

John Rogers Commons: Are His Insights Important in Teaching Modern Labor Economics?¹

Francis M. McLaughlin²

Introduction

John Rogers Commons (1862-1945) was one of three most important early twentieth century American economists identified as Institutionalists. The others were Thorstein Veblen, and Wesley Clair Mitchell. Commons was also the most prominent American labor economist prior to World War II. He joined the faculty of the University of Wisconsin at Madison in 1904 and remained there until 1934. He was the major figure in what was known as The Wisconsin School. At Wisconsin Commons worked closely with Robert LaFollette and the Progressive movement, and many of his colleagues and students played major roles in Roosevelt's New Deal. His influence in American labor economics was eclipsed after World War II by a resurgent neoclassical labor economics that gradually relegated Commons' institutional orientation to the periphery of economic discourse. A common opinion among neoclassical economists is that the work of institutional economists in the Commons tradition was largely descriptive and lacked theoretical content. Commons, however, presented his major text *Institutional Economics*³ as a work of economic theory. This paper contains a description of the theoretical core of *Institutional Economics* and an evaluation of it from the perspective of its potential usefulness in the teaching of modern labor economics. Part I describes the theoretical perspective of neoclassical economic theory in order to clarify the institutional perspective by contrast. Part II describes Commons' alternative perspective. Part III presents the conclusions derived from this comparison of the two alternative perspectives.

¹ Prepared for the 37th Annual Lonergan Workshop, Boston College, June 20-25, 2010.

² Associate Professor, Department of Economics, Boston College

³ Commons, John R., *Institutional Economics*, Transaction Publishers, 1990, original publisher MacMillan, 1934.

The Neoclassical Perspective

In neoclassical economics the economy is described as a system of interdependent factor and product markets. Labor economists focus attention on the subsystem of interdependent competitive labor markets embedded in the competitive market system that describes the economic system as a whole. In neoclassical labor market theory both the equilibrium wage (i.e., price) of a unit of labor service, and the equilibrium level of employment of units of labor service are determined by the equation of the supply of and demand for labor services under competitive conditions. The behavior of the suppliers and demanders of labor is explained by their desire to maximize their subjective utility (i.e., satisfactions). The objective of maximizing profit often used to explain employer behavior is simply a proxy for the utility maximizing objective of employers. The labor supply function (or curve) relating all possible wage rates and the total quantity of labor supplied at each wage rate in the market is arrived at by summing the supply functions of all individuals who offer labor for hire. In the simplest case each individual's utility is a function of hours of leisure and income. The income is used to gain utility by the consumption of market-supplied goods. In order to maximize utility each individual selects the combination of market goods and leisure that is best for him in the light of restrictions imposed on him by the going market wage (i.e., the price at which he can sell his time as labor services), and the total number of hours of time available to divide between supplying labor to acquire income, and consuming leisure.

The market labor demand function (or curve) relating all possible wage rates and the aggregate quantity of labor demanded is the sum of the labor demand functions of all employers that demand labor in the market. In the simplest case the labor demand function for each employer is determined as follows. Each firm has what economists call

a production function. This sums up all the known technological information (i.e., engineering information) about how productive inputs can be converted into output. It is one piece of the total information needed by the firm management in order to choose both the profit maximizing level of production and the profit maximizing method of producing that level of production. The firm owner (or manager) combines the technological information contained in the production function with pecuniary information about the market prices of all inputs, including labor services. This combination of technological and pecuniary information answers the question of the best way (i.e., the cost minimizing way) of producing whatever level of output the firm decides to produce (i.e., the profit maximizing level of output). The firm manager then obtains information about the going market price for firm output, and in the light of this price selects the level of output that will maximize firm profit. This determines simultaneously the profit maximizing level of employment offered by the firm. At this level of employment the value added to firm output by the last unit of labor services employed will be equal to the wage rate paid per unit of labor service in a competitive labor market. This static abstract idealized picture of competitive labor market equilibrium is obviously highly simplified, and there is a rich literature in economic theory considering all sorts of qualifications and extensions of this basic model. Nevertheless, it is the basic building block in the structure of contemporary micro economic theory.

The theoretical prism provided by the theory of competitive labor markets embedded in a system of interdependent competitive factor and product markets has well recognized strengths. The most important of these is that it provides a way of understanding those economic phenomena that are the focus of study in labor economics. These are the observed levels and structures of wages and employment, and the observed changes in these levels and structures that take place over time. Empirical investigation has revealed repeatedly that observed wages and employment levels and structures resemble in a substantial way what the economist expects to find in the economic world

on the basis of the theory of competitive labor markets. Thus the theory is a useful way to understand the world of economic production and distribution, an understanding of which is clearly a primary objective of economic theorizing. Most labor economists believe that the theory of a system of interdependent markets provides more understanding and insight into phenomena of primary interest to economists than any available alternative body of theory. It thus accomplishes a fundamental task of any body of economic theory.

