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The Wage Setting Process: A Democratic Conception of Fair Market Exchange

THOMAS CHRISTIANO
University of Arizona

Abstract: I here defend a conception of fairness in labor markets. In particular, I argue that we should take a procedural approach to the evaluation of fairness in markets. The procedural approach defended here goes beyond the traditional procedural view that requires only the absence of force and fraud. It also avoids the pitfalls of other classical conceptions of fairness in the market, such as the idea of a just wage or just price. I contend that fairness in markets is analogous to fairness in the democratic process. I thus critique Joseph Heath's discussion of fairness in labor markets: although I agree in part with his assessment of the just wage tradition, I argue that there is room for the analysis of fairness in markets. I lay out a conception of fairness that is based on the analogy with democracy. The basic procedural idea is that of equal power, understood in markets as a robust form of equality of opportunity and equal cognitive conditions. As such, the procedural idea of equal power argued for here can be given an interpretation within perfectly competitive markets and, furthermore, can be applied to imperfectly competitive markets. I thus draw out a number of institutional implications of this account for how the background institutions of society ought to be organized and how firms should be regulated and organized.

Keywords: democracy, fair exchange, markets, procedural justice, equality of opportunity, equal power

JEL Classification: A13, J31, J58, P13

I. INTRODUCTION

In this paper I defend a conception of fairness in labor markets. I argue that we should take a procedural approach to the evaluation of fairness in markets. But the procedural approach I advocate diverges quite substantially from the traditional procedural view that requires only the absence of force and fraud. It goes beyond a merely rule based account

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of correct procedures and attends to the distribution of power that participants bring to the market. And it avoids the weaknesses of the other classical conception of fairness in the market: the idea of a just wage or just price. Fairness in markets, I contend, is analogous to fairness in the democratic process, in that it is concerned with the process by which decisions are made and in particular with the distribution of power among the parties who participate in the process. Hence, the view on offer is procedural but deeply egalitarian.

I start with a discussion and critique of Joseph Heath's stimulating discussion of fairness in labor markets. Though I agree in part with his assessment of the just wage tradition, I argue that there is room for thinking about fairness in markets. In part, his approach suffers because it displays undue confidence in unaided markets that is not warranted given research in contemporary economics. It also fails to make the case against fairness as an important standard for evaluating markets. I then lay out a conception of fairness that is based on an analogy with democracy. This analogy helps us overcome the pitfalls of the traditional theories and it enables us to understand the appropriate place of state institutions in the shaping of markets and the creation of background conditions of fairness. The procedural idea of equal power can be given an interpretation both in perfectly competitive markets and in imperfectly competitive markets. I show how this approach has implications for conceiving how firms ought to be organized and for defining a fair process of wage setting in the highly imperfect conditions of the labor market.

In section II, I critique Heath's discussion. In section III, I lay out the concerns I have with traditional conceptions of fairness and show the need for a new approach, for which I lay out the groundwork. In section IV, I lay out my principle of equal capacities and show how it is an analog of political equality. Section V discusses how the principle applies to the division of labor. Section VI then applies the principle to perfect and imperfect markets. Section VII illustrates how the principle can justify various kinds of regulation of the market.

II. JOSEPH HEATH'S CRITIQUE OF THE FAIRNESS IN MARKETS

I find Joseph Heath's (2018) critique to be stimulating but quite unclear. I discern three main theses in his paper and a further supplementary thesis: (I) markets will not deliver justice, desert, or other related moral goods. They can, at best, be expected to provide efficient outcomes (the

markets not fair thesis); (II) norms of fairness or desert ought not to be used to criticize or defend market transactions (the irrelevance of fairness thesis); (IIa) norms of fairness and desert as they apply to local exchanges are inalterably in tension with efficiency (the conflict between fairness and efficiency thesis); (III) markets tend to channel resources to their best uses, in terms of the satisfaction of wants (the market efficiency thesis).

The first main thesis is a negative and essentially empirical thesis: (I) markets will not deliver justice, desert, or other related moral goods. They can, at best, be expected to provide efficient outcomes (Heath 2018, 4). Efficiency is understood in terms of the maximum satisfaction of human wants. Here he gives an extended and insightful argument against the idea that desert has anything to do with the observation that labor earns an income equal to its marginal revenue product in a perfectly competitive market (10-15). He also argues against Aquinas' thesis that exchange in which one person benefits from another's hardship is unjust.

The second main thesis is also a negative thesis: (II) norms of fairness or desert ought not to be used to criticize or defend market transactions (4). Theses I and II are quite different. One could think that markets do not give people their fair shares or their deserts but still think that they should be modified to come closer to giving people their fair shares or what they deserve.

Heath argues in favor of II (the irrelevance of fairness) by appeal to a number of considerations. First, he argues that the underlying principle of markets is to channel resources to their best uses understood in terms of the satisfaction of human wants (8). To focus on desert or fairness in the process of market exchange would divert attention from, and interfere with, the pursuit of this main objective. Second, he argues that we ought to evaluate markets in a systemic way and not in terms of standards for evaluating individual exchanges taken one by one. From the systemic perspective we see how markets satisfy human wants, which is achieved by ignoring local concerns of fairness. A third argument is that considerations of desert and fairness apply to everyday, small-scale cooperative interactions and not to the impersonal and systemic forces of the market (9). Thesis II is supplemented by a further thesis (IIa) which claims that norms of fairness and desert as they apply to local exchanges are inalterably in tension with efficiency.

These arguments are not persuasive. Heath acknowledges that efficiency is one very important part of the evaluation of markets but that it may not be the only consideration. This leaves open the possibility that desert and fairness could or should play a role in the evaluation of markets. It raises the question whether the consideration of efficiency is overridden by considerations of desert or fairness in certain cases. The idea that the purpose of the market system is efficiency does not preclude one from investigating how the system operates in particular transactions. By analogy, the purpose of war making is to win wars, but this does not preclude an independent concern with how prisoners or civilians are treated. Likewise, the purpose of the criminal justice system is to punish the guilty and deter crime, but this does not preclude an independent concern with how we treat the accused.

