3 The institutional justice of the market process

Entrepreneurship, increasing returns, and income distribution

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I. Introduction

Critics of economics have long claimed that economists are deaf to the cries of the poor. This, however, is not an accurate portrayal of the situation. In keeping with the spirit of economics as a science that focuses on the means that best serve to achieve certain ends, economists have long debated the best ways to reduce poverty. They have, therefore, always been sensitive to the plight of the poor and have always paid due attention to the closely related problems of poverty and inequality.

The classical political economists working in the methodological tradition of David Hume and Adam Smith emphasized how an institutional framework of private property, freedom of contract, and mutual consent channels competitive behavior away from negative-sum games in the distribution of wealth into positive-sum games that generate an ever-growing pie of wealth to distribute. This expansion of wealth is based upon the discovery of pure profit by entrepreneurs alert to opportunities to trade and to innovate.[1] The entrepreneurial market process in turn creates generalized increasing returns and reinforces the scope for peaceful social cooperation under the division of labor (Boettke and Candela 2017). In short, classical political economy, by demonstrating the effectiveness of a "system of natural liberty" (Smith 1776 [1981]) to generate peace and prosperity, illustrates the complementarity of individual liberty, economic prosperity, and peace.

This does not imply, however, that classical political economists, as well as early neoclassical economists, such as Carl Menger, did not emphasize the *justice* of the market process. "The economic policy of classical political economy," Menger writes,

> was precisely dedicated to the most immediate and urgent needs of the time in which it came into being, a time full of unjust class privileges and detrimental restrictions on the poor and weak, full of irrational and self-interested over-regulation. Smith and his disciples recognized the needs of *Social-Politik* in their time very precisely when they first pressed for the

> abolition of the harmful restrictions on workers and when they opposed the state interventions in the economy detrimental to the poor.
>
> (emphasis original, Menger 1891 [2016]: 482)

The justice of the market process, according to classical political economists, is based on institutions that foist neither legal discrimination nor dominion upon individuals but instead afford each individual equal opportunity before the law to realize their full potential in cooperation with others.

It is important to note here, however, that economists from Smith to Menger were not advocating a public policy conclusion per se; rather, their public policy conclusions were a by-product of a particular understanding of economic science. The pursuit of profit opportunities in the marketplace generates patterns of income distribution that disproportionately accrue to successful entrepreneurs. These same market processes, however, also generate a *tendency*, not only to attract entry by competing entrepreneurs but also to erode monopoly power and drive profits down to zero. "Uncertainty and entrepreneurship," Machovec states, "were central to the classicals' understanding of the market process – a centrality that is irreconcilable with the equilibrium vision that succeeded it" (1995: 158).[2]

We argue in this chapter that the transformation in the vision of economics from one in terms of processes to one in terms of equilibrium yielded public policy implications regarding the role of government and distributive justice. Although classical political economists had made a case regarding the *institutional justice* of the market process, this argument became overshadowed in the late 19th and early 20th centuries by early neoclassical economists who defended the market in terms of the equilibrium pricing of factor payments. Justice according to the early neoclassical economists was defined in terms of market outcomes that approximate the marginal valuation of the productive contribution of each factor of production. The persistence of this equilibrium paradigm today, among both proponents and critics of the market, has led to the notion that there is an inherent trade-off between income equality and economic prosperity. By squeezing from our analysis of the market not only the notion of uncertainty and entrepreneurship, but more importantly our understanding regarding the institutional context in which capital is accumulated and maintained *through time*, we also exclude from our analysis the inherent tendency by which payments to factors of production are equalized across markets by entrepreneurial arbitrage opportunities. In other words, without including institutions and entrepreneurship into our analysis, we fail to understand how it might be possible for the market process to generate a tendency toward greater income equality and greater economic prosperity simultaneously.

Absent an understanding of the institutional framework generating this dynamic pattern of equalization, the appearance of income inequality at a given point in time will justify government intervention as a *deus ex machina* for distributive justice. However, such intervention itself will only redirect the market process toward the pursuit of profit opportunities in the form of regulatory capture (Stigler 1971) and in the seeking of monopoly privileges among special interest groups (Tullock 1967), perpetuating income inequality against the desires of those who wish to use government intervention to eliminate income inequality. Ultimately, our policy conclusions regarding distributive justice cannot be divested from our understanding of what is regarded as economic science. This chapter proceeds as follows. In Section II, we outline the justice of the market process as discussed primarily by Buchanan and Kirzner. In Section III, we juxtapose more recent critiques regarding the distributive justice of the market by Piketty with those made by Tullock, Stiglitz and Zingales. Section IV concludes.

