LIBERALISM, ECONOMIC FREEDOM, AND THE LIMITS OF MARKETS*

By Debra Satz

I. Introduction

Liberalism is often understood as an antipaternalistic and antiauthoritarian fighting creed whose hero is the autonomous decision-maker. Liberals have typically argued that people are entitled to make their own choices, even if those choices are in error. Nevertheless, liberalism has had a complex relationship with the question of market freedom. On the one hand, some liberals see the market as a key forum for carrying out people's uncoerced choices; market relationships are the antithesis of relationships based on authority and compulsion. On the other hand, some liberals defend collective intervention in market choices, particularly in cases in which these choices would lead to serious harms to others, or are based on false information or extremely asymmetric bargaining power.

The term "liberalism" thus encompasses a range of divergent views about market freedom that nevertheless share a core commitment to the value of individual choice. According to a widely shared (but, I will argue, erroneous) view, "classical" liberals are those who insist that unregulated or minimally regulated markets are inseparably entwined with individual freedom. The central thought here is that the dispersion of power that results from an unregulated or minimally regulated market economy is necessary to protect individuals from state control. Freedom, on this view, requires that individuals be free to buy and sell any or all of their goods on a market, without a central authority directing the production and distribution of those goods.

A prominent story about liberalism alleges that classical liberalism was displaced in the late nineteenth and early twentieth centuries by a "revisionist" version.[1] This revisionist liberalism severs the close link between liberty and markets: unregulated or minimally regulated markets are viewed as only contingently related to individual freedom. The central thought here is that a commitment to individual liberty can sometimes require substantial intervention in markets: left to themselves, markets

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[1] Cf. Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), 6.

can produce extremely bad outcomes and can lead to large inequalities that undermine liberty.

In this essay, I want to complicate this picture of the relationship between classical and revisionist liberalism by pointing out a revisionist strand in the writings of liberalism's earliest defenders. These "classical" liberals recognized that market liberty was not always compatible with individual liberty. In particular, they argued that labor markets required intervention and regulation if workers were not to be wholly subjugated to the power of their employers. Functioning capitalist labor markets (along with functioning credit markets) were not "natural" outgrowths of exchange, but achievements hard won in the battle against feudalism. Further, and crucially, the existence of such markets required closing off other market choices.

In their writings, the classical liberals offer insights into the limits of the market that are missing from the approach of revisionist liberalism. In presenting the classical theorists' argument about the need for interventions in labor and credit markets, I will appeal to the liberal thinker who is often thought to be particularly hostile to intervention in the market: Adam Smith. My argument will stress Smith's understanding of the distinctions between *kinds* of markets and the need for interventions in labor and credit markets if the increase in substantive freedom that capitalism brings about is to be preserved.

II. Ground Clearing

Markets are institutions in which exchanges take place between consenting parties. The phrase "between consenting parties" is crucial: market exchanges are voluntary.[2] Armed robbery is not an example of market exchange. In market exchange, the parties consent to the exchange. Both buyer and seller have the freedom to refuse an offer and to attempt to strike a better deal with someone else. There is no market where there is no possibility of exit.

Furthermore, a single act of exchange does not constitute a market. For exchanges to turn into markets, there have to be a certain number of them and they have to happen with predictability. Even regular exchange is not sufficient for a market: markets depend on institutions to enforce their terms, "especially if an exchange involves a promise of payment only in the future."[3] In the memorable phrase of legal scholars Lewis Kornhauser and Robert Mnookin, economic transacting in the market occurs "under

[2] As Milton Friedman puts it, "The possibility of coordination through voluntary cooperation rests on the elementary—yet frequently denied—proposition that both parties to an economic transaction benefit from it, *provided the transaction is bilaterally voluntary and informed.*" Ibid., 13. It is noteworthy how little time economists have spent on analyzing the concept of a "voluntary" act.

[3] See Ravi Kanbur, "On Obnoxious Markets," in Stephen Cullenberg and Prasanta Pattanaik, eds., *Globalization, Culture, and the Limits of the Market* (New Delhi: Oxford University Press, 2004), 42.

the shadow of the law."[4] The ordinary market participant counts on the state for her security when walking to and from the grocery store; even the extra-ordinary entrepreneur would not engage in high-risk initiatives without a variety of state guarantees. Thus, all markets depend not only on background property rules but also on coercive mechanisms to enforce exchanges.

III. The Liberal Case for Respecting Voluntary Transactions

Why do so many liberal thinkers emphasize the importance of the freedom to exchange through a market? There are two contemporary arguments in favor of not interfering with people's voluntary transactions on a market: both have roots in Adam Smith's *The Wealth of Nations.* The first argument stresses the connection between market freedom and individual liberty.[5] The second stresses the connection between market freedom and efficient economic production. In recent economic theory, the argument from efficiency has eclipsed the argument from liberty, although, as is well known, liberty was central to Smith's own defense of markets.

With respect to the link between markets and freedom, proponents of this link cite a range of important effects that markets have on an individual's ability to develop and exercise the capacities of a free agent:

1. Markets present agents with the opportunity to choose between a large array of alternatives.
2. Markets provide incentives for agents to anticipate the results of their choices and thus foster instrumental rationality.
3. Markets decentralize decision making, giving to an agent alone the power to buy and sell goods and services without requiring her to ask anyone else's permission.
4. Markets place limits on the viability of coercive social relationships by providing (relatively) unimpeded avenues for exit.
5. Markets decentralize information.
6. Markets help undermine racial, ethnic, and religious discrimination.
7. Markets allow people to practice and try out various alternatives.
8. Markets enable liberal individuals to cooperate without having to agree on a large range of questions of value.