The argument from the impersonality and systematicity of the market misses the fact that persons have daily interactions with others that play a large role in determining the qualities of their lives. They seem very much to be concerned with fairness in these interactions. There is no argument here for thinking that fairness considerations ought not to apply. Finally, Heath presupposes that fairness and efficiency are in opposition to one another. There is ample evidence that perceptions of fairness enhance the productivity of workers and perceptions of unfairness detract from that productivity (Cohn, Fehr, and Goette 2015). That is surely an efficiency concern. There is also theoretical reason to think that within incomplete and imperfect markets, efficiency suffers as a consequence of maldistribution (Stiglitz 1994).

The above remarks involve minor skirmishes about the character of the argument Heath gives. More important problems arise with thesis III. This thesis asserts that markets tend to channel resources to their best uses, in terms of the satisfaction of wants (Health 2018, 8). This thesis, coupled with the earlier theses, suggests that one ought to leave the labor market “to its own devices” so that it can bring about want satisfaction (27-28). The trouble with this thesis is that it is not clear what Heath means by ‘markets’. There are at least three different interpretations throughout the paper. The first meaning of ‘market’ is a perfectly competitive market or some reasonable approximation of it. The second meaning is an arrangement closer to actual markets but

unaided by government. The third meaning is a setup of markets that are regulated by government.

To telescope a bit, thesis III (the market efficiency thesis) is true of perfectly competitive markets, but it is not clear that theses I (markets not fair) and II (irrelevance of fairness) are true of these markets. Thesis III (market efficiency) is not true as it applies to imperfectly competitive markets whereas thesis I (markets not fair) may indeed be true of them. This is the message of general equilibrium analysis of incomplete and imperfect markets. Since actual, unaided markets are never perfectly competitive and complete, they are not necessarily efficient, and often are inefficient. Furthermore, efforts to make imperfectly competitive markets more competitive in various respects often do not enhance their efficiency. Often, the best way to enhance the efficiency of an imperfectly competitive market is to add a further imperfection to the market. This is the message of the general theory of the second best and of general equilibrium models of incomplete markets.

These points can be explained further. There is a very tight connection between efficiency, understood as Pareto optimality, and perfectly competitive and complete markets. This is established by the proofs of the two fundamental theorems of welfare economics. The first says that for perfectly competitive and complete markets, every equilibrium is Pareto optimal. The second says that one can attain any Pareto optimal equilibrium depending on the initial distribution of endowments (Debreu 1959). But the conditions for these results to obtain are extremely stringent. They require large numbers of consumers and producers, no transaction costs, full information about the agents, endowments and technology, no externalities, and markets for every possible state of the world, present and future. The consequence of these conditions is that no one has market power, and that credit and insurance in the form of Arrow-Debreu securities are available to anyone so income can be smoothed over time.

I return to comment on the normative features of these conditions below, but for the moment it is essential to recognize that very few of these conditions are ever met in actual economic markets (Laffont 1989, 54). Actual markets, whether regulated or not, are highly incomplete and imperfectly competitive. Asymmetries of information, transaction costs, externalities and a serious incompleteness in markets are the normal state of affairs. To use one simple and obvious case, consider the case of firms. In the Arrow-Debreu model, firms are merely production sets

(Hart 1995, 15; Coase 1988; Williamson 1985). The existence of a firm, understood as a hierarchical organization, is ignored entirely. But such entities exist because of the high transaction costs involved in constantly renegotiating what are necessarily incomplete contracts. Firms exist to overcome problems of transaction costs and asymmetries of information. And they bring in their wake many further problems of efficiency.

The results of general equilibrium theory in the context of incomplete markets, moreover, should be very sobering for any champion of unaided markets. In general, the basic results for models that have even a small degree of complexity are that there are many equilibrium points and that none of them are Pareto optimal. Indeed, none of them are even constrained Pareto optimal. In other words, the equilibrium points that markets reach can generally be improved by external government action such as taxation or required contracting (Geanakoplos 1990; Laffont 1989; Stiglitz 1994).

So, thesis III is clearly supported in the case of complete and competitive markets, but it is challenged in the case of incomplete and imperfectly competitive markets, which are the kinds of markets that populate the real world. Additionally, it would seem that for markets to work reasonably well, it may be necessary for government to play a significant role.

One cannot assume in response to this that what is needed are more competitive markets. When there are serious market imperfections, one must take account of the general theory of the second best. Here is the classic statement of the theorem:

> The general theorem for the second best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable […] Specifically, it is not true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled (Lipsey and Lancaster 1956, 11-12).

Lipsey and Lancaster illustrate many different contexts in which the general theorem for the second best holds. But one context in which the existence of a market imperfection is best supplemented by another market imperfection is the context of patents. The production of information has long been thought to be a problem for the standard

Arrow-Debreu model, first recognized by Arrow himself (1962, 617). Yet innovation is one of the central features of the productivity of modern market economies. The central difficulty is that the production of information (say, about a new and more efficient way of producing some good) is a fixed cost and is highly risky. But once the information is produced, it is easy to replicate. The consequence of this is that there should be no innovation since the innovator cannot reap the benefits of the innovation. The only way to create an incentive for potential innovators is to create a market imperfection by granting the producer a monopoly over the use of the information in the form of a patent. Thus, we need to violate one of the conditions of market completeness (symmetric information) in order to overcome another problem (non-convexity in production) (Arrow 1962, 617; Stiglitz 1994, 141). Lipsey and Lancaster argue that this is a general feature of imperfect markets.

There is a significant debate about whether such imperfections may be useful in labor markets as well. There are three main issues that people have discussed in this context. One is the problem of monopsony and the subsequent weakness of bargaining power of workers. Two is that there are major information asymmetries in this context. Three is that there seems to be some evidence that workers are motivated in significant ways by considerations of fairness.

Analyses of the problem of monopsony go back to Adam Smith. Monopsony occurs in a market to the extent that the buyers are few while there may be many sellers. It can occur in degrees. Such conditions can give market power to the buyers. Smith argues that this is a general feature of certain kinds of labor markets. He says that when there are relatively few capitalists with wealth, while workers are many and poor, the tendency is for wages to be pushed down (Smith [1776] 1982, Book 1, Chapter VIII). Recent equilibrium analyses of wage determination suggest that under conditions of monopsony, wages can be pushed down below what might be secured in a competitive market, while the amount of labor employed could be lower than the equilibrium amount (Boeri and Van Ours 2013, Chapter 2). As such, the major part of the producer surplus (the gains from trade) ends up benefiting the employer.