II. The demand for justice in the market process

II.I The emergence of the allocation paradigm

Despite the fact that socialism failed to achieve its stated goals of income equality and advanced industrial production over the course of the 20th century, critics of the market continue to see these goals as substitutes, and not complements, to the market process. "It is because capitalism is seen by millions as being built on injustice as one of its essential and defining characteristics," Israel Kirzner writes, "that the system is despised and even hated in much of the world" (1989 [2016]: 5). The fact that the outcomes of income distribution through the market mechanism have been considered unjust has also generated wide support for income redistribution, namely, through progressive income taxation and transfer payments. Like many public policy conclusions, the justification for income redistribution among economists is based upon the way in which economists conceptualize the market as a mechanism of income distribution.

In *The World in a Model*, Mary Morgan shows how economists build models "to depict some particular phenomenon or to figure out some puzzle or problem about a set of relations in the economic world" (2012: 387). She focuses on modeling as a method of inquiry that economists think about and use to contextualize historical phenomena. Morgan focuses on two meanings of the term modeling. The first relates to the formalization of an economic argument, including forming, shaping, and outlining an argument. Through formalization, the second meaning of modeling relates to making historical data subject to rules of conduct or manipulation (2012: 20).

Such model formation can be understood as a process of idealization, or the formation of "ideal types"[3] in the Weberian sense; it is "a process of picking out the relations of interest, and isolating them from the frictions and disturbances which interfere with their workings in the real world to give form to simpler, and 'ideal', world models" (Morgan 2012: 21). Like maps, models rely on omission as they cannot represent every detail but are to be understood as articulate artifacts – compressed accounts of things in the world expressed in an appropriately specialized form and language. As such, economic narratives "*are built into the identity of the model from the start*" (emphasis original, Morgan 2012: 362). Morgan's point is important for our analysis because alternative models of income distribution generated by the market will highlight not only different historical narratives about income distribution but also alternative policy conclusions regarding the state's role in generating a more equal distribution of income.

The narrative that markets generate an unjust distribution of income follows from the emergence of an *allocation paradigm* in economic modeling beginning in the late 19th century. "The main assumption of the allocation paradigm," Coyne writes, "is that the outcome of exchange is an equilibrium where all gains from exchange are exhausted" (2010: 16). Viewed in terms of this paradigm, the market is always in a state of static equilibrium, where each individual has perfect information regarding the endowments of all the other market participants, and therefore of the underlying distribution of income, which is predetermined by given institutional, technological, and resource constraints. "But this way of perceiving the society's economic problem as an allocation problem implies, in turn, that the problem of distribution is *a problem of sharing out a given pie*" (emphasis original, Kirzner 1988b: 177), which, by logical construction, is also known to a "distributor" who wishes to redistribute income.

Though classical political economists were able to demonstrate the complementarity of peace, prosperity, and individual liberty with a market economy, as James Buchanan has highlighted, their demonstration implied nothing directly about the *distributive justice* of the market (1991: 245). Unfortunately, however, the analytical response that their neoclassical successors delivered failed to directly confront claims of market injustice, specifically because it delivered an argument of market justice in terms of equilibrium.

The allocation paradigm that emerged amongst the early neoclassical economists, including John Bates Clark (1899) and Phillip Wicksteed (1894),[4] was based upon an application of Euler's theorem to the distribution of income, which states that under the assumption of constant returns to scale, the separate marginal value products of each factor of production exhaust the total value of output. The exhaustion of payments from total output to factors of production had both positive and normative implications. Positively speaking, Euler's theorem illustrated mathematically that the share of total output accrued to owners of capital is derived from its marginal contribution to output. Normatively speaking, this implies that the redistribution of income is unjustified, because the income paid to capitalists is not a result of exploitation or theft of labor income.

However, the marginal revolution in economics introduced, as Thomas Kuhn would put it, a change in basic economic paradigms – one that causes "scientists to see the world of their research-engagement differently." Such a change, in fact, is so far-reaching that "in so far as their only recourse to that world is through what they see and do, we may want to say that after a revolution scientists are responding to a different world" (Kuhn 1962 [1996]: 111).

This point is especially relevant when it comes to the response of the early neoclassical economists to Marxist accusations of exploitation and injustice in the marketplace, for this response failed to address these points in terms of how Marxists had understood the market, namely, in terms of the market as a rivalrous process – a paradigm that they shared with the classical political economists.[5]

Marxists regarded exploitation as a positive aspect of the capitalism system. By abolishing private property, and subsuming production for direct use under a single, rational plan, Marxists argued that market rivalry between capitalists would be abolished, and with it the exploitive extraction of surplus value. Moreover, Marxists condemned market rivalry for its monopolistic tendencies. This monopolistic tendency, according to Marx, ultimately results in capitalist production becoming centralized under larger enterprises that would subsume production under the conscious guidance of fewer and fewer producers. The end result of the rivalrous process can be conceived of a bilateral monopoly, in which one immense firm is a single seller of goods and the single "buyer" of labor.

