The Just Price Mechanism

How bargaining behind the veil of ignorance could eradicate the wrongness of economic inequality

Introduction

Capitalism and free markets have brought about tremendous amounts of prosperity. Yet they have also caused immense, accumulating inequality, paralleled by accumulating resentment. Many people ask themselves whether free markets are fair, and whether their partaking in the markets is just. Philosophers from different schools of thought (Friedman 1962, Graeber 2012, Keynes 1930, Sandel 2012, Tomasi 2012, Wells 2018) argued that free markets are not just per se. They can only work justly within a certain scope or under special conditions.

The big question is what would make free markets also just markets.

In this essay, I explore whether the three market conditions of monopoly, perfect competition and monopolistic competition are just. Unsurprisingly, I come to a negative conclusion. I go on to propose a radical measure of justice, namely the idealistic Just Price Mechanism that makes the payoffs of any economic transaction equitable. The justification of this mechanism is rooted in the theory of justice of John Rawls (1971) and in particular in the rationality behind the veil of ignorance.

Further, I explore how the proposed mechanism would eliminate the wrongness of market power coercion strategies, and how it would amplify capitalism along the lines of prosperity, virtue and freedom.

The coffee case

I would like to illustrate my argument with a thought experiment. Suppose I like to drink coffee on my way from home. I could arrange a thermos can of coffee, but to spare myself the hassle I am prepared to pay €2,00 to buy my coffee from a coffee tent. Last year there were two tents offering different coffee blends[1] at €1,25 and €1,30, then the multinational brand Beastlé set up a third tent and the price went down to €0,75. Now Beastlé is the only tent and the price is €1,75, which I can still afford.

My neighbour used to run one of the tents that went out of business. He told me that with the cost price of €1,00, they could not compete against Beastcafé drinks offered at €0,75. He read Beastlé's annual report and believes that their cost price is roughly the same. On the one hand, their enormous scale of operations makes production much cheaper by spreading the fixed costs over a vastly greater number of products sold. But on the other, their army of unnecessary secretaries, facility managers, event managers, lawyers, accountants, and then HR managers needed to manage all the aforementioned bullshit jobs (Graeber 2018) balances out that cost advantage. The real difference is that Beastlé can afford MBA graduates who are trained in market power strategies such as predatory pricing and has access to cheap capital on Swiss stock exchange.

I regret my neighbour's bankruptcy since I believe his coffee blend tasted better than Beastcafé.

The problem: markets may be free, but they are not just

Prosperity and justice are invariably among the top priorities of people and societies worldwide. Capitalism has led to an explosive growth in prosperity (Heilbroner 1999). Having relatively free markets for land, labour and capital

[1] The suppliers of the blends enforced exclusivity, so that tent A could not sell tent B's blend and vice versa.

allowed societies to produce a vastly greater amount of goods. However, there is nothing about the free markets that would produce justice (Tomasi 2012).

Radical libertarians would claim that freedom itself is justice (Nozick 2009, 359). However, even liberals recognize that unrestricted free markets lead to the restriction of freedom caused by inherent problems such as monopoly and neighbourhood effects (Friedman 1974, 9; Friedman 1962, 20). Thus we can say that free markets lead to unfree hence unjust consequences in a paradoxical, self-defeating manner. Nonetheless, since Adam Smith made his case that societal good is best brought about by the invisible hand that emerges from free markets, the good is all too often equated with unrestricted freedom of egoistic agents. Whatever is produced by the free market, is judged to be good and just. "Economic ethics has been outsourced to the markets" (Wells 2018, 1).

Empirically we know that free markets produce enormous economic inequality (Roser 2017). This inequality is often justified by the fact that those who are worst off are able to benefit from economic growth and growing inequality in absolute terms, i.e. their income rises, albeit by far not so rapidly as the income of the rich.

Let us explore the market dynamics using the coffee case, and see if we can find them to be just. The three situations to address are monopoly, perfect market competition and monopolistic competition.

First, we look at the situation where Beastlé is the only provider of coffee in a given geographic area. The monopolist is free from price competition and is only constrained by the elasticity of the demand. Beastlé can charge me €2,00 per coffee and earn a 100% margin. Since competition is absent, the monopolist has a low incentive to increase efficiency through innovation, therefore, the moral desert of economic growth is nearly absent[2].

[2] Large monopolies could claim the merit of efficiency that occurs because of the diminishing marginal production costs. This kind of efficiency arises in virtue of their size rather than their deliberate action.