Information asymmetries can fuel problems of efficiency as well. Adverse selection is the first part of this. If employers know things about how the firm is doing that the workers do not, distrust between workers and employers can grow so that workers do not believe

employers when the latter express the need to work harder in difficult times. Furthermore, if workers do not know how long they are to be in a job, as a result of employment at will, they may lack the kind of commitment necessary to develop firm specific skills (Freeman and Lazear 1995). Moral hazard can also arise to the extent that monitoring and enforcement of incomplete contracts are costly; hence, workers may not work as hard as they could. These negative effects on productivity can be amplified when workers do not think they are paid a fair wage for their work. The evidence suggests that workers slack off when they think that they are not being paid fairly (Cohn, Fehr, and Goette 2015).

The main efforts to rectify these problems in modern economies have been realized through unions and collective bargaining, as well as worker participation in the management of firms and minimum wage laws. These institutions give workers voice in the setting of wages and work conditions and thus enable workers to overcome problems of information, weak bargaining power, and unfair wages. The evidence suggests that unions can have a positive effect on the productivity of workers while diminishing inequality.[1] Evidence also suggests that the decline of unions plays a significant role in the increase in inequality of income and wealth in the United States (Rosenfeld 2014).

No doubt these modifications of the working environment involve changes that are conceived as distortions in the context of perfect competition (unions become monopolistic suppliers of labor) and that is perhaps one of the reasons why people have turned against unions. But once we see that the labor market is already distorted by market imperfections, it may not be surprising to find that further distortions may enhance the efficiency of markets.

Once we take account of the imperfections of markets and the theory of the second best, the usual strategy of insulation, which involves leaving markets to their own devices, seems to lose its luster. It is often the case that government interference and regulation can enhance the efficiency of markets. Since markets are generally incomplete and imperfect, there is no general presumption against interfering with markets, though sometimes, surely, it will be a bad idea. But if there is no general presumption against interference in markets for the sake of efficiency, it is no longer clear why there should be a

[1] See Freeman (2008) and Freeman and Medoff (1984) for a classic analysis of the contribution unions make to the productivity of the firm.

general presumption against interfering with markets for the sake of other values.

A final point to consider is this: it seems mistaken to think that efficiency is the sole criterion for evaluation of markets if we are evaluating perfectly competitive markets. Perfectly competitive markets realize a number of important goods of fairness. I will explain this in more detail once I have laid out my own conception of fairness in markets. But Heath's theses I (markets not fair), II (irrelevance of fairness), and III (market efficiency) cannot be jointly true of unaided markets. And, we must hope that they are not jointly true of all regulated markets, that is, we must hope that we can have fairness and efficiency in regulated markets. In what follows, I will develop my conception of how markets can be made fair while preserving efficiency.

III. FAIRNESS IN INDIVIDUAL TRANSACTIONS

Here I will sketch a conception of fairness in the context of individual exchange that demonstrates in what respects perfect competition can be fair and in what respects it fails to be fair. This sketch is then extended to imperfect competition. First, I argue that there is a need for a new conception of fairness in exchange. Second, I clarify some of the basic terms this conception employs. Third, I provide the basic motivation for looking for a democratic conception of exchange. Fourth, I lay out the democratic conception of exchange. Fifth, I show how this conception explains part of the appeal of, and remedies the difficulties with, perfect competition. Sixth, I apply the notion of fairness to imperfect competition. Seventh, I show how this conception of fairness could suggest remedies to unfairness in actual markets.

The view I develop here attempts to avoid the pitfalls of the two classical accounts of fairness in exchange. The first account includes the classical natural law approach of equal exchange in value, as well as other accounts that attempt to define the just or fair or non-exploitation price, which are the bases of the traditional theory of the just wage.[2] The idea here is that an exchange is fair when the price paid for some good or service is equal in value to the good or service, or that the price is the fair price for that good. The problem with this approach is that the

[2] The classical version of equality in exchange is Aristotle (*Nicomachean Ethics)* and Thomas Aquinas (*Summa Theologica II*). Karl Marx may also be committed to this ideal of equality in exchange (*Capital vol. I*). Alan Wertheimer is the contemporary defender of a version of a kind of non-exploitation price conception (Wertheimer 1996).

benefits of transactions can be quite heterogeneous and hard to compare outside the points of view of each of the participants (I am using the terms 'exchange' and 'transaction' equivalently here). It may be very unclear in many circumstances whether the goods exchanged are equal in value in a more objective sense. The one attempt to elaborate an account of a fair price when there are heterogeneous preferences, namely the price determined under perfectly competitive conditions, is also not capable of delivering an account of the fair price, or so I will argue below. The second more procedural type of account of fairness is the voluntariness account. It says that an exchange is fair when it is voluntary. Much will depend on what voluntariness means, but all of these accounts also fail to provide an account of fairness. If the notion of voluntariness implies only the absence of coercion and fraud, or rights violations, then there will be many intuitively clear cases of unfairness that are not captured by the account (as in cases in which rescuers extract very high rents from the rescued persons).[3] If the notion of voluntariness is defined in terms of the presence of acceptable alternatives, then there will be a number of intuitively fair transactions that will be counted as unfair (as in cases in which a professional rescuer earns a reasonable fee for rescuing a person).[4] I argue that a different way of understanding fairness in transactions is needed.[5]

First, I will draw a few distinctions. One, the account of fairness that is being developed here is a procedural account. Procedural here means to determine the rules and conditions under which exchange takes place. Hence, it is not a complete account of fairness; such an account would require a view of the proper distribution of goods that should result from all the exchanges that people engage in. I do not attempt an overarching account of distributive justice here—rather the procedural account imposes constraints on distribution. By a procedural account, I do not merely mean an account of the formal rules of exchange: I also include the distribution of power that people bring to the exchange. Two, the view I outline here is not an account of exploitation *per se*, though it should have significant implications for a proper conception of exploitation. The difference is that exploitation is a notion that applies primarily to individual actions, while the notion of fairness I am elaborating here is a structural notion that tells us what the proper