The allocation paradigm that emerged after the marginal revolution, however, failed to confront these criticisms head on. Instead, it dismissed the critiques of the market made by Marxists only by assuming such critiques away. As the allocation paradigm became increasingly dominant among early neoclassical economists, particularly after its explication by Francis Edgeworth (1881) and later Frank Knight (1921), its preoccupation with static equilibrium meant that it could not offer a coherent defense of the Marxist claim that markets give capitalists increasing monopoly power. Rather than employ equilibrium analysis as a method of contrast to illustrate the functional significance of institutions, specifically by engendering alternative patterns of income distribution under conditions of uncertainty, competitive equilibrium instead became a normative benchmark among early neoclassicals by which to assess the competitive outcome of income distribution (Boettke 1997).

Ironically, the neglect of market rivalry and entrepreneurship as a part of economic science by its early neoclassical defenders would yield the same normative implications regarding the justice of the market process as those held by their early Marxist critics. Because neoclassical economists take the model of perfect competition as their point of theoretical departure, defining entrepreneurial profits out of existence, the presence of firms selling goods above opportunity costs not only implies monopoly power, but even worse, the presence of "unearned" rents to capitalists.

Let us be clear, however, that our intent has not been to provide a wholesale critique and dismissal of the marginal revolution, or of the neoclassical theory of marginal productivity that followed. Rather, we simply wish to point out that by justifying the distribution of income in terms of market *outcomes*, early neoclassicals were able to provide a mathematically valid explanation for the justice of income distribution through the market mechanism. However, by constructing a case for the distributive justice of the market in terms of the productive contributions of land, labor, and capital to output *after the production* *process has been concluded*, it would be more precise to say that the early neoclassicals demonstrated that the incomes paid through the market mechanism were *not unjust*. By defining their argument in terms of equilibrium, they could not provide an argument for the justice of *residual payments*, or the profits earned by the entrepreneur under conditions of uncertainty.

In a most recent article, Israel Kirzner has made this point quite clearly by critically analyzing what he refers to as "Friedman's universal ethic" (2019: 90), justifying income distribution under capitalism. As Kirzner argues, "Friedman, like most mainstream micro-economic theorists, see the economics of the market, basically, from the ex post perspective" (2019: 97), after a productive process has been concluded, and in which all payments to factors of production have exhausted the value of total output. In *Capitalism and Freedom* (1962 [2002]: 161–162), Friedman states that the "ethical principle that would directly justify the distribution of income in a free market society is, 'To each according to what he and the instruments he owns produces'." Friedman does not neglect that there is a role for the state to enforce private property rights under the rule of law, which we also discuss further in Section III.

However, for Friedman, like his early neoclassical predecessors, distributive justice was assessed strictly in terms of productive contribution, and therefore irrelevant to explaining why entrepreneurial profits emerge, and why they might be just or unjust *before a production process has been concluded*. The main reason, Kirzner explains, is that distributive justice in terms of productive *outcomes* "has no relevance for any kind of 'production' into which nothing is deliberately contributed. Discovery is exactly this kind of 'production': it does not, by definition, result from any consciously planned deployment of resource services" (2019: 95–96). Before factors of production can earn their relative contributions to the value of total output, these productive factors must be discovered in the first place, after which they are allocated to their most valued uses in production. This production process does not occur automatically; it must be catalyzed by entrepreneurs, who earn profits for creating value for consumers by allocating resources to their most valued uses and bear losses for misallocating resources to less valued consumer uses.

The implication here is that payments to land, labor, and capital are not earned by virtue of their ownership. As Ludwig von Mises has argued:

> *Ownership of the means of production is not a privilege, but a social liability.* Capitalists and landowners are compelled to employ their property for the best possible satisfaction of the consumers. If they are slow and inept in the performance of their duties, they are penalized by losses. If they do not learn the lesson and do not reform their conduct of affairs, they lose their wealth. No investment is safe forever. He who does not use his property in serving the consumers in the most efficient way is doomed to failure. There is no room left for people who would like to enjoy their fortunes in idleness and thoughtlessness. The proprietor must aim to invest his funds in such a way that principal and yield are at least not impaired.
>
> (emphasis added, 1949 [2007]: 311–312)

Rather, such payments are a *by-product* of entrepreneurs discovering their productive contributions to output in the first place, and deploying them to productive uses in such a way that creates additional economic wealth. Increases in the productive contributions of land, labor, and capital owe their value to their discovery by entrepreneurs.