Liberal theories that assign substantial weight to individual freedom thus tend to allot a central role for market allocation, pointing to the market realm as a place where the capacity for individual choice is devel-

[4] Robert Mnookin and Lewis Kornhauser, "Bargaining in the Shadow of the Law: The Case of Divorce," *Yale Law Journal* 88 (1979): 950.

[5] In this essay, I use the terms "freedom" and "liberty" interchangeably.

oped. Markets also help minimize the extent to which individuals can be subjected to externally imposed forms of coercion or socially ordained status. Within the bounds of justice, then, liberals tend to believe in, and indeed extol, the principle of freedom of contract.

With respect to the second argument, it is widely recognized that markets are efficient forms of social organization and usually more efficient than nonmarket alternatives. In particular, markets appear to be an efficient means for getting people what they want. Economic theorists see markets as mechanisms that enable the optimal satisfaction of people's preferences.

Efficiency is most often interpreted (by present-day economists) in terms of the concept of Pareto optimality. A social state is Pareto optimal when it is the case that no one can be made better off (in terms of his or her utility) without making someone else worse off. An extremely elegant result, the so-called "fundamental theorem of welfare economics," shows that under ideal conditions all perfectly competitive market equilibria are Pareto optimal. The idea of Pareto optimality has obvious ethical appeal, for it seems clear that it is better to make people better off, and that if one of two prospects is better for someone than the other, and at least as good for everyone else, then it is better.[6]

Thus, liberals celebrate markets because markets are conducive to both individual freedom and economic efficiency, where efficiency is understood in terms of making people better off, that is, yielding greater satisfaction of preferences.[7]

IV. Enter Real Markets

The simple story about liberalism and its changing relationship to market freedom runs as follows. Classical liberals such as Adam Smith developed the basis of a theory of ideal markets with the implication that intervention in the economy was (in general) inimical to both freedom and efficient economic development. Revisionist liberals recognized that real markets fail to live up to the textbook fiction of ideal markets in three important ways: transacting agents often lack relevant information; they engage in exchanges with third-party effects; and many markets in which agents participate are distorted by monopolies. According to the simple story, the discontinuity between classical liberalism and revisionist liberalism is primarily a disagreement over the extent to which real markets converge with ideal markets.

[6] It is, of course, possible to challenge this claim. See Anne Phillips, *Which Equalities Matter?* (Cambridge: Polity Press, 1999).

[7] There is a complex link between the efficiency and liberty defenses of ideal markets; although they overlap in certain respects, they are also in tension with each other. Amartya Sen has explored the tensions between Pareto optimality and freedom. See Amartya Sen, "The Impossibility of a Paretian Liberal," *Journal of Political Economy* 78 (1970): 152–57.

This story is incorrect. Classical liberals had a greater sensitivity to the limits of ideal markets, and to the problems with real markets, than this narrative suggests. Not only did they recognize the need for intervention in markets characterized by externalities, poor information, and monopoly, but also, as I will show, they saw the need to restrict certain exchanges if even ideal markets were to promote liberty. Below, I will argue that classical liberals like Adam Smith recognized that without some limits on particular markets, the new capitalist freedoms would degenerate into feudalism.[8] In particular, Smith and other classical liberals recognized something that contemporary liberals often overlook: the choices that an agent faces are not exogenously given. Allowing certain types of markets to operate can foreclose other choices that an agent might herself prefer to have and, in the extreme, can render her with no meaningful alternative choice. This important insight will be elaborated below in Section VII.

Some earlier arguments by classical liberals for the restriction of markets do resonate with the revisionist liberal case for regulating markets. To begin with, then, I want to consider the grounds that revisionist liberals appeal to in order to justify interference in the workings of markets. There are chiefly three such grounds: (1) incomplete information, (2) external effects, and (3) monopoly or extremely asymmetric bargaining power.

A. Incomplete information

Even the most committed proponents of unregulated markets recognize that certain information preconditions must be met for any given exchange if it is to be truly beneficial to the exchanging agents. As Milton Friedman puts it, both parties to an economic transaction benefit from it "provided the transaction is bilaterally voluntary and informed."[9] In the presence of reliable information, an exchange that previously looked attractive may turn out to be mere fool's gold. In fact, an exchange entered into with deficient information may leave me worse off after exchanging than I would have been had I never entered the transaction in the first place (e.g., buying a used car that turns out to be a lemon).[10]

Information is relevant to a person's preferences, and incomplete information may lead a person to enter into transactions that are inconsistent with her preferences. This means that in the presence of faulty informa-

[8] John Locke had earlier argued that no one has the right to sell himself into slavery: there are limits to the degree of permissible personal subjection to others. See John Locke, *Second Treatise of Government*, in Peter Laslett, ed., *Two Treatises of Government: A Critical Edition* (Cambridge: Cambridge University Press, 1988).

[9] Friedman, *Capitalism and Freedom*, 13.

[10] Cf. George Akerlof, "The Market for 'Lemons': Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84 (1970): 488–500.

tion, we cannot assume that free exchanges will be Pareto optimal. Just how faulty information has to be to justify interventions or to overturn previously agreed on exchanges is, of course, a difficult question of social policy.

