is not generally known, or else (as with the tobacco shops) the information is hiding in plain sight but available only to those who happen to be looking for it.

Profits are the *ex post* rewards to those who look hardest and most energetically, or who perhaps out of sheer dumb luck happen onto the correct answer. Profits are the result of taking a resource out of one use and redirecting it toward an alternative use that consumers prefer.

Again, Mises's (1952) statement is instructive:

> Profits are never normal. They appear only where there is a maladjustment, a divergence between actual production and production as it should be in order to utilize the available material and mental resources for the best possible satisfaction of the wishes of the public. They are the prize of those who remove this maladjustment; they disappear as soon as the maladjustment is entirely removed. In the imaginary construction of an evenly rotating economy there are no profits. There the sum of the prices of the complementary factors of production, due allowance being made for time preference, coincides with the price of the product.

But how much profit is necessary to allow entrepreneurs to carry out this function of directing resources to their higher values uses? Might profits be excessive? And won't the excessive profits improve the welfare of some arbitrarily selected (i.e., "chosen" by market forces) entrepreneurs who are illiterate, undeserving jerks? Mises goes on, and makes a distinction about what we might think of as "excessive": "The greater the preceding maladjustments, the greater the profit earned by their removal. Maladjustments may sometimes be called excessive. But it is inappropriate to apply the epithet 'excessive' to profits."

Profits accrue to redirecting resources in response to the "orders" of consumers. If resources are badly misdirected compared to what consumers want, then the profits can be quite large. Still, no one knew about the misdirected resources, or the profit opportunity, until the entrepreneur proved their existence by making profits. Anyone could have done it, perhaps, but the entrepreneur did do it.

The problem with this reasoning is that it stops short. The income differences are, indeed, *morally* arbitrary. But they are by no means *consequentially* arbitrary. And Rawls's central justification for income inequality is not moral, but consequential. It is stated in terms of

benefits to those who are least well off. Capitalists may in no moral sense deserve the profits that they reap. But creating a system where work and risk are hugely rewarded, in the relatively rare instances where the benefits to the least well off are proportionately enormous, is consistent with the asserted goals of the Rawlsian project.

VII. Conclusion

My maintained claim throughout the paper is that something like market institutions, married to the same collection of political liberties Rawls privileges, best accomplishes the desirable consequences Rawls establishes for "justice as fairness." Rawls spurns both utilitarianism and paternalism, either of which might rule out pure market institutions. His "difference principle," properly understood, denies the acceptability of *ex post* utilitarian principles based on diminishing marginal utility of income (take a dollar from Bill Gates, harming him little, and give it to a homeless person, benefitting him greatly, and increasing total social welfare).

The crucial part of my argument is the claim (and I think that this is the only consistent reading of Rawls) that this process of realized institutions takes one step, not two. We do not implement markets (the production stage, in Mills's approach), allow the least well off to receive the benefits of choice and autonomy, and *then* move to a separable and interest-informed redistribution of income and wealth. It is all done at once, and even if the two step procedure were possible it is still certain that the redistribution step would be anticipated by those contemplating market action in the production step.

In concrete terms, if Foreman the verger had known that most of his profits were going to be taken to "help" the poor, he would not have taken the risks inherent in opening a string of shops. *And the poor would have been greatly harmed, by being denied access to convenient and competitive shops in the market.* If your goal is to benefit those who are least well off, you have to let some apparently undeserving people keep the profits that result for providing those benefits. But the profits, as I have said repeatedly, are not the end result, but a byproduct of the end result of making better off those who are least well off.

The consequence of competing profits away is that new things are invented, and produced, and delivered. If consumers like them, a consequence is that entrepreneurs earn profits; else, entrepreneurs incur losses. Price, profit, and loss provide a feedback mechanism by which consumers can "vote" (with their dollars) for things they want, and deny votes to everything else. In this way, the sovereignty of the consumer is assured, but in a way that requires no direction or collaboration among consumers. Successful entrepreneurs often create dazzling arrays of new things, none of which would exist without the expected reward of profits.

Thus it may be a fact, is surely a fact, that there are large elements of luck and morally arbitrary accidents in profits and the distribution of wealth. But these are far less objectionable when they are thought of as necessary byproducts of a system that produces consumer sovereignty. The Rawlsian project, as I see it, should focus on the very real imperfections in market processes, deviations from the assumptions of euvoluntary exchange. Many of the claims made by market advocates are vulnerable to limits, or even outright contradiction, if exchange does not satisfy the conditions I have laid out. Middlemen can steal and defraud; externalities can destroy the environment and do great harm to innocent bystanders; common pool property arrangements like fisheries or oil reserves can be decimated by greed directed in harmful directions.

A number of authors have proposed a Hayek / Rawls fusion. Interestingly, one of those who believed that were some complementarities was Hayek himself. Hayek says, in Law Legislation and Liberty (volume 2, 1976, page 100):

Before leaving the subject [of "social justice," a notion Hayek elsewhere compares to a "moral stone" as a category mistake] I want to point out once more that the recognition that in such combinations as 'social', 'economic', 'distributive' or 'retributive' justice the term 'justice' is wholly empty should not lead us to throw the baby out with the bath water. Not only as the basis of the legal rules of just conduct is the justice which the courts of justice administer exceedingly important; there unquestionably also exists a genuine problem of justice in connection with the deliberate design of political institutions, the problem to which Professor John Rawls has recently devoted an important book. The fact that I regret and regard as confusing is merely that in this connection he employs the term 'social justice'. But I have no basic quarrel with an author who, before he proceeds to that problem, acknowledges that the task of selecting specific systems or distributions of desired things as just must be '*abandoned as mistaken in principle, and it is, in any case, not capable of a definite answer. Rather the principles of justice define the crucial constraints which institutions and joint activities must satisfy if persons engaging in them are to have no complaints about them. If these constraints are satisfied, the resulting distribution, whatever it is, may be accepted as just (or at least not unjust).*' This is more or less what I have been trying to argue in this chapter.[26]

[26] The italicized text is a quotation from Rawls (1963). I thank Will Wilkinson, who discusses both these quotations and the ideas of fusion on his blog, among other places. http://www.willwilkinson.net/flybottle/2004/11/16/more-on-hayekrawls-fusionism/ . Flew (2001), however, points out that it is likely that Hayek never read Rawls's later works, particularly the "important book." It is certainly true that Rawls (1971) is much more interested in social justice as an outcome than as a process.

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