However, neoclassical theory has remained relatively silent on the *ex ante* process by which entrepreneurs discover the productive contributions of resources to output, and how such competitive behavior unintendedly generates a pattern of income distribution, which is not fixed and given. However, by defending the justice of the market in terms of static *equilibrium* under constant returns, early neoclassical economists remained silent in their defense of distributive justice in terms of *rivalry* under *increasing returns*, where economic profits are omnipresent. As Buchanan and Yoon argue, "Euler's theorem simply did 'too much work' in the whole explanatory enterprise to be jettisoned" (1999: 516), leading to the neglect of how markets work to generate such an outcome in the first place. By deemphasizing the role of entrepreneurship and how alternative institutional arrangements incentivize different forms of entrepreneurship, mainstream economic theory has had little explanatory power regarding whether one pattern of income distribution is just or unjust. The neglect of an institutional analysis of the entrepreneurial market process left a gap in the analysis of distributive justice, which would be later filled by a discovery paradigm that emerged in the post–World War II era.

II.II. The resurgence of the discovery paradigm

Our discussion thus far has highlighted and emphasized the fact that the emergence of an allocation paradigm in economic science during the late 19th and early 20th centuries has had public policy implications regarding income redistribution, which remain among economists to this day. During this same period, however, the

> truth is that there was, among most economists (Austrian, Marshallian, or Walrasian) in the early twentieth century, a superficial, shared understanding of markets that submerged important distinctions that would become apparent only much later. In this shared understanding, there coexisted elements of appreciation for dynamic market processes and elements of appreciation for the degree of balance – the degree of equilibrium held to be achieved by markets.
>
> (Kirzner 1988a: 2)

This shared understanding would bifurcate during the middle and latter half of the 20th century not only into the dominant allocation paradigm that we have discussed thus far but also into a discovery paradigm that came to be refined and articulated by economists of the Austrian School, such as Ludwig von Mises, F.A. Hayek, and Israel Kirzner, economists of a "neglected branch" of the Chicago School (Boettke and Candela 2014), including Armen Alchian, James Buchanan, Ronald Coase, and Harold Demsetz, and more recently, Edmund Phelps (2013) and Deidre McCloskey (2006, 2010, 2016).

These economists, working in the tradition of Adam Smith, have concentrated primarily on exchange behavior in an open-ended world of uncertainty and "the various institutional arrangements that arise from this form of activity" (Buchanan 1964: 214). Like the classical political economists, they understood that in an institutional context of private property, freedom of contract, and the rule of law, the entrepreneurial actions of individuals are coordinated and guided by relative price changes. Analytical attention is not restricted to the world of static equilibrium but to the dynamic evolution toward equilibrium, wherein entrepreneurs discover the marginal contribution of each factor of production and are rewarded with residual profits for doing so.

The main assumption of the discovery paradigm is that knowledge regarding the marginal value products of the factors of production is not assumed to be given. Rather, it must be *learned* through a process of entrepreneurial discovery. "The problem of economic organization," Alchian and Demsetz argued, "the economical means of metering productivity and rewards, *is not confronted directly in the classical analysis of production and distribution.*[6] Instead, that analysis tends to assume sufficiently economic or zero cost means, as if productivity automatically created its reward" (emphasis added, 1972: 778). In a world of uncertainty, however, not only the total output but also the separate marginal products of land, labor, and capital cannot be perfectly identified. Moreover, the marginal value products of land, labor, and capital do not exhaust the sum of total output. Rather, there exist *generalized increasing returns* to total output that result as a by-product of entrepreneurial discovery.

Generalized increasing returns do not refer simply to the increasing returns to scale that sometimes characterize production within firms. Rather, generalized increasing returns refer to the returns that result from broadening the *scope of production and exchange*, i.e., by broadening the extent to which individuals can engage in specialization in the market. For example, as Randall Holcombe notes:

> Henry Ford could not have succeeded in mass-producing automobiles until there was a substantial market, including infrastructure such as roads, gasoline stations, and repair facilities. Bill Gates could not have made his fortune had not Steve Jobs seen the opportunity to build and sell personal computers, and Steve Jobs could not have built a personal computer had not Gordon Moore invented the microprocessor.
>
> (Holcombe 1998: 50–51)

According to our account, generalized increasing returns occur concurrently and continuously with specialization among owners of land, labor, and capital (Buchanan and Yoon 1999: 514). The extent of productive specialization and social cooperation under the division of the labor is institutionally contingent. What determines the extent of the market is the security of private property and freedom of contract under the rule of law. Without the rule of law, however, there will exist generalized increasing returns to entrepreneurial activity in the form of rent-seeking, cronyism, and regulatory capture. The opportunity to transfer existing wealth through political discretion attracts unproductive entrepreneurship, resulting in the destruction of economic wealth that would have otherwise been distributed via the price mechanism.