Faulty information is relevant to a person's preferences and thus to Pareto optimality. Yet even if free exchanges based on misinformation are inefficient, perhaps they should be respected. Shouldn't agents be free to engage in inefficient exchanges? After all, information is not only a precondition of choice but also an object of choice. Even if greater knowledge is desirable to an agent, it is often costly to acquire. A rational agent decides how much information it is worth her while to acquire: in many cases, deficient information stems from her own agency.

This response, while it raises an important consideration, overstates its case. It neglects the role that information itself plays in the idea of free choice. An agent needs a certain amount of information in order to imagine and distinguish among alternatives, and to assess them. In this sense, some information is a precondition of choosing. Where information is grossly defective, where an agent is mistakenly ignorant of any possible alternatives to her action, her "agency" is weakened.

In cases in which time and uncertainty break the link between perceived and actual consequences, it becomes questionable whether (and to what extent) the agent actually consented to (i.e., chose) those consequences. Consider the case of an individual selling a body part, such as a kidney. It is doubtful that this person can really know the consequences of selling her kidney, especially as those consequences extend far into the future. Insofar as this is true, then, we can question the extent to which the individual can be said to truly consent to a contract to sell her kidney, since she might not have entered into the contract had she had more information. Of course, we have to tread carefully here, because choice by competent adults under some amount of imperfect or limited information is still, in an important sense, choice. Nevertheless, it is reasonable to assume that the more defective the information, the weaker the person's "agency" in the transaction will be, and the less clear it is that the person is choosing to make that actual transaction. The greater the information omissions or distortions, the more uncomfortable many liberals will be about enforcing a contract. Liberal discomfort with an exchange is likely to be even higher when the outcomes of decisions made with poor information are very bad for at least one of the parties, and the results are irreversible.[11] Such considerations have led at least some liberals to object to kidney markets and to enforcing commercial surrogacy agreements.

[11] See Debra Satz, "Noxious Markets: Why Some Things Should Not Be For Sale," in Cullenberg and Pattanaik, eds., *Globalization, Culture, and the Limits of the Market*, 11–38.

B. External effects

One important reason to interfere in real-world markets is that sometimes the consequences of people's free transactions "spill over" and impose significant costs on (unwilling) third parties. These costs are usually referred to as "externalities," and they form the core of the theory of market failure.[12] So, for example, the effects of pollution cannot be restricted only to the parties whose market exchanges produce it. Likewise, sales of weapons on the international market have effects on people who are far removed from the parties to the transaction. These spillover consequences can render certain exchanges inefficient.

Spillovers need not be taken as support for market restriction; indeed, economists often view spillovers as evidence that the market has not been sufficiently enlarged. Externalities exist because there is a mutually advantageous exchange that is unexploited. The theory of market failure is not so much a theory of what is wrong with certain markets, but of what goes wrong if and when additional markets are not available. For example, if the costs of pollution could be bought and sold on the market, then the externality would be internalized by the contracting parties. In principle, there are no limits to the market. In reality, however, many markets are missing or incomplete, and economists will often look to intervention to curtail or redress a market's external effects.

Third-party effects, like imperfect information, are ubiquitous. If all the cases where third parties bear costs could count to prohibit an exchange, freedom of contract would largely be at an end. Thus, liberals have focused on developing a theory of those third-party effects that should be considered harms. In a rough-and-ready way, the presence of these harms is taken to require societal intervention. This is only a rough-and-ready case because it is important to consider that regulatory institutions are liable to interest-group capture and bureaucratic sclerosis. A little inefficiency might be preferable to a lot of red tape.[13]

While many liberals are likely to view harmful externalities as a reasonable justification for market regulation, those who are libertarians generally do not. Libertarians do not deny that market outcomes sometimes produce bad consequences for others. Instead, they claim that these effects, as the unintended consequences of voluntary actions, are not morally objectionable unless they interfere with rights or are based on force or fraud. Since libertarians tend to eschew welfare rights, the question is whether markets have external effects on people's liberty or prop-

[12] Other bases of market failure include the existence of natural monopolies, non-zero transaction costs, and economies of scale.

[13] A classic defense of private property rights is that such rights allow people to internalize externalities: without private property rights, the commons would deteriorate. See Harold Demsetz, "Toward a Theory of Property Rights," *American Economic Review: Proceedings and Papers* 57 (1967): 347–59.

erty rights. If such violations occur as by-products of free exchanges, then libertarians might well see a case for market restriction, or at least for compensation for those whose rights are violated.[14]

C. Asymmetry of bargaining power

Monopoly in the market wreaks havoc with the fundamental theorems of welfare economics, severing the link between unregulated markets and Pareto optimality. Whereas mainstream economic analysis tends to rely on a framework in which agents do not have market power—since no one agent is taken to be able to determine the market price, and entry and exit from the market is unimpeded—in real-world markets there may be pockets of market power working even when there is no issue of monopoly in the classic sense.

Many real-world markets allow one agent to exercise considerable power over another, as when a moneylender in a small village charges usurious rates of interest or when big corporations have, with respect to their employees, an asymmetric power to exit from an economy.[15] Consider the example of asset sales of livestock and land at "fire sale prices," which regularly happen in drought-stricken areas in poor countries. Even when there is no element of monopoly in the operation of these markets, they set in motion processes of dispossession of assets by the poorest and accumulation by the richest. Such markets involve people forced by their own necessity to sell at a price that is well below what people who are less poor would hold out for. In such cases, it might be argued that markets are actually compatible with de facto monopoly pricing.