[3] I have Nozick (1974) in mind.
[4] The classic formulation of this kind of account is Wood (1995).
[5] I develop these arguments in detail in Christiano (2015).

background conditions and rules of exchange ought to be. What is being developed here is a set of principles for the evaluation of the fairness of the background conditions, such as the distribution of opportunities and cognitive conditions, and the rules of exchange. To be sure, exploitation often takes place when there are unfair background conditions, but the idea of exploitation imports a distinct set of standards concerning how people are supposed to deal with each other under these conditions and the application of a conception of exploitation often presupposes an account of unfair market exchange.[6]

The distinctive approach I attempt here is grounded in the idea that there is a fundamental analogy between democracy in collective decision making and an egalitarian principle for evaluating the background conditions of exchange in decentralized decision making (see Christiano 2008). Ultimately, I adopt the view that the standards of fairness in collective decision making (that is, decision making in which everyone participates in each decision, e.g. in majority rule) and in decentralized decision making are grounded in one single more abstract principle. That single principle is a principle of equal distribution of power in the context of disagreement and conflict, as well as in the context of cooperation. Space constraints prohibit me from developing this hypothesis further: hence, I develop the structural similarities between the contexts of decentralized and centralized decision-making, all the while respecting the differences.

What supports the idea that there is such an analogy are the similarities between what people do when they engage in agreement making with others and when they participate in collective decision making. First, in both activities, persons attempt to shape the social world they live in. In decentralized decision making they attempt to shape that world in the many agreements they enter into by altering the rights and duties people have to each other and the distribution of benefits. The sum total of agreements a person enters into over a lifetime give shape to the social world the person lives in.

Second, though cooperation and mutual advantage are central to agreement making, so is conflict. Our aims often conflict with those we exchange with in that we strive to give less to obtain more (and so do the people we exchange with). The conflict between wage earner and employer fits this scheme clearly. The outcome of an agreement is then

[6] For some classic discussions of exploitation, see Cohen (1979), Roemer (1985), Steiner (1984), Wood (1995), and Wertheimer (1996).

partly determined by a distribution of power among the parties, (which I will explain in greater detail on the next page). For now, the fact that the content of an agreement favors the person with market power over someone without it, is sufficient to illustrate the idea. I will argue that power differentials make a difference even under conditions of perfect competition.

Third, the justifications for granting powers to shape the social world are grounded in the same common liberal concerns. Persons have different interests that conflict and we give each person some power to pursue those interests. Persons disagree on how best to shape their social worlds and we give each person some power to act in accord with his or her own judgment. Furthermore, there is at least a basic part of these issues about how best to shape the social worlds that we do not think ought to be decided by expertise. We think that people ought to be able to make the basic decisions about how their society is organized, and how their lives with others are organized, on the basis of their own judgments. In my view, this is the common core of liberalism at the root of democracy and liberal rights (Christiano 2008, Chapters 3 and 4). In one case, they are meant to provide people with the power to participate in centralized decision making and in the other they are meant to give people power to engage in decentralized decision making.

Because the interests of persons are of equal importance and we think that each person is to be treated as an equal in this context of conflict and disagreement, I affirm that fairness requires that power ought to be distributed equally in centralized (or collective) decision making and in decentralized decision making. I cannot develop this argument further here.[7] Here, my aim is to utilize the analogy with democracy, and the strong commitment most people have to democracy, to argue that the analogical variant of equal power should be applied to the context of exchange.

To be clear, I do not mean to imply that these decentralized settings ought to be centralized and democratized in the traditional way. My intention is to show that there is an analogy between participation in democratic collective decision making and the activities of persons in decentralized settings. The values involved in personal relationships and development and the distinctive values that arise from people cultivating their particular talents and ideas must be given some

[7] I have developed it in some detail for democratic and basic liberal rights in Christiano (2008).

significant protection from collectivization. In following the tradition of economic theory of Adam Smith and John Maynard Keynes, I argue that some kind of open market system is important for putting resources to productive uses (though, it usually will not involve a free market system, as I argued above).

IV. THE PRINCIPLE OF EQUAL CAPACITIES

With these motivating ideas in the background, I sketch an account of fair exchange, which I then apply to perfect and imperfect markets. An intuitive and useful starting point is to think about fairness in agreements in the case where there is only one exchange between two people that will determine their whole lives. In this case, the appropriate background fairness conditions for such an exchange consist in the realization of equal capacities for that exchange. Let us call this the principle of equal capacities. This breaks down into two components: equal cognitive conditions and robust equal opportunity for exiting or refusing entry into the arrangement. Equal cognitive conditions involve equal access to information relevant to one's interests and concerns and abilities to negotiate desirable arrangements. The basic institutional supports for this are a system of education and systems of protections of consumers in the contexts of arrangements with great asymmetries of information. We achieve equal opportunity by making sure that people have the resources that enable them to exit or refuse transactions and enter others that advance their interests. The basic determinant of power in the context of agreement making is the value of the outside option for a person. A person with good alternatives to entering a particular agreement has bargaining power over the content of the agreement. Persons with equal opportunities for exit have a kind of equal power. In this sense, I am talking about real opportunities and not merely formal opportunities. Education, basic needs provision, and other goods give people opportunities to choose among transactions by enhancing their bargaining power.

These conditions give each person equal power to shape the agreement with another actor according to terms she judges best. And this gives each person equal power to shape the social world she lives in. Giving either person less than equal capacities, at least for normal adults, would amount to treating that person's interests as having less than equal importance.

In most cases, of course, persons engage in many exchanges with many different people. Here the principle of equal capacities directs us to say that the persons must have equal capacities globally, in the sense that they start from background conditions that ensure equal capacities for all. This equal capacity condition need not be fully maintained throughout different exchanges, because previous agreements a person enters into may curtail opportunities she will have in later encounters. If this is done knowingly, the later encounter in which there may be some local inequality of opportunity or inequality of cognitive conditions is not unfair. Furthermore, individuals may choose to focus on some agreements in which they think of themselves as having much at stake and reduce focus on other exchanges in which they think of themselves as having less at stake. So, the account does not assert that there need be equality between persons in every agreement making context. It requires only a kind of global equality of capacity for determining whole life prospects.