The consumer (i.e. my) surplus is disproportionally lower than the producer surplus. If the price was €2,00 the surplus ratio would be 0 to 100 in favour of the monopoly. The current price of €1,75 results in a ratio of 25:75 in favour of Beastlé, which is still unjustifiably unbalanced. Besides, on the account of preference utilitarianism, I have been denied the preference of buying my favourite coffee blend. All in all, this situation cannot be judged to be just.

Second, let us explore a perfectly competitive market. Had the two coffee tents been in perfect competition with each other, the retail price would have been €1,00. Perfect competition is the dream of many economists since the consumer value is maximized to its limits and the production resources are allocated in the most efficient way. Indeed, the surplus ratio would be 100:0 in my favor. What's not to like?

The race to the bottom strips sellers of all their profit. Consequently, it renders them unable to invest either in innovation or in scaling up and thus impedes the increase of economic efficiency. Perfect competition is not sustainable in the long run: zero profits will cause business owners to exit and reallocate their capital to markets with lower competitive pressures where it can generate (more) profit.

Perfect competition can be seen as an inverse monopoly, since the entire surplus is acquired by a single side of the exchange. A well-known historical example is the systemic capitalist monopoly on the means of production that led to the exploitation of labourers, which was morally wrong (Wood 2004, 259). However, the exploitation can just as well be seen as resulting from a perfect market competition of the suppliers of labour. Thus we cannot judge perfect competition to be just.

Finally, in-between the monopoly and perfect competition there is monopolistic competition[3]. In the coffee case, that is the situation before the bankruptcy of the initial two suppliers. Before Beastlé entered the market, the competition between the two tents was not perfect, since they were charging prices beyond

[3] For simplicity, the other forms of imperfect competition, namely oligopoly and duopoly, are counted as being essentially monopolistic.

their cost price. They were able to do so because of several reasons. For one thing, both of them had earlier lowered their cost prices by investing in more efficient machinery and outsourcing some tasks to specialized parties, while keeping their prior retail prices. More importantly, however, they used a market power strategy: product differentiation relying on demand elasticity. Remember, the two tents sold different coffee blends. If my neighbour lowered his price from €1,25 anywhere down to €1,00, he would still not lure enough clients from his competitor in order to make more profit than he was making at €1,25, because they still preferred his competitor's blend. His competitor had exactly the same problem. Moreover, both of them discovered that they would lose customers – and profits – as a result of demand elasticity if they raised their prices. They had deployed their egoistic tools of profit maximization to the greatest extent possible[4]. Upon entering the market, Beastlé deployed yet another egoistic market power strategy, namely predatory pricing, to drive competitors out of business[5].

On the surface, the surplus ratios of the two tents did not seem exorbitantly unjust. Given my maximum of €2,00, they were 25:75 and 30:70, both in favour of the respective suppliers. One could see a parallel with the Smithian thinking: a struggle of strictly egoistic forces results in quite acceptable, almost fair, conditions alongside producing many riches. However, market power, being a form of power, necessarily involves coercion, i.e. causing agents to pursue some course of action which they would not have pursued otherwise. Therefore, market power is not just, and since monopolistic competition necessarily involves market power, it is not just either.

Going back to the two fundamental goals of prosperity and justice, we can say that free markets are not just, although they do lead to great levels of prosperity. Economic inequality produced by markets, at least insofar as it is the result of coercion, is wrong.

[4] For the sake of the argument, we leave the cartel arrangements out of consideration.
[5] Demand elasticity was such that the €0,75 price tag lured enough customers away from the competition.

A final point to be made here is that of conflation and hypocrisy. Note that in the coffee case, some of the profit of the two tents was caused by increased efficiency and some of it was caused by market power. Generally, we find efficiency increase praiseworthy since it leads to greater prosperity: we can make more goods with fewer resources. The three common ways to increase efficiency are innovation[6], specialization and economy of scale. Market power, on the other hand, is coercion and therefore blameworthy. However, in practice, it is impossible to distinguish between them. We cannot know whether a certain business success resulted from an increase in efficiency or deployment of some coercive market power tool. Often we even do not care: in lieu of the price mechanism (Hayek 1945) shareholders only care about the single characteristic of profitability, regardless of whether the profits were generated by increased efficiency or coercive market powers. Successful businessmen are celebrated by their societies on the Smithian assumption that they have generated many common goods. They present themselves as deserving meritocratic heroes of the public good, yet in practice their success is earned by coercion to an unknowable degree.