In fact, even perfect competition, where every agent is paid according to the marginal product of the factor she owns, may not be enough to correct for highly asymmetric bargaining power. This is because an agent's bargaining power is affected not only by her assets at the moment, but by her assets overall, including her wealth and property. The point here is simply to note that background property rights and wealth partly determine each party's relative ability to hold out for more acceptable terms. Property rights thus distribute market power as well as goods; and certain distributions may yield such asymmetric bargaining power between the agents as to approach monopoly power.

In sum, revisionist liberals endorse three reasons to intervene in markets, all of which can arise when real-world markets diverge from ideal markets. Imperfect information, external effects, and monopoly pricing all generate inefficiencies; moreover, imperfect information and monopoly can objectionably weaken the agency of transacting individuals, while

[14] Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974).
[15] This paragraph is drawn from my essay "Noxious Markets."

externalities distribute costs on individuals who are not treated as transacting agents at all.

V. Revisionism in Classical Liberalism

Adam Smith, of course, knew nothing about the "fundamental theorem" of welfare economics, which he greatly antedated. Smith's defense of unregulated markets did not rest on their purported allocative efficiency, but rather on the tendency of markets to promote the accumulation of capital and the growth of income, and principally on their connection to freedom. However, Smith does recognize that there are contexts in which markets require governmental restriction: contexts in which there are market failures.

The most important case Smith sees for governmental intervention on grounds of externalities is education. Because parents have little time for the education of their children, and because the children of poor families must be put to work at an early age, many children have no chance to acquire the skills for any but the most mindless occupations. This "corruption and degeneracy of the great body of people" [16] is inevitable without some attention from the government. Smith argues that basic education (for example, literacy) provides a communal benefit that transcends the gains of the person being educated. Conversely, failure to educate children can produce public ills: less labor mobility, greater poverty, and less economic growth. Smith harshly criticizes the irrationality of failing to provide public expenditures for education: "For a very small expense the publick can facilitate, can encourage, and can even impose upon the whole body of the people, the necessity of acquiring those most essential parts of education." [17]

In addition to its role in education, Smith saw roles for the government in certifying the quantity and quality of traded commodities, in the minting of coins, in the administration of justice,[18] and in the provision of public works and national defense.[19] In each of these cases, allowing unfettered markets has public costs, even though such markets may benefit the individuals involved in the private transactions. For example, even though individual families might benefit from pulling their children out of school and immediately putting them to work, their private action has costs for the society as a whole.

In his writings against usury, Smith also demonstrated an awareness of the informational problems inherent in certain types of markets. Few commentators have called attention to Smith's advocacy of legal restric-

[16] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), ed. R. H. Campbell and A. S. Skinner (Oxford: Oxford University Press, 1976), 781.

[17] Ibid., 785.

[18] Ibid., 814.

[19] Ibid., 815.

tions on usury. While Smith objected to the legal banning of charging interest on loans, he granted his qualified approval to the existing usury laws in Great Britain that limited the rate of interest to 5 percent:

> In countries where interest is permitted, the law, in order to prevent the extortion of usury, generally fixes the highest rate which can be taken without incurring a penalty. . . .
>
> The legal rate, it is to be observed, though it ought to be somewhat above, ought not to be much above the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten percent, the greater part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest. Sober people, who will give for the use of money no more than a part of what they are likely to make by the use of it, would not venture into the competition. A greater part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it.[20]

The economist Amartya Sen correctly reads this passage as expressing Smith's recognition that in some contexts the pursuit of private gain (by prodigals and projectors) can lead to social loss.[21] There is, however, another aspect of this passage that Sen does not note: Smith's understanding that credit markets are characterized by asymmetric information. The actions of the prodigal borrower—pursuing misguided or myopic ventures—make a default on repayment likely. If credit markets are characterized by asymmetric information and moral hazard, then rationing by government may be a needed feature of such markets.

Finally, Smith seems to recognize the problems that can arise when agents in a market have extremely asymmetric power. In his writings on the regulation of wages, he notes: "When the regulation . . . is in favor of workmen, it is always just and equitable; but it is sometimes otherwise when it is in favor of the masters."[22] Smith recognized that merchants tend to use their market power to pursue their own interests by wielding political influence. In Book IV of *The Wealth of Nations,* Smith attempts to unmask the ways that merchants use their inordinate economic power to influence politics, particularly by influencing restrictions on imports. Likewise, he objects that the apprentice system is enacted in the interests of the powerful and subjects workers to the power of their masters; and he supports a tax on carriages such that "the indolence and vanity of the rich

[20] Ibid., 356–57.
[21] Amartya Sen, *Development as Freedom* (New York: Alfred Knopf, 1999), 124–25.
[22] Smith, *Wealth of Nations,* 157–58.

is made to contribute in a very easy manner to the relief of the poor,"[23] thus placing the poor in a better bargaining position on the market.

Smith recognizes both the advantages of markets and the ways that particular markets require regulation if economic growth is to be preserved and individual freedom secured. In at least some strands of his writings, then, he shows an awareness associated with the revisionist liberals: real markets deviate from ideal markets in important ways. Some real markets are built on asymmetric information, give rise to externalities, or manifest profoundly unequal bargaining power.

VI. The Issue of the Limits of the Market Recast

Consider a voluntary transaction in which all the features of a perfect market are present. That is, there is perfect knowledge on the part of all of the transacting agents; there are no externalities; and there is no monopoly power. Do liberals have any reasons for forbidding this transaction?