This is meant to realize a kind of democratic value in the context of decentralized decision making, because the two conditions in the one-shot case in effect specify circumstances in which persons have an equal say in the structuring of their relations with each other. And the global principle of equal capacity gives persons a kind of equal say in the formation of their social lives together with others when they engage in a series of agreements with many people. The two conditions specify a kind of condition of global equal bargaining power between parties such that each person has an equal say in the formation of the contents of the series of agreements they enter into (Christiano 2016).

V. EQUALITY OF OPPORTUNITY AND THE DIVISION OF LABOR

With this basic conception of the democratic approach to market exchange in mind, I will develop the idea of equality of opportunity in greater detail. When we think of equality of opportunity in modern societies, we think of the division of labor as fixed and equality of opportunity as a means of filling the various positions in the division of labor.[8] So, there is equal opportunity to fill positions of authority and management, as well as wage labor and so on. This can make equality of opportunity appear non-attractive, since it seems to leave the structure of the division of labor, no matter how oppressive, in place. It merely gives each person a chance to occupy any of these positions. So, to use

[8] For example, this is how Rawls approaches equality of opportunity in his (1971).

an extreme example, it would seem that if there were a society of masters and slaves, we could give each person an equal opportunity to occupy the positions of master or slave. This would remain a very unattractive society even if the equality of opportunity were as complete as could be.[9]

But, here, the democratic conception of exchange and of equality of opportunity, which gives people equal power over the terms of their association with others, presents a very different picture. Presumably, with their equal power, individuals would shape the division of labor in ways that are attractive to them. So, equality of opportunity ought to play a large role in determining the character of the division of labor in society. The division of labor would not be fixed, but subject to the choices of people as they determine, on an equal basis, what kind of relations they wish to enter into with others. As a consequence, we may not see the kinds of deep asymmetries that exist between wage laborers and managers, or between workers and owners, as we see in modern societies.

The relationships that we see in most modern societies are, in large part, the consequence of dramatically unequal opportunity and the subsequent unequal power that people have before they enter into the exchange relationships. Wage laborers are usually people who have had little access to education, relatively low-income parents, and in general, few opportunities to improve their lives.[10] They are happy if they find a place in the society. Managers, entrepreneurs, professionals, and owners of capital tend to come from very different family and educational backgrounds than the wage laborers. To the extent that there is change in the division of labor, it tends to come from the upper middle class and the wealthy, while the rest must accept what they get. And those changes reflect the interests of the competing elites that struggle for a say over the structures of economic life. Hierarchy between them and the rest is simply taken as a given because the rest do not have the power to alter it. With genuinely equal opportunity, these kinds of hierarchical relationships would not disappear entirely, but they would be significantly less in evidence. People who have equal power to others will not tolerate being placed in an inferior position with regard to others.

[9] See Fishkin (2014) for the introduction of this important and innovative idea.
[10] See Davis and Mazumder (2017) for evidence of inequality of opportunity in the US.

There are a number of qualifications that need to be explained concerning this principle. First, it is important here to note the scope of the proper effects of decision making. The prime focus for these decisions is the constitution of the division of labor in society, the aims of production, the conditions of work, the local fairness of wages and the division of work, and the array of consumption goods. These are the conditions that are most appropriately determined by the efforts to shape the social world that are involved with agreement making. People may choose to focus on some of the aforementioned conditions more than others, depending on what they think most important. The accumulated effects of the many agreements made with equal capacities as background condition ought not to determine the structure of the distribution of income in the society as a whole (that is, whether the distribution is equal or unequal, and the degree of inequality). Decisions about the distribution of income in society as a whole are most appropriately made by the society as a whole in the traditional democratic way.

Second, since I am advancing a principle of equal opportunity, I need to say something about what kinds of things can produce inequality in the outcomes of the processes of agreement making. One, those who knowingly exert themselves and make use of their opportunities for the sake of a particular good are more likely to achieve that good, other things being equal, than those who knowingly do not exert themselves for the sake of that good. Such differences do seem to be defensible grounds for inequality of income and they are defensible grounds for one person having more authority or more interesting work than another.

Two, a more controversial and complex inequality-generating phenomenon is variation in natural talent. I cannot give a complete treatment of this issue here. Variation in natural talent (as opposed to acquired abilities) is not a defensible ground in itself of differences in income. The idea here is that differences in natural talent are essentially determined by the relation of one's natural abilities to those of others. It is a matter of luck that my natural abilities are higher or lower than those of others. That I have a natural ability is not in itself a matter of luck, but its relation with others is. In the simplest economic terms, my natural abilities are talents depending on the supply of, and demand for, such abilities. It is hard to see why I should receive extra benefits merely

because of my particular position within the larger distribution of abilities.

Things are more complicated in the case of the distribution of meaningful work and social power. Two people who are competing for a particular social position may end up in different positions with regard to the division of labor if their realized natural talents imply that they should occupy those positions. One person may have more power if she is better able to use it than another. Or she may have a more interesting job because of her greater abilities. The question is, what can justify this? What justifies it is that it is important to have a division of labor in which people are placed in the jobs in which they can do the most good. It can be justified by the principle that we ought to think that generally beneficial inequality can be justified over equality in which people are worse off, and by the idea that it is important that people be able to realize their talents. The realization of natural talent implies that persons are benefited when they exercise those talents. To require that people not be able to exercise their talents so that they have no more bargaining power than others would be to make others worse off, as well as the person who is deprived of the opportunity to exercise talent.[11]

Finally, there will be some inequality in shaping the division of labor for reasons that are similar to the inequalities we see and accept in political democracy. Some will be more able to come up with desirable schemes for shaping the division of labor and more able to persuade others to accept them. As long as these differences occur against the background of equal cognitive conditions and equal opportunity and result from processes of persuasion, they are legitimate.