How does our account of generalized increasing returns relate to an account of the *institutional justice* of income distribution in the market process? According to Israel Kirzner, a market society under private property and the rule of law is characterized most distinctively "*by freedom of entrepreneurial entry*" (emphasis original, 1985: 29). The institutional justice of the market process, and the pattern of income distribution that it engenders, is based upon the fact that it allows and protects the possibility for the discovery of wealth *where it did not previously exist in the minds of other individuals.*

The institutional justice of the market process that arises from such generalized increasing returns is based on the fact that entrepreneurial discoveries feed on each other, giving each individual the possibility and opportunity to *discover* what is due to them in terms of overall well-being. The complementarity of peace, prosperity, and individual liberty in a market economy does not simply manifest itself in a greater availability of consumption, but as a greater range of options available to individuals in the way they are able to participate as producers under the division of labor. Contrary to the objections that specialization under capitalism is unjust and fosters routine and monotonous work that is alienating and exploitative to the worker, Edmund Phelps argues that

> an increasing general level of wages is *liberating* (emphasis added): it enables persons confined to the lower reaches of the available wages – unskilled workers, in the usual terminology – to move from work they previously could not afford to reject to work that is more desirable. A person working in the "domestic economy" as a homemaker or as paid help in other people's homes could afford to move to a job that is not so isolating; someone working in the underground sector could afford to take a job in the legitimate economy with its greater respectability and lesser dependency; someone could afford to leave a job in the business economy for one with initiatives, responsibilities, and interactions that make it more rewarding. Thus higher wages also result in what may be called *economic inclusion*.
>
> (emphasis original, 2013: 47)

Rather than being limited in their choice of work by class, social status, or legal discrimination, greater freedom of entry and exit, due to greater social mobility, is *liberating* to workers and allows them to work with greater dignity. The most important consequence of generalized increasing returns is not just increases in productivity that afford individual's higher income. Rather, "it has been the opportunities it has offered to men and women to extend and develop and improve their capacities" (Friedman 1962 [2002]: 169).

Generalized increasing returns harness the creative powers of individuals who would otherwise be excluded from specialization under the division of labor due to legal impediments that are unjust, such as regulatory restrictions, licensing, or other monopoly privileges that bar entry. As private property becomes more secure under the rule of law, individuals become freer to enter and exit contractual relationships with other prospective employers. Individuals become free to pursue an entrepreneurial project of their own by forming a new firm, introducing new products, or initiating a new technique of production.

III. Income inequality and institutions: rent-seeking versus profit-seeking

Economists in the post–World War II era have done extensive research on the consequences of long-term economic growth for the distribution of income (Solow 1956; Kaldor 1957; Stiglitz 1969; Katz and Murphy 1992). Since the financial crisis of 2008 and the ensuing recession, however, the subject of income inequality has generated a great deal of interest, among both economists in favor of income redistribution, such as Thomas Piketty and Joseph Stiglitz, and economists skeptical of income redistribution, such as Gordon Tullock and Luigi Zingales. Much of the current debate has turned on the nature of capital and how returns on both physical and human capital are earned.

In his widely acclaimed book *Capital in the Twenty-First Century* (2014), Thomas Piketty argues that capitalism contains within it tendencies that lead to growing inequalities over time. The main argument Piketty puts forth is that the rate of return on capital tends to be higher than an economy's growth rate. As a result, wealth accumulated in the past grows faster than output and wages. He offers the reader a simple model to illustrate why the accumulation of capital causes ever-increasing inequality.[7]

Though indeed Piketty's model is disciplined by *syntactic clarity*, yielding a logically valid argument, it comes at the expense of *semantic clarity*, based upon logically unsound assumptions (Boettke 2012: 314). Revisiting the discussion by Morgan mentioned earlier, the logical unsoundness of Piketty's argument is based on his underlying assumption about capital. As Morgan states:

> Any scientist's ability to reason in a chosen style is thus clearly dependent on the contingent history of that discipline, and whether that method is accepted within it. . . . Once accepted by a group of scientists, a style of reasoning comes to seem natural to them, so natural that they do not question it.
>
> (Morgan 2012: 17)

This observation made by Morgan has great relevance for Piketty's adoption of an aggregative concept of capital, which can be traced back to Knight's

"Crusonia Plant" model of capital as an ever-growing homogenous mass (1944). The Knightian capital theory differs markedly from the Austrian capital theory, where capital is viewed as something that is heterogeneous and multi-specific (Lachmann 1956 [1978]). In fact, as several prominent capital theorists working in the Austrian tradition have noted, if capital was homogenous in use and capable of perpetual and automatic growth, there would be no economic problem of capital maintenance or of allocating capital to its most valued uses (Hayek 1936). Moreover, monetary calculation would also become unnecessary because, for example, there would be no need to rationally calculate the least costly way to build a railroad, as there would be no difference between platinum and iron (Mises 1920 [1975]).