Some people believe that under these conditions it would be illegitimate to interfere with private choices on the market. Under such conditions, markets would function, as the philosopher David Gauthier once put it, as moral "free zones."[24] Although many contemporary liberals have recognized that real-world markets are often rife with asymmetric information, monopoly, and third-party harm, they have said little about the need to place limits on market freedom under ideal conditions. Indeed, the two dominant schools of liberal economics—Paretian welfarism[25] and libertarian public choice[26]—defend an ideal market without limits. The primary normative properties of the general equilibrium system—including the fundamental theorem of welfare economics mentioned above—*depend on* there being a market in everything, including futures and uncertainty. The distinctive contributions of the public choice school are derived from *assuming* that commodity-like relationships determine outcomes in arenas not customarily thought of as economic, including voting.

In *Anarchy, State, and Utopia,* Robert Nozick draws out the implications of the view that ideal markets should not be regulated, and claims that respect for liberal freedom in ideal conditions entails that individuals even have the right to sell themselves into slavery.[27] Here, Nozick recognizes a point made earlier by John Stuart Mill: while slavery is usually rooted in an initial act of coercion, it is not necessary for slavery to originate in violence and force. People driven by poverty or preference

[23] Ibid., 725.

[24] David Gauthier, *Morals by Agreement* (Oxford: Oxford University Press, 1986), 95.

[25] See Kenneth Arrow and Frank Hahn, *General Competitive Analysis* (San Francisco: Holden-Day, 1971).

[26] Some key public choice economists are James M. Buchanan, Gordon Tullock, and Anthony Downs.

[27] Nozick, *Anarchy, State, and Utopia,* 331.

might have reasons to opt to become slaves: this was, in fact, the case in some parts of medieval Europe. Both bonded labor and serfdom have, at times, been voluntarily chosen.[28] However, unlike Nozick, Mill attempts to articulate a principle that, while asserting the priority of individual freedom, would nevertheless disallow contractual, voluntary slavery. In *On Liberty,* Mill argues that allowing the voluntary alienation of one's freedom through a slave contract is incompatible with a recognition of the priority of that freedom. He writes:

> In this and most other civilized countries, for example, an engagement by which a person should sell himself, or allow himself to be sold, as a slave would be null and void, neither enforced by law nor by opinion. The ground for thus limiting his power of voluntarily disposing of his own lot in life is apparent, and is very clearly seen in this extreme case. The reason for not interfering, unless for the sake of others, with a person's voluntary acts is consideration for his liberty. . . . But by selling himself as a slave, he abdicates his liberty; he foregoes any future use of it beyond that single act. He therefore defeats, in his own case, the very purpose which is the justification of allowing him to dispose of himself. He is no longer free, but is thenceforth in a position which has no longer the presumption in its favor that would be afforded by his voluntarily remaining in it. The principle of freedom cannot require that he should be free not to be free.[29]

Note that Mill does not base his argument against voluntary slavery contracts on potential harm to others, or the presence of faulty information, or asymmetric bargaining power. Mill's argument against voluntary self-enslavement contracts appeals to liberty.

What should we make of Mill's argument? Although it is rhetorically suggestive, I do not find it (at least as stated) a powerful argument. Why is respecting voluntary slavery contracts inconsistent? Mill views liberty largely in terms of noninterference, and if I sell my*self* into slavery no one is interfering with me. Indeed, Mill's claim about slavery is especially puzzling since, in *On Liberty,* he argues that a person should be free to kill himself by jumping off a bridge. Why is freedom compatible with killing myself but not with selling myself? Mill's text gives us no answer.

As we reflect on Mill's and Nozick's views on voluntary slavery, we are left with a more general question: Does a commitment to freedom require that one respect all market choices, including bonded labor contracts and

[28] Cf. Orlando Patterson, *Slavery and Social Death* (Cambridge, MA: Harvard University Press, 1982).

[29] John Stuart Mill, *On Liberty* (1859), ed. Elizabeth Rappaport (Indianapolis, IN: Hackett Publishing, 1978), 101.

credit contracts at usurious interest rates, if made under ideal conditions? I believe that the classical economists can help provide us with an answer.

VII. Adam Smith and the Limits of Ideal Markets

There are two aspects of Smith's thought that I want to draw on in answering this question about the limits of ideal markets. The first is Smith's understanding that without intervention in certain types of market choices the advance in freedom that capitalism represents over feudalism will not be preserved. The second is Smith's understanding that markets differ in kind and that some markets can shape their participants in troubling ways.

A. Smith as an anti-feudal thinker

If we read Smith as a classical liberal according to the canonical story, then he believed that market regulation is to be rejected because it strengthens the hand of governmental power and compromises individual freedom. That is, the main danger to the new system of natural liberty is the overexpansion of governmental power. Smith's "invisible hand" of the market shows us a way to organize society that can replace the visible fist of government. On this interpretation, Smith can be seen as a close forerunner of Friedrich Hayek; the invisible hand brings about a kind of spontaneous order—order without coercion and, indeed, without any social planning.[30]

Yet the invisible hand was not central to Smith's economic and moral thought. The economic historian Emma Rothschild has shown, in her well-documented book *Economic Sentiments,* that Smith only used the term "invisible hand" three times, one of which was clearly meant to be ironic.[31] The term only appears once in *The Wealth of Nations,* in the context of an argument that legislators should leave merchants alone to pursue their private interests since so doing is actually most conducive to the public good. Interestingly, however, in the same chapter Smith also says that merchants and manufacturers are "always demanding a monopoly against their countrymen" and that they "are the people who derive the greatest advantage from it [monopoly]."[32] In this context, Smith is worried that government action would simply strengthen the merchants' hand, by legally granting them rights to monopoly.