VI. ECONOMIC EXCHANGE IN THE MARKETS

Now that we have the principle of equal capacity laid out, I want to apply the principle to the evaluation of markets. Here I want to point to two different sources of power, understood as the ability to get what one wants from a system of social cooperation. The first source of power is derived from the initial endowment a person has when entering a market. We see this in both perfect and imperfect markets. The second

[11] This is not to say that persons having more interesting jobs because they are more talented than others is entirely just. Many think there is still some injustice here, but it may be more just than the leveling down alternative. See Christiano and Braynen (2008).

source of power emerges from imperfect markets with monopolistic or monopsonistic competition. It introduces an element of bargaining power in the determination of the wage.

VI.I. Perfect Competition

If we think about perfectly competitive and complete markets carefully, they partially realize an ideal of social cooperation.[12] The system is a (partial) ideal of cooperation because there are no impediments to cooperation and so cooperation is efficient. But it also realizes certain minimally egalitarian and libertarian qualities. Since there are no externalities and markets range over all possible states of the world (of which each person is aware), each person gets what he or she pursues against a minimally egalitarian background. The background is minimally egalitarian since there is no market power. And since credit is available on a costless basis and there is no cost in moving from one position to another, those with low external endowments have a robust opportunity to occupy any social position to which their talents are suited. Furthermore, each person has unlimited availability of insurance (since there is no moral hazard or adverse selection) and so can take care of themselves in every eventuality and can thus establish a kind of independence from others. These conditions go a long way in eliminating exploitation. Furthermore, each person earns an income that is equal to her marginal product. The objections that Heath and others have made to the marginal productivity principle do not hold when everyone is a part of the same perfectly competitive and complete set of markets and where people come in a few clearly distinguishable types. So, from the perspective of perfectly competitive markets, markets do deliver on a number of important fairness norms. The absence of market power, universal opportunity, and independence from others are all highly desirable features that can be understood in terms of the democratic conception of fairness. And this is part of their appeal. Hence Heath's theses I (markets not fair) and II (the irrelevance of fairness) are not true of perfectly competitive markets.

[12] This may sound funny since we are talking about competition. But in fact, the competition involved in perfectly competitive markets is not competition in the usual sense. There are no losers, strictly speaking, in perfectly competitive markets as there are in imperfectly competitive markets. Imperfect competition often takes the character of a contest or tournament. Perfect competition involves people costlessly finding the most productive position suited to them. See Stiglitz (1994, 110).

The ideal is incomplete because it does not rule out the possibility that the satisfaction of individual preferences depends to some degree on differences of endowment, both external and internal. For the same reason, while there is universal robust opportunity, it is not equal opportunity. This is why the equality is only minimal. And there is little room for solidarity in such a system above and beyond the respect for property and exchange rights.

We see two possible effects of differential initial endowment in competitive markets. Assume that labor is homogeneous, that there is only one wage set for everyone, and that there are very many firms and very many laborers. The first possible effect is that, if all potential laborers have a higher initial endowment, then the supply curve of labor will shift to the left so that the intersection with the demand curve for labor will determine a higher wage but lower employment. The greater size of the initial endowment makes less employment a more desirable option. The equilibrium wage will shift as a consequence of the change in the aggregate supply of labor. Here we see that though the individual laborer is a price taker, the aggregate of laborers together can shift the wage higher or lower depending on the size of the initial endowments that workers in general have. When workers have very little in the way of initial endowment, their wages will be significantly less than when they have a large endowment on average (see Figure 1).

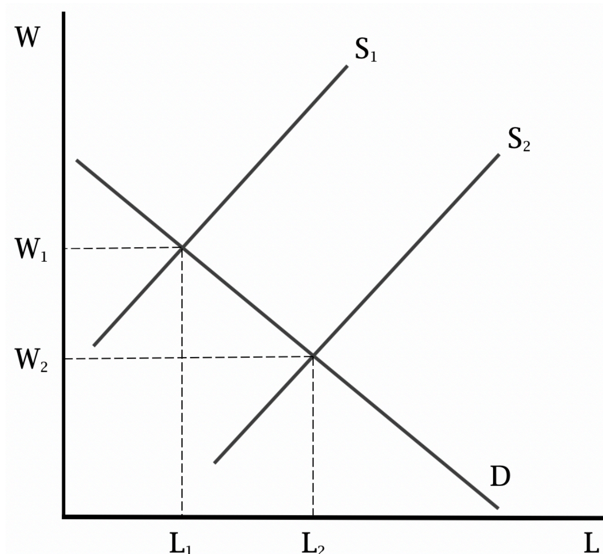

Figure 1. Effect of endowment on labor supply[13]

[13] As workers acquire, in the aggregate, a greater endowment, the labor supply curve shifts to the left from S_2 to S_1, increasing the wage (from W_2 to W_1) and decreasing the amount of labor (from L_2 to L_1). See Kaufman (2010, 436) for graph.

The second possible effect is that if an individual laborer has a higher endowment but others do not, this person will tend to work only for higher wages. If the equilibrium wage does not change, this person will work less hours (again, assuming labor is homogeneous). This is the effect of individuals being price takers. This person cannot produce a higher wage for himself but he can improve his situation.

We can see in these two situations, two different types of power concerning the ability of people to get what they want from a system of social cooperation. The individual worker in a competitive market is a price taker and so cannot determine the wage she will get. But if she has a greater endowment, she can choose to work more or less. She has greater capacity to get what she wants, though no power to get others to change their behavior, which in this simple model means no capacity to change the wage offered by the firm. In the instance where all workers are wealthier, each individual remains a price taker but there is a sense in which the collectivity of workers is a kind of price maker just as the collectivity of firms is. That is, they determine the aggregate labor supply curve; and the prices that are determined here will depend on the initial endowments of workers and firms. There is a competitive equilibrium wage, but that wage depends on the supply and demand for labor, which in turn depends on the endowments of those who are hiring labor and the endowments of those who sell their labor.

The standard economic conception of exploitation, which asserts that exploitation occurs to the extent that there is a difference between the competitive equilibrium wage and the actual wage, does not have a critical role to play in perfectly competitive markets.[14] We may nevertheless think that there is something unfair or unjust about exchanges wherein workers come to competitive markets with very little endowments and the owners of firms come with great endowments.