Returning to Piketty's argument, those economists following the Austrian tradition of Mises and Hayek would counter Piketty by stating what Holcombe captures best in his review of *Capital in the Twenty-First Century*:

> β measures the aggregate monetary value of wealth (including land), whereas in fact capital is a heterogeneous collection of producer goods that, combined with labor, produce output. Capital and monetary wealth are two different things. This obscures the fact that owners of capital must first make decisions about what type of capital to invest in, and then decide how that capital can be best employed to earn a positive return.
>
> (Holcombe 2014: 552)

What Holcombe is suggesting here is a fundamental distinction that Mises draws in *Human Action* between "capital goods" and "capital" (1949 [2007]: 259). Individuals may choose to increase the amount of capital goods by engaging in more roundabout production. However, the processes of capital investment, allocation, and maintenance are not independent and cannot be separated from one another. Precisely because the structure of capital is heterogeneous in use, multi-specific, and complementary, though not perfectly so, to alternative capital combinations for the demands of entrepreneurs (Lachmann 1956: 12), the monetary value of capital has economic relevance only within a context of private property rights.

Without monetary exchange in the means of the production, it will be impossible to calculate the relative returns of investing in particular capital goods across competing consumer demands (Mises 1949 [2007]: 262). Yet Piketty argues that the higher rate of return on capital is not attributed to the derived demand of heterogeneous capital goods. Piketty makes it appear that a return on capital is a passive activity devoid of any active entrepreneurial discovery or monetary calculation of heterogeneous capital goods for that matter.

For Piketty, the capitalist earns a return on capital simply by virtue of his ownership, rather than the fact that capital has value only because it derives a stream of income from its being employed productively toward its highest-valued uses. Therefore, the recurring theme in Piketty's book is that inequality of income and wealth is generated by inherited wealth, which requires "public institutions and policies that would counter the effects of this implacable logic: for instance, a progressive global tax on capital" (2014: 35).

The question here is not whether less inequality is a desirable goal. As George Stigler has written elsewhere, economists since Adam Smith "have always been opposed to inequality of income" (1949: 1) as a policy objective. The question, rather, is whether the most effective means to reduce income inequality is by taxing the rich and redistributing income to the poor or by eliminating legal barriers that impede the discovery of profit opportunities and generate productivity gains among the least advantaged in society, the latter being proposed by Adam Smith. Building on this point, Friedman states that there "is a clear justification for social action of a very different kind than taxation to affect the distribution of income," namely, by adjusting

> the rules of the game so as to eliminate these sources of inequality. For example, special monopoly privileges granted by government, tariffs, and other legal enactments benefiting particular groups, are a source of inequality. The removal of these, the liberal will welcome.
>
> (Friedman 1962 [2002]: 176)

There is also a more important distinction to be made between the justification and the motivation behind income redistribution. Though liberals may agree with egalitarians that the reduction of income inequality is a justifiable goal, this does not necessarily mean that existing income transfer programs are actually motivated by this goal. The "poor do indeed receive substantial amounts of money in the United States," Tullock argues, "but nowhere near the total amount transferred. The bulk of the transfer goes to the politically influential and well organized" (Tullock 1997: 3).

According to the U.S. Census Bureau, total outlays by the U.S. federal government were just over $3.8 trillion, of which roughly $2.4 were allocated toward transfer payments between individuals (U.S. Census Bureau 2012: 313). Therefore, roughly two-thirds of the U.S. federal spending has gone to income redistribution. Of the $2.4 trillion spent toward transfer payments, however, roughly $623 billion went to "income security," or transfer payments to the poor, needy, and disabled, roughly 26% of the total amount of all transfer payments (U.S. Census Bureau 2012: 312).

Though an appalling figure from the standpoint of an individual who desires policies that benefit the least well-off in society, this is a logical outcome of democratic politics, which incentivizes public policy officials to concentrate benefits on well-organized and well-informed special interest groups and disperse the cost of such income redistribution on the masses of the ill-informed citizenry. Tullock's discussion on rent-seeking and wealth transfers relates directly to our account of generalized increasing returns. Both highlight how the institutional framework directs entrepreneurial activity. An institutional environment that grants ever greater political discretion over the distribution of income will generate generalized increasing returns to cronyism, rent-seeking, and the accumulation of wealth via income transfers, at the expense of the least advantaged in society.