At the same time, if the merchants were actually able to secure a monopoly over productive assets or with respect to essential goods on their own,

[30] See John Gray, *Liberalism* (Minneapolis: University of Minnesota Press, 1986), 42.

[31] Emma Rothschild, *Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment* (Cambridge, MA: Harvard University Press, 2001), 117.

[32] Smith, *Wealth of Nations,* 467.

then leaving them alone would not likely serve the public good. For example, Smith supported government intervention to oblige employers to pay their workmen in money, not in kind, when prices were falling, and he supported wage regulation when it was in favor of the workmen but not when it was in favor of the owners.

Rather than seeing Smith as opposed to government intervention per se, it might be helpful to recall that Smith's arguments against intervention in markets are focused on a specific social order: feudalism. Many of the regulations that Smith vociferously condemned were vestiges of a precapitalist order: the vested interests of the merchants seeking to protect their inflated profits, the powerful guilds that restricted the free entry of individuals into professions and trades. Smith celebrated the freedom to buy and sell not only as an impetus to economic growth and wealth, but also as a form of emancipation from a particular form of political oppression. Markets undermined social relationships built on servility:

> Commerce and manufactures gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived almost in a continual state of war with their neighbors and of servile dependency upon their superiors. This, although it has been the least observed, is by far the most important of their effects.[33]

Smith contrasted the freedom of the new industrial order based on market exchange with the organization of feudal society. Under feudalism, peasants and laborers were dependent on the feudal landowners for their subsistence and for protection from violence by others. This extreme dependency supported relations of servility between the lord and his subjects: the peasant's bowing and scraping before his "superior." Peasants had a duty to obey any of the lord's commands, no matter how arbitrary, humiliating, or costly such commands were. An important point about this servile relationship between serf and lord is that it was voluntary: the serf was tied to his master by apparently voluntary acts of loyalty. Given his economic, political, and cultural circumstances, subservience to the lord was the peasant's best option.

Markets liberated individuals from this abject dependence on one powerful person by allowing producers to sustain themselves through exchanges with thousands of anonymous and indifferent customers:

> Each tradesman or artificer derives his subsistence from the employment, not of one, but of a hundred or a thousand different customers.

[33] Ibid., 412.

> Though in some measure obliged to them all, therefore, he is not absolutely dependent on any one of them.[34]

Freedom of commerce, according to *The Wealth of Nations,* brings about individual emancipation from personal, political, and, indeed, physical oppression. According to Smith, this end of abject servility to masters, along with good government, was "by far the most important" of all the effects of markets. Market freedom undermined the relations of personal subjection and servility that characterized feudalism. In particular, the extension of the market made possible a society of horizontal relationships—a society in which relationships between people were based on free interaction, equality, and reciprocity.

However, Smith also recognized that the ability of laborers to escape from their servility to one master was dependent on a number of conditions, including how competitive the labor market actually was. He was extremely aware of the tendency of the merchants to attempt to bring the state in as an ally in controlling their workers—a tendency that he argued must be resisted. But to resist this tendency required limits on markets: not only must state officials be able to operate independently of the interests of the merchants, but there must be restrictions on the ability of merchants to enter into (contractual) collusion with each other to drive down the price of labor; and there must be measures taken to prevent workers from becoming overly dependent on a single employer.

Rather than propounding a doctrine of spontaneous order, Smith continually stressed that markets can function as vehicles of freedom and efficiency only under very definite institutional arrangements. Markets require a "separate independent state" to promote the well-being and freedom of the poor, a state cut loose from the power of merchants, guilds, religious groups, and prejudicial social norms. Smith wrote that the system of law would never be completely secure against such interests and would need to be counteracted by a universal system of education, and by regulation of labor markets to protect the freedom of the workers.

The danger to workers was not merely that employers might collude to hold down wages; even if employers did not collude, workers were harder to organize than employers, since workers existed in greater numbers. Furthermore, workers had fewer resources to engage in protracted struggles with their employers. For this reason, Smith was far more sympathetic to intervention on behalf of workers in labor markets than to government intervention in other markets. Unfortunately, as Smith recognized, most government intervention tended to be on the side of the employers. Even legally protected guilds, which look like combinations of workers, actually serve only the interests of employers by obstructing

[34] Ibid., 420.

the free circulation of labor. Smith writes of such combinations that "a thousand spinners and weavers" may be dependent on "half a dozen wool combers," who by refusing to take on apprentices can "reduce the whole manufacture into a sort of slavery to themselves."[35]

Ironically, the main schools of contemporary liberal economic thought that support the expansion of the market domain—libertarian public choice and Paretian welfare economics—are unable to represent the capitalist transformation of the labor market, from a relation of dependency between servant and lord to one of equality between producers and consumers, as an improvement. For that transformation depended on limiting the power one person could exercise over another, and this, in turn, depended on setting limits on the scope of markets and limits on freedom of contract.