The sense of unfairness can be explained by the democratic conception of exchange. We do not just have a prior distribution of goods among persons—that prior distribution makes a difference in what persons can do relative to others. The initial endowment has a power conferring role, and the distribution of endowments determines the distribution of power among the persons in the market. The workers

[14] See Marshall ([1920] 2011, Book VI, Chapter 3). Also see Pigou (1938, 550) who, in addition, seeks to account for the cost to the worker of working in assessing the fairness of a wage. Wertheimer (1996) seems an expression of the basic neo-classical view of exploitation attributed to Marshall.

collectively exercise a kind of power that can alter the offered wage. And in the case of the individual price takers, a greater endowment enables them to shape aspects of their own lives more than a lesser endowment.

To be sure, the individual power in the perfectly competitive market is not bargaining power since it cannot affect the wage offer. But it is power nevertheless, which determines how people are able to live in the world and interact with others. Hence, the democratic conception illuminates the fairness of exchange in perfect markets and the limits of fairness in perfect markets.

VI.II. Imperfect Competition

I have shown how the democratic conception of fair exchange applies to perfect markets; I will now show how it applies to imperfect markets. In order to discuss imperfect competition, we need to refine the conception of equal capacity that led us to equal opportunity. The worry here can be expressed by means of the example above of a master and slave society. Suppose there is a society of masters and slaves in which each person has a real equal opportunity to become one or the other. Once you become one or the other, your prospects in life are set. The masters have a lot of power and the slaves have very little. We may think that there is something intuitively wrong about this kind of society because of the structure of the division of labor. This division of labor gives some a great deal of power while leaving very little for others. Even if everyone has an equal opportunity to become one or the other, the idea that this arrangement gives people equal power over their social lives is implausible.

It is important to note here that this is not a case in which inequality of power is merely the result of different people's choices. Given the structure of the division of labor described above, some people will have to become slaves regardless of their talents or their preferences. Even if everyone is equally talented and motivated, some will lose power. The inequality that arises in this case is unjust. To be sure, equality of opportunity can often be counted upon to break down this kind of inequality but there may be circumstances in which this inequality is fairly rigid, in the sense that the market may not provide a remedy for it. The democratic conception gives us strong reasons for remedying this injustice.

I contend that imperfect competition gives rise to this possibility. In some cases, even when everyone has an equal opportunity to enter into

any position in the hierarchy, some may acquire market power while others must accept it. I will illustrate the general reasoning with the example of monopsony. Persons who start out with the same endowments and opportunities may end up in a relation of monopsony in which some have market power and others must submit to that power. The case I have in mind involves two conditions not present in perfect markets: there is some degree of increasing returns to scale so that there is some tendency to concentration of productive activities in a small number of firms; and there are difficulties in the mobility of labor. From increasing returns to scale and low labor mobility, we get some degree of monopsony, which puts the buyer of labor in a position of market power relative to the laborer. For an extreme case, consider an area where only one firm employs all the labor. In this extreme case, the monopsonist is much like a monopolist with regard to buyers. The firm under monopsony competition sets wages. In this kind of circumstance, the wages offered by the firm to the workers are lower than the equilibrium wage under perfect competition and so lower than an efficient wage, and the level of employment is lower than the equilibrium level (Boeri and Van Ours 2013, Chapter 2). While the extreme case of monopsony is fairly rare, there are degrees of monopsony in which there is significant asymmetry between the workers' abilities to take other jobs and the firm's ability to take new workers.[15] What is important here is that normally there is a clear asymmetry of power in determining the wage rate and working conditions.[16] This division of labor can be rigid, perhaps because the managers see it as in their interests to retain a hard division between workers and managers—even in cases in which the overall product increases with more worker participation (Freeman and Lazear 1995, 29).

To the extent that there is some rigidity in this particular division of labor, the inequality of power that arises must be counted as a kind of illegitimate inequality. It ought to be remedied in accordance with the democratic conception.

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[15] For a fuller picture of monopsony and degrees of monopsony as well as the idea of dynamic monopsony, see Manning (2003).

[16] This is probably the most commonly observed phenomenon about labor markets in both classical and neo-classical works. See Smith ([1776] 1982) and Marshall ([1920] 2011). This reference to unequal bargaining power in imperfect markets pervades contemporary discussions of imperfect labor markets. See also Kaufman (2010) for an in-depth discussion.

VII. INSTITUTIONS

I have articulated the democratic analogy between centralized decision making and decentralized decision making. I have articulated and defended the basic principle of fairness for decentralized decision making (by way of analogy with fairness in collective decision making). I have shown how the democratic conception illuminates the value of perfect competition and shows its limits. I have also shown how the democratic conception gives us insight into issues of fairness in imperfect markets. In this section, I will briefly lay out some institutional recommendations that are suggested by the democratic conception of markets. Each presents a way in which the society collectively shapes markets so as to establish equal power or to reestablish it when it is lost in the market. I should say that these recommendations are made primarily for purpose of illustration. They are not meant to be fully justified conclusions but demonstrations of how the democratic conception can be a fruitful source of institutional thinking.

There are three issues that need to be dealt with. One, the society must set the background conditions for fair interaction among persons in the market. Two, a society must set conditions in the workplace to remedy a problematic division of labor, such as when monopsony becomes prominent. Three, a society must set conditions in the workplace to remedy the failure to establish equality of opportunity in society.

I have three institutional devices in mind. First, there are institutional requirements of a society that provide *ex ante* equality of opportunity and equal cognitive conditions in a society that makes significant use of markets. Second, there are institutional mechanisms that regulate the relation of employer to employee. They are meant to equalize the distribution of power as a remedy for when the division of labor creates an illegitimately unequal distribution of power, or when there is inequality of opportunity in a society. Third, there are institutional mechanisms that are meant to enhance the voice of workers in the context of monopsonistic markets with rigidly hierarchical firms, or in the context of a market's failure to achieve equality of opportunity for a society.