The Just Price Mechanism

John Tomasi (2012) argues that even though markets cannot produce justice, this does not mean that markets cannot be just. In order to make markets just, we need a conception of justice that is external to the markets, that is then applied to them. In this work I will involve the renowned conception of justice as fairness by John Rawls (1971), and in particular the concept of the veil of ignorance[7] or the original position.

John Rawls proposed to use the original position in order to define the structuring rules of a whole society. Such rules would necessarily be just. My proposal has a somewhat lesser scope. I propose that all the prices in markets be

[6] Not all innovation is praiseworthy: innovation aimed at refining market power tools is as blameworthy as those tools are.
[7] Friedrich Hayek proposed essentially the same concept of the veil of ignorance some 30 years before Rawls, according to Tomasi (2012).

determined by the Just Price Mechanism (hereinafter the JPM). This would confer justice on free markets.

Behind the veil of ignorance, rational agents have no knowledge of their identity, and thus no knowledge about their economic status and position in any given transaction. All they know is that a certain transaction is about to take place, that the seller has a certain cost price of the good, and that the buyer has a certain maximum bid price, that represents the economic value of the good to the buyer. The seller and the buyer, collectively called the parties, need to agree on the price. The agents behind the veil know that if the transaction takes place, both parties will gain from it because otherwise at least one of them would refuse to transact. The degree to which each party benefits from the transaction is their surplus[8]. Rationality presupposes the desire to maximize one's surplus.

Now since the agents behind the veil do not know on what side of the transaction, indeed, of any possible transaction, they are, the only rational thing for them to agree upon is that the surplus of the two parties is equal. Surplus equality is to be proportional, i.e. the surplus of each party should stand in equal proportion to the initial value brought in the transaction by that party.

Any deviating arrangement of the price would result in unequal payoffs from a transaction, thus hurting one party while benefitting the other. According to Rawls, behind the veil of ignorance there is no rational reason to accept any sub-optimal rule that might hurt the agent[9].

So what if my neighbour and I decide to go behind the veil of ignorance in order to figure out the just price of a cup of coffee? Intuitively, one can say that since the cost price is €1,00 and I am prepared to pay €2,00, the just price is €1,50. Each of us gets a surplus of €0,50. Yet that is not the outcome of the JPM, since our initial investment is not the same. My neighbour would get a 1,5x on his

[8] Respectively, the buyer or consumer surplus and the seller or producer surplus.
[9] A possible objection would involve the Rawlsian Difference Principle, that is, a possible world that would not implement the JPM and yet let those who are worst-off have a higher degree of basic goods and liberties. Due to limitations of space, I cannot address this objection here, but I recognize it to be a substantial one.

investment and I, paying €1,50 to get a €2,00 of value would get 1,33x. That is not equal, so no rational agent in the original position would accept that price. The correct price determined by the JPM is in fact €1,41 since it produces the same surplus for each party.

The generalized JPM formula is:

$$Just\ Price = \sqrt{askprice_{\min} \times bidprice_{\max}}$$

The JPM presupposes that the price is calculated in every single transaction, or at least, between any two given agents during a specific period of time. Since the perceived consumer utility, but also the cost price of goods vary, any fixed price would not be just.

One could object that determining the prices by JPM would make markets unfree. While it is quite true that agents would lack the possibility to enter transactions that benefit their interests disproportionately and hurt the interests of the counterparty, or vice versa, all agents would enjoy perfect freedom to choose what transactions they enter. Thus price competition would not suffer and the Price Mechanism (Hayek 1945) would not be distorted. The freedom that is taken from agents away is the freedom to hurt each other economically[10].

In the original position, rational agents would agree that JPM should apply to all market transactions. This would mean a radical change in how prices get offered, negotiated and accepted. There is, however, an even more profound aspect. The JPM requires the knowledge of the seller's minimum price[11] and the buyer's maximum price, i.e. the utility value of the particular good to them. In real world,

[10] On a side note, JPM does not prohibit any donations, so whenever an agent genuinely wishes to promote the interest of the others they are free to do so with or without connection to a particular transaction.
[11] In most cases this is the cost price, however, circumstances might compel sellers to sell under the cost price.

rational agents that strive to maximize their utility have a strong incentive to withhold that information. Sellers bluff with higher cost prices in order to justify higher prices, while buyers have a stake in devaluing their desired goods in order to get a better bargain. Therefore, unfortunately, the present proposal is bound to remain an idealistic one. However, it is not beyond the realm of future possibility that a system is developed that could have the knowledge of the cost price of all goods, and reliable access to the mental states of agents in order to gauge their subjective estimate of goods' value. At present, various cryptocurrencies already allow embedding of algorithms that get executed with every transaction and can influence its terms. Alternatively, an arrangement where buyers pay their maximum prices for every purchase and receive later refunds is worth investigating. After all, David Graeber[12] (2012) suggested that it is time for humanity to switch to a new form of money that would be morally superior.