Similar to Tullock's analysis, both Joseph Stiglitz and Luigi Zingales, although on opposite sides of the political spectrum, have been fervent critics of the crony capitalist environment in the United States and its contribution to increasing income inequality. Tullock is not alone in attributing increasing income inequality to rent-seeking. Stiglitz most recently has written that rent-seeking has not only undermined income equality but also a just distribution of income. As he states, "rent seeking is pervasive in the American economy, and that it actually impairs overall economic efficiency. The large gaps between private rewards and social returns that characterize a rent-seeking economy mean that incentives that individuals face often misdirect their actions" (Stiglitz 2012: 133–134), such as

> selling to government products at above market prices (noncompetitive procurement). The drug companies and military contractors excel in this form of rent seeking. Open government subsidies (as in agriculture) or hidden subsidies (trade restrictions that reduce competition or subsidies hidden in the tax system) are other ways of getting rents from the public.
>
> (Stiglitz 2012: 50)

Income redistribution has been most unjust precisely because it creates incentives whereby individuals earn monopoly rents through the use of government force, diminishing the extent to which individuals can create new wealth by taking advantage of new productive opportunities that would have been afforded to them via the generalized increasing returns to peaceful cooperation and productive entrepreneurship under the division of labor.

In a recent book, *A Capitalism for the People* (2012), Luigi Zingales argues that the rules of the economic game have shifted such that the United States is much less of the land of opportunity than it was when he moved here from Italy. Instead, as the United States has more and more sought to mimic the European social democracies, a regulatory environment that has produced a *different* sort of capitalist system, one in which regulatory capture becomes increasingly pervasive in a regulatory environment that grows increasingly complex. As Zingales argues:

> [F]or markets to work their magic, the playing field must be kept level and open to new entrants. When these conditions fail, free markets degenerate into inefficient monopolies – and when these monopolies extend their power to the political arena, we enter the realm of crony capitalism.
>
> (2012: 47)

Rent-seeking, cronyism, and the distributive injustice that emerges from the capitalist system that Zingales discusses are a by-product of the expansion of regulation that concentrates benefits on the politically connected, the costs of which are dispersed on the masses of rationally ignorant voters (Holcombe 2013). The point here is not to argue that all income inequality is driven by the unintended consequences of the redistribution of the income by government, namely, to special interest groups. Rather, it is to suggest that such public policy measures, despite the best intentions of policymakers, redirect entrepreneurial incentives toward the unjust accrual of monopoly rents, thereby perpetuating income inequality, precisely because such efforts will be corrupted by the influence of interest-group politics, however well-intended income redistribution may be.

IV. Conclusion

As Adam Smith once wrote, the "difference of natural talents in different men, is, in reality, much less than we are aware of" and the "difference between the most dissimilar characters, between a philosopher and a common street porter, for example, seems to arise not so much from nature, as from habit, custom, and education" (Smith 1776 [1981]: 28–29). Though the source of exchange and specialization is the differences in skills and physical endowments between individuals, these differences are much more a by-product, rather than a cause of specialization itself, from which the distribution of income emerges.

Questions of distributive justice in the marketplace are about what distribution of income is due to each individual. However, if the source of growing income inequality is not due mainly to any natural inequalities in skills, talents, or physical talents, and if our goal is to promote the conditions by which individuals do not earn income in a zero-sum or negative sum-manner, the question to ask then is the following: what set of institutional arrangements generates a pattern of income distribution that is consistent with affording individuals the greatest scope of possibilities for specialization under the division of labor?

As our predecessors in classical political economy had taught us, questions of distributive justice are institutional in nature, and therefore require an institutional solution. The institutional framework of a market economy not only generates peace, prosperity, individual liberty and distributive justice by unleashing the possibility for generalized increasing returns to exchange and production. Questions regarding distributive justice that are answered in terms of equilibrium analysis assume away ex ante the process by which income is generated and distributed, and whether or not the equilibrium outcome in the distribution of income from comparative institutional arrangements is just or unjust.

In an open-ended world of uncertainty, where marginal products of factors of production must be discovered, an institutional environment that erects legal barriers, stifles productive entrepreneurship, and provides monopoly privileges will generate generalized increasing returns to unproductive entrepreneurship. This perverse redirection of generalized increasing returns to capturing political discretion generates a pattern of income redistribution that is unjustified, not only because income is redistributed by rent-seeking at the expense of the least advantaged in society, but also because it crowds out the possibility for the least advantaged individuals in society to climb the economic and social ladder, thereby perpetuating income inequality.