The first set of recommendations involve the *ex ante* conditions for equal capacity. I include in this a system of public education that gives people an equal set of cognitive conditions for approaching the market

and for approaching their duties as citizens. I also have in mind a powerful welfare state that provides an unconditional basic income as well as universal health care insurance. In part, the welfare state institutions supply a kind of equality of initial endowments with which persons can face the market. In part, the welfare state institutions are a remedial response to imperfection in markets because imperfectly competitive markets are not capable of supplying insurance to worse off persons as a result of adverse selection and moral hazard. Notice here that the welfare state institutions are not merely conceived as satisfying needs, but also as enhancing the power of workers in perfect markets and the bargaining power of workers in imperfect markets, which are justified by the democratic conception. Thus, the democratic conception can provide guidance in determining what the shape of these institutions ought to be in a just society.

The second set of recommendations concern the regulation of the workplace. In the context of imperfect markets, some have greater bargaining power to determine the contents of the agreements they enter into with others as a result of different capacities for exit. In the context of monopsonistic labor markets, the remedies will involve rebalancing the distribution of power in the context of the workplace through workplace regulation. This diminishes the power of the employer, say, by regulation of workplace conditions, employment protection laws, and minimum wage. In each of these cases, the regulation diminishes the ability of the employer to bargain with the employee by limiting the options available to employers. Each of these can enhance the bargaining power of the workers in the workplace.[17]

The third set of recommendations involve giving voice to employees in the workplace. Collective bargaining and workplace democracy can be remedies for unequal power in the workplace, whether that unequal power derives from inequality of opportunity or from a rigid division of labor. This democratic conception of exchange suggests that a loss of power with respect to exit can be compensated for by means of a gain in power in voice. I will call this the *remedial principle*. The idea is that both the power of exit and the power of voice are powers that enable one to shape the social world one lives in. So, if a person has a very low and unjustly distributed power of exit and that power of exit cannot be improved for some reason, then one can enhance that person's ability to

[17] See Beori and Van Ours (2013, 40-53) for minimum wage laws, and (291-303) for employment protection laws.

shape the social world they live in by giving them some kind of voice in the activities from which they have a diminished power to exit. If the two kinds of power are really of the same sort, then one should be able to remedy a deficit in one by increasing the amount of the other.

It is important to distinguish between global voice and local voice here. A person has a kind of global voice to the extent that they can participate in collective decision making with regard to the whole society they live in. This is the traditional avenue of democratic politics. A citizen in a democratic society has a voice in global decision making regarding the global properties of the society. Local voice is voice in some more particular cooperative activity in which one participates. Being on the governing board or being represented by someone on the board of a corporation gives one local voice over that small part of society that the board controls. Voice in a university department gives one local voice over elements of one's working environment and hiring. It is the enhancement of local voice, and not global voice, that is an appropriate initial remedy for the diminished power of exit in decentralized decision making. Local voice is what enhances a person's power to shape the local social world she lives in, which power is diminished by diminished power of exit.

So, to the extent that the employer-employee relation is one of monopsony and rigidly determined hierarchies in firms, or the distribution of exit power is an unjust one, the situation can be made more just by giving workers rights to participate in the running of the firm. This might be over working conditions, wages, and even investment decisions. By giving workers under these conditions a voice in the firm, their relative lack of power that derives from poor exit opportunities or market rigidity is remedied by an increase in the power of voice in the running of the firm. Another possible form of remedy along similar lines would be that the workers are organized as a union in which each worker has some kind of a say.[18] This remedy combines the exit dimension with the voice dimension in an interesting and complicated way: it allows voice to substitute for exit when the latter is not available on an egalitarian basis.

This argument for workplace democracy, to the extent that there is one, is not a general argument. Workplace democracy is a remedy for a particular set of defects in markets and for a highly unequal distribution

[18] See Freeman and Medoff (1984, Chapter 6), for the classic analysis of how unions improve voice.

of power. But there is continuity here. There are circumstances where employees have a great deal of bargaining power, even individually. They have a great deal of say by virtue of their bargaining power. Here workplace democracy is not a direct implication of the theory of fairness. And there are intermediate cases, conceivably, in which workers have a significant amount of bargaining power, but still a somewhat unjustly small amount of power. Fairness may require some lesser degree of participation in these contexts, though it may require some. Furthermore, there are other remedies available for realizing equal power, such as union organization, enhancement of the welfare state, and regulation of the employment relation. Sometimes these introduce greater equality of power than workplace democracy.

To conclude this discussion, the remedial recommendations that I have made are meant to promote democratic equality, but there may, in some cases, be losses of efficiency that must be traded-off against the gain in equality. I do not mean to claim that the democratic aspect of market exchange always has priority over other concerns. That said, it should be noted that there have been many studies arguing for the superior efficiency of some workplace participation and collective bargaining as well as employment regulations. These institutions can give much needed voice to workers in the context of imperfect competition with serious asymmetries of information.[19] But these complex empirical issues are the subject of another paper.

VIII. CONCLUSION

I have argued that there is an important ideal of fairness in the process of market exchange in opposition to Heath's claim that fairness is not to be sought out in markets (2018, 4). This ideal is a procedural ideal that is analogous to the procedural ideal of political equality in democratic decision-making. I have argued that this ideal can be seen to be in play in the context of perfectly competitive and complete markets. And I have argued that it can be brought to bear on the more familiar incomplete markets. I concluded by showing how the principle of equal capacities can be brought to bear on the justification of institutions.

[19] See Freeman and Medoff (1984) for the argument that unions generally improve the productivity of firms. And see Freeman and Lazear (1995) and Bowles and Gintis (1993) for discussions of the productivity of worker participation.

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Thomas Christiano is Professor of Philosophy and Law at the University of Arizona and a Fellow of the Institute for Advanced Studies in Toulouse. He has been a Laurence Rockefeller Visiting Faculty Fellow at the Princeton University Center for Human Values, a Visiting Fellow at All Souls College, Oxford, a Visiting Fellow at the Research School of the Social Sciences at the Australian National University, and a Fellow of the National Humanities Center. He is the author of *The Constitution of Equality: Democratic Authority and Its Limits* (Oxford: Oxford University Press, 2008) and *The Rule of the Many* (Boulder, CO: Westview Press, 1996). He is Co-Editor in Chief of *Politics Philosophy and Economics*. His research is in, and he has written many papers in, the areas of democratic theory, distributive justice, philosophy of international law and economic justice.

Contact e-mail: <thomasc@email.arizona.edu>