Consider a contemporary example. Millions of people today work in conditions that can only be characterized as bonded labor, debt peonage (where a debtor is held in servitude by a creditor), and serfdom. But these conditions are often entered into voluntarily in order to escape acute poverty or starvation. According to contemporary welfare economics, if the laborers are rational individuals maximizing their utility, then they must be better off. According to public choice theorists, if the laborers are competent adults, then to restrict their choices is to treat them paternalistically as wards of the state. Neither theory can explain what is wrong with such contracts, except insofar as they generate externalities, reflect imperfect information, or arise in situations of monopoly.

Yet to appreciate the problems with these forms of labor, we have to move beyond these dimensions of markets. A central problem with bonded labor contracts and other contracts that put people into relationships of extreme dependency with others emerges when we consider that the set of choices a person faces is not given. The range of choices an individual has is not exogenously determined, but largely endogenously (internally) determined by the existing property rules, distribution of power, and social norms. Smith saw that relationships of servile dependency produced choices that undermined the freedom and good government that capitalism brings.

Child labor provides an interesting illustration of the phenomenon by which permitting a particular "choice" (to be utterly dependent on an employer) can lead to far fewer available choices for the agent. Poor parents in developing societies often send their children to work because they can see no other way of supporting their families. For each individual family, child labor looks to be the family's best option for survival: child labor can generate the income that keeps family members from starving to death. At the same time, however, the availability of child labor may serve to drive down the wages of adult laborers, thus making child labor necessary for every family's survival. The availabil-

[35] Ibid., 143.

ity of child labor can thus trap families and societies in a low-wage, low-productivity equilibrium in which children are raised to be ignorant and uneducated, with few options open to them. Not only would children be better off in such circumstances if they went to school, but so too would their families. The institution of child labor restrains the set of alternatives available to poor families, so that they have no better choice than to send their children to work.[36] Child labor also, and perhaps most centrally, restrains the choices of poor children, since it corrupts their development, causing them to have less ability to choose than they would have had if they had been educated. Interestingly, permitting child labor is in the interests of some employers, since it provides them with a cheaper source of labor than adults. Such employers may seek to manipulate the choice environment.

The economist Garance Genicot provides an example of the ways that landlords can strategically restrain the choices available to laborers such that these laborers voluntarily accept bonded labor. In her model, peasants choose between bonded labor and casual labor, and landlords and local credit institutions compete with each other on the credit market. If bonded labor is allowed, the enforcement capabilities of the landlords and the local credit institutions will be different. Since bonded laborers agree to work for the landlord over the period of the loan, the landlord can subtract the amount due directly from the laborers' wages. By contrast, local credit institutions have to rely on implicit agreements in which the threat of losing future credit opportunities prevents borrowers from defaulting on loans. Genicot shows that the (mere) possibility of entering into bondage, even if not taken, harms poor peasants' access to credit by improving their options in the case of default. A poor peasant who defaults on a loan to a local credit institution now has another option to obtain credit. She can now sell herself into bondage to secure a loan. Thus, bonded labor has the potential to render the implicit promise to repay a loan unenforceable and therefore prevents asset-less peasants from gaining access to formal credit. Moreover, landlords can set the terms of bonded labor such that peasants are denied credit from local institutions.[37]

Voluntary bondage, child labor, and debt peonage replicate the feudal relations between individuals that Smith denounces. Those in bondage are entirely dependent on one individual for their survival, and they have few if any alternative options. Enforcing genuinely free labor markets requires restrictions on bonded labor, laws that guarantee the right to exit from employment, education that makes this right not merely a right in name only, and restrictions on monopoly and monopsony, with perhaps an additional role for the state as a source of credit to poor families.

[36] See Debra Satz, "Child Labor: A Normative Approach," *World Bank Economic Review* 17, no. 2 (2003): 297–309.

[37] Garance Genicot, "Bonded Labor and Serfdom: A Paradox of Voluntary Choice," *Journal of Development Economics* 67, no. 1 (February 2002): 101–27.

Because of the endogenous nature of the choices an agent faces, we need to focus not only on the moment of individual choice, but also on the way that institutions can enhance or restrict her range of choices. If it is true that without limits on labor or credit markets, such markets would degenerate into relations characterized by subordination and extreme servility, then it is not concerns of paternalism or efficiency that prompt restrictions on markets but an argument about the need for collective self-protection. Without some restrictions on markets and property rights, a person's real opportunities could shrink to zero and she could become extremely dependent on a small set of individuals who would wield great power over her. The most important of the market's effects—its erosion of servile dependency and its promotion of the liberty and security of individuals—would be dramatically undercut. Bonded labor, whether contractual or not, is objectionable because it constitutes a relation of personal subjection, in which one party enjoys arbitrary power over another. It also changes the options that are open to an agent, whether she wants to engage in bonded labor or not.

The examples of child labor and bonded labor illustrate the blurriness of the distinction between the imposition of an institutional form of servitude and the limitations placed on individual choice by the lack of alternatives. Powerful agents often act to restrict the set of choices open to less powerful agents, who then voluntarily accept the choice that is in the best interest of the powerful.