Notes

1 It is important to mention here that although we used the term "classical political economists" broadly, we acknowledge exceptions to the broad characterization we make. Nevertheless, as Machovec writes, unlike "Ricardo, the vast majority of the classical economists, including those of the UK, reasoned about the market by addressing one or more aspects of the competitive process" (Machovec 1995: 98). Moreover, "Ricardo reasoned purely in equilibrium terms. . . . Ricardo therefore is the odd man out. His narrow treatment of the market was uncharacteristic of his era, more neoclassical than classical, but consistent with his desire to focus exclusively on comparative statics" (Machovec 1995: 96–97). See also Holcombe (1998).

2 As Stigler notes, in "their explanations of the workings of a competitive economy the most striking deficiency of the classical economists was their failure to work out the theory of the effects of competition on the distribution of income" (1957: 5). Thus, the classical economists were not able to provide a logically satisfactory theory of income distribution to complement their theory of competition and the market process and thus failed to deliver a convincing argument regarding the distributive justice to critics of the market process (Buchanan 1991: 244).

3 According to Caldwell (2004: 90), "The ideal type selects out from an infinite reality the characteristic features that are of interest to the *investigator*. An ideal type is not a description of objective facts but, rather, what Weber calls. . . 'a purely ideal *limiting* concept with which the real situation or action is *compared*.'"

4 To say that both Clark and Wicksteed were exclusively equilibrium theorists who had no understanding or appreciation of the market as a dynamic process of adjustment would be misleading. For example, Wicksteed's *The Common Sense of Political Economy* (1910 [1933]) is much closer to classical political economy in emphasizing the process by which market prices guide individuals and coordinating the plans of buyers and sellers toward equilibrium (see also Kirzner 1999 [2015]). Our point here is that in their defense of the justice of income distribution, Clark and Wicksteed had defended the distributive justice of the market in terms of equilibrium, which had defined away a defense of entrepreneurial profits.

5 As Don Lavoie states in *Rivalry and Central Planning*, "it is a great merit of Marxian – and Austrian – analysis that capitalism is understood to be always in disequilibrium" (1985: 35). Schumpeter as well writes that "what [Marx] aimed at analyzing was not a state of equilibrium which according to him capitalist society can never attain, but on the contrary a process of incessant change in the economic structure" (1942 [1947]: 28). This is evidenced by Marx, in which he writes the following: "They [purchase and sale] will of course always attempt to equalize one another, but in the place of the earlier immediate equality there now stands the constant movement of equalization which evidently presupposes constant nonequivalence" (1939 [1973]: 147–148). See also Lavoie (1983) on Marx's disequilibrium theory of money.

6 To put this into context, we interpret Alchian and Demsetz's use of the term "classical analysis" to refer not to the way in which classical economists, such as Smith, Hume, or even Mill, analyzed production and distribution. Rather, they are addressing how the neoclassical approach typically treated its analysis of production and distribution, which is, as they mention in the quote, in a framework of zero transaction costs.

7 Though a comprehensive discussion of Piketty's argument is beyond the scope of this chapter, let us briefly explain Piketty's argument. Although Piketty keeps the mathematical

sophistication of his argument to a minimum, the historical phenomena that he describes about the convergence and divergence of income distribution are nonetheless modeled by isolating a few key variables of interest into mathematical relationships. Piketty identifies three mathematical relationships that form his economic model: (i) the first fundamental law of capitalism (FFC); (ii) the second fundamental law of capitalism (SFC); and (iii) the central contradiction of capitalism (CCC).

The FFC, which represents an accounting identity, postulates that the share of income going to capital, α, is equal to the return on capital, r, multiplied by the capital/income ratio, β, i.e., $\alpha = r \times \beta$ (Piketty 2014: 52). The SFC postulates that the capital/income ratio (β) will tend to equal the ratio of saving (s) to economic growth (g), i.e., $\beta = s/g$. Unlike the FFC, the SFC represents a long-run tendency (Piketty 2014: 166). From these two equations, Piketty derives the CCC, which postulates that in the long run, particularly as capital markets grow more perfectly competitive, the rate of return on capital exceeds the growth rate of the economy, or $r > g$. What logically follows from the CCC is that inherited wealth grows faster than output and wages (Piketty 2014: 571).

Piketty's main policy conclusions, such as the implementation of a global progressive tax on capital coupled with a highly progressive income tax to remedy income inequality, are derived from the CCC. Yet, such normative conclusions are based on the modeling of certain key economic variables, the interaction of which deductively yields the CCC.

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