The impact of the JPM on market power and economic efficiency

One may ask themselves now whether the JPM would actually solve the problem of injustice caused by coercive market power tools, and, since market power can be indistinguishable from praiseworthy economic efficiency enhancers such as innovation, whether it would affect the latter negatively. Market power tools are used by market players in order to obtain monopolistic control of the market, which is the ability to dictate prices. By removing the very ability to set prices, this incentive is eliminated. The only two ways for a seller to increase their profit is either to decrease their cost price (and share the extra surplus with the buyer) or to deliver more value to the customer.

In the coffee case, Beastlé would simply not be allowed to charge prices below its cost price. If they would like to compete with the Just Price of €0,75 with respect to €2,00 customer value, the cost price would need to be as low as €0,28. On the other hand, my neighbour would have been in a far better financial shape receiving €1,41 instead of €1,25 – a net +64% of profit – before Beastlé's

[12] "…we should start thinking about completely radically different forms of money entirely."

appearance, and therefore much better able to invest in cost reduction himself and to endure a short-term squeeze.

So what about this cost reduction by innovation, specialization and efficiencies of scale? As discussed, JPM allows profit growth only by increasing the (perceived) buyer value or by reducing the cost price, in other words, by increasing economic efficiency: making more with less. That happens to be precisely the prosperity goal of the society at large. Now it is possible that under the current conditions a company might decrease its production cost by implementing an innovation, keep its prices stable and thus earn a higher profit. Under the JPM, half of this extra profit might be a sufficient incentive to implement the innovation in the first place. Since increasing efficiency by innovation is a common societal good, rational agents behind the veil of ignorance should agree that investment in innovation should have a delayed effect on the cost price, i.e. be protected along the lines of our current protection of innovation by patents.

With regard to specialization, I would argue that it would be amplified by the JPM since agents would be much more willing to engage in trade under the conditions of certainty of receiving fair payoffs.

Regarding efficiencies of scale, the primary monopolistic incentive of growth would be rendered irrelevant by the JPM. In fact, efficiency of scale would cease to be the excuse for monopolistic growth. Mergers would make economic sense only in those cases where real substantial savings can be realized by means of growth, and those savings would necessarily be shared with the customers.

JPM in terms of virtue and freedom

So far I have argued that the Just Price is likely to increase prosperity. Let us now focus on what JPM can mean for virtue and freedom, the other two pillars of justification of capitalism.

First, still somewhat related to prosperity, I would argue that JPM would lead to the abandonment of many jobs related to market power tools and strategies.

Since market power revolves around competition with other firms that try to use market power, these jobs fall under the “goons” category of bullshit jobs in the taxonomy of David Graeber (2018, 36). Obliteration of these jobs would mean substantial savings for companies that would necessarily be shared with their customers, leading to more prosperity. However, it would also mean that the job market gets rid of morally degrading “opportunities”.

Related to the previous point, the remaining jobs would become more meaningful. Under “normal” conditions of coercive competitive strategies companies and thus their employees almost necessarily engage in coercion and exploitation, often denying or repressing that fact and indulging in false self-celebration. However, humans usually find genuine meaning in helping others, which is the opposite of coercion and sincerity, the opposite of hypocrisy. Eliminating market power tactics and necessitating equitable surplus distribution is likely to transform jobs into ones that are genuinely helpful to others and thus deeply meaningful.

In terms of freedom, the JPM would introduce an absolute freedom from being coerced into sub-optimal or unfavorable transactions. It would certainly increase the freedom of choice of economic counterparties since there would be no need to track and discriminate against unethical players. Finally, JPM would free people from the constant feeling of resentment caused by the realization that whatever they do, they are taken unfair advantage of, and/or at some level, they engage in unfair exploitation themselves. On the contrary, the realization that you are always paying the fair price is liberating.

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