Adam Smith recognized that free contract employment was a momentous instance of progress, liberating individuals from the tyranny of servitude. While he advocated the use of markets in many circumstances, he did not hesitate to investigate those economic circumstances where particular restrictions could enhance liberty. Thus, although he was hostile to labor market regulations that benefited employers, he was tolerant of such regulations when they were in favor of workers: "When the regulation . . . is in favor if the workmen, it is always just and equitable, but it is sometimes otherwise when it is in favor of the masters."[38] Smith's recognition that there are good reasons to reject institutions (including underlying systems of property rights) that reduce an agent's options so that servile dependency is her best alternative opens the door to limitations on freedom of contract. The reasons for imposing these limitations overlap with, but also go well beyond, the revisionist liberal's reasons for regulating markets (externalities, incomplete information, and monopoly). For it is not only consistent with Smith's analysis that bonded labor, child labor, and usury be prohibited, but also that incorporated (company) towns be banned, as well as markets in political influence. The point is that without restraints on

[38] Smith, *Wealth of Nations,* 157–58.

freedom of contract, we do not get capitalism. We get a system of voluntary feudalism.[39]

B. Market heterogeneity

Adam Smith saw the market as a heterogeneous set of institutions. Smith and his followers offered distinct theories of the functioning not only of markets for goods, but also of markets for land, credit, and labor. Land, credit, and labor were considered to be peculiar in a variety of ways: land had fixed natural limits; credit was forwarded on the basis of a future promise to pay with uncertain enforcement; and labor was a commodity embodied in human beings.

It is because Smith saw labor as a special kind of commodity that he viewed labor markets in a way that differed from the way he viewed other kinds of markets (for example, a market in corn). Unlike a corn market, a labor market directly shaped the capacities of human beings:

> The employment of the great body of the people comes to be confined to a few operations; frequently to one or two. But the understandings . . . of men are necessarily formed by their ordinary employments. The man whose whole life is spent performing a few simple operations of which the effects too are perhaps always the same . . . has no occasion to exert his understanding or to exercise his invention in finding out expedients for removing difficulties which never occur. He naturally loses, therefore, the habit of such exertion and generally becomes as stupid and ignorant as it is possible for a human creature to become. . . . [He is incapable] of forming any just judgment concerning many even of the ordinary duties of private life. Of the great and extensive interests of his country, he is altogether incapable of judging. . . .[40]

Smith recognized that a worker's preferences and capabilities were shaped by the structure of the labor market. For this reason, Smith objected to the one-sided training of the apprenticeship guilds, to the power of incorporated towns, and to the degradation of workers into mere things at work. He was aware that markets have not only economic but also social and political effects: in particular, markets push forward the development of the division of labor, which in turn produces not only economic growth but also a one-sided worker incapable of taking part in

[39] See also Elizabeth Anderson, "Adventures in Contract Feudalism," http://left2right.typepad.com (February 10, 2005).

[40] Smith, *Wealth of Nations*, 781–82.

social decision-making. The growth of the division of labor deprives workers of their "intellectual, social and martial virtues."[41]

In his discussions of the pin-making factory, Smith detailed how workers spent their waking hours focusing on one small facet of pin production. How could such workers—if shaped only by these tasks—rise to the level of citizens participating in choosing their circumstances and goals? Smith's striking admission of the limited nature of industrial workers in a capitalist economy was later developed by Hegel and Marx in their ideas of the alienation of labor. Like these later social critics, Smith recognized that the functioning of labor markets inevitably raises questions relevant to the structure of public life, in a way that the functioning of a market in apples does not.

For Smith, labor markets are not only economic institutions that allocate labor across industries and distribute income; they are also political and cultural institutions. Labor markets shape our culture, foster or thwart various human capacities, and support or undermine structures of power. For Smith, the market would fail even if it were efficient and "voluntary" if it also supported an undemocratic structure of power, or fostered political opportunism, or placed workers in relations of servile dependence with manufacturers. In contrast to the excessively abstract, formal representations of freedom, efficiency, and markets in contemporary economic theory, Smith understood that the virtues of capitalism lay in the concrete social relations, motivations, and norms through which market exchange takes place. In modern parlance, we might say that Smith recognized that labor markets were endogenous insofar as they shaped the values, preferences, and choice-sets of workers.[42]

VIII. Conclusion

Revisionist liberals have more in common with the classical liberals than is often supposed. But the classical liberals, as exemplified by Adam Smith, offer key insights on the relationship between markets and freedom that are missing from contemporary liberal approaches. I have sought to recover two important Smithian insights.

First, the distinction between externally imposed restrictions on choice and internally limited choice-sets is not sharp. Institutions, including markets, shape the range of choices that are open to an agent and thus her degree of effective freedom. If certain markets—child labor markets, bonded labor markets, credit markets—can restrict the choices open to an agent, independently of whether or not she chooses to participate in them, then

[41] Ibid., 782.

[42] See also Samuel Bowles and Herbert Gintis, "The Revenge of Homo Economicus: Contested Exchange and the Revival of Political Economy," *Journal of Economic Perspectives* 7, no. 1 (1993): 83–102.

this makes these markets problematic. Moreover, this restriction in the range of choice is not simply a problem of "externalities": the choice-sets of even those who choose to participate in such markets (e.g., voluntary bonded laborers) may be forever altered.

Second, liberals should address markets as cultural and political institutions as much as economic ones. Certain markets shape individuals: consider labor markets, or child-care markets. These markets are constitutive. How such markets are organized has a significant bearing on the development of our capacities, preferences, and choice-sets. Thus, labor markets can be organized in very different ways, ways that not only change the prevailing wages of workers but also give employers more or less control over their employees. The implication of this is not that such constitutive markets should be abolished, but rather that we should structure such markets to preserve relations based on reciprocity and not on coercion. In thinking about the interconnections between markets and freedom, we need to pay attention to the relationships that different markets support as well as to the distributions that they achieve.

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