The theory of competition also has an important normative property. Under certain rigorous assumptions, described in the theory of perfect competition, it can be demonstrated theoretically that a competitive economic system produces an optimal solution to the fundamental economic problem of allocation. Competition allocates an economy's scarce resources most efficiently, and efficient allocation has been a major focus for economists following the path breaking theoretical work of Stanley Jevons in England, Leon Walras in Switzerland, and Carl Menger in Austria in the third quarter of the 19th century. Allocation in a competitive economy is efficient in the sense that, given the initial distribution of ownership of the society's scarce productive resources, no individual economic actor's subjective economic welfare can be improved without a negative impact on the subjective welfare of another economic actor. This leads to the proposition that any imperfection in the system of competition that can be eliminated will likely lead to improved welfare in the aggregate, by increasing the subjective utility of some person or persons without decreasing the subjective utility of anyone else. In effect, the removing of a market imperfection will provide some person (or persons) with a cost free lunch (or cost free lunches). This conclusion about the normative social desirability of a competitive system provides a powerful *a priori* argument in favor of free competitive markets.

There are other related practical properties of competitive theory. It provides a method for predicting the likely effects of policy actions that impinge upon the labor

market. The theory can be useful, for example, in predicting the likely effects of changes in laws and regulations affecting the labor market. Consider an historical example. In 1973 the United States Congress enacted the *Age Discrimination in Employment Act* abolishing mandatory retirement at age 65. Competitive theory provides a framework for thinking systematically about the likely effects of such a change in the law on such things as the labor supply, employment, and earnings of older Americans. In a similar vein, if some workers have lower earnings than are regarded as socially desirable the theory of labor demand provides insights into what might be done to raise their earnings levels. The theory also provides insight into what might be done to improve the efficiency of particular economic operations. Such real advantages of the theory of competitive markets should not be lost sight of or minimized.

The Economics of John Commons

Commons' mature theoretical work is contained most completely in his *Institutional Economics*, although his core ideas are also found in *The Legal Foundations of Capitalism*,⁴ his autobiography *Myself*,⁵ and in *The Economics of Collective Action*.⁶ Although the relevance of his theoretical work to the labor economics is the focus of this paper, it should be kept in mind that his ideas have much wider application. The place to begin is with an explanation of what he meant by institutions, and to describe the insight that gave birth to his focus on institutions. He called institutions "collective action exercised in control, liberation, and expansion of individual action."⁷ He had learned the printing trade at thirteen years of age in a shop owned by his father, and later when a student at Oberlin in his early twenties, he took a job as a printer at the *Cleveland Herald*,

⁴ Commons, John R., *Legal Foundations of Capitalism*, MacMillan, New York, 1924.

⁵ Commons, John R., *Myself*, MacMillan, New York, 1934.

⁶ Commons, John R., *The Economics of Collective Action*, Wisconsin, 1970, first published in 1950.

⁷ Commons, John R., "Institutional Economics," *American Economic Review*, Dec.1931, p. 648.

and joined Local 53 of the Typographical Union, and there he discovered the meaning and significance of collective action. He learned his "only rights and liberties in typesetting were administered by that little society of printers."⁸ He extended the concept of an institution to organizations of all types, and coined the term going concern to describe the form taken by organized collective action, and used the term custom to describe unorganized collective action. A going concern was any group that controlled individual action, and it included a family, a union, an informal group, a corporation, a trade association, a business organizations, the Federal Reserve System, the state, and even the aggregate economy. He observed that as individuals enter into the activity of a going concern they alter their habits as they fit themselves into the pattern of the group's activity.⁹

Commons claimed orthodox economics had neglected collective action. He attributed this to the influence of Adam Smith and John Locke who established modern economics on the abundance and harmony of nature, rather than on scarcity and conflict. Commons believed that if Smith had considered scarcity and conflict his attention would have been drawn to the social need to establish harmony through institutional constraints. Smith failed to see that the mutuality he observed among men was the historic product of collective action that created mutuality out of conflict of interest. Commons had studied the origins of the common law, and concluded it was the visible hand of common law courts, and not Smith's invisible hand, that was the source of social harmony. The courts had taken over customs and enforced them. Smith substituted psychological propensities for customs and institutions. He replaced collective action with the propensity to truck, barter and exchange, the instinct of sympathy, and the sense of propriety, and his focus on these psychological propensities led him to place economics within a framework of individualism where conflict of interest among men

⁸ Commons, John R., *The Economics of Collective Action*, pp. 25-27. This story is also in *Myself*.

⁹ *Op. cit.*, *American Economic Review*," p. 649.

was absent. Commons found nothing in Smith about the need for negotiations to establish enforceable rights and duties in transactions where conflict was present, and Commons observed that this deficiency was even more pronounced in the work of Jeremy Bentham and the orthodox economists of the late 19th century. In contrast David Hume prior to the publication of *The Wealth of Nations* called attention to the fact of scarcity in the physical world, and the consequent need to find ways to resolve the conflicts of interest arising from that scarcity. In the early 19th century Robert Malthus followed Hume's lead and based his economics on scarcity, but in the subsequent development of English economics the main line of orthodox theoretical development followed Smith and not Malthus. Commons took his cue from Hume and Malthus and turned his attention to the task of finding a place within the economic thought of his era for the collective action necessary to deal with scarcity and conflict.¹⁰

In Commons' theoretical framework collective action exercised within going concerns, or as unorganized custom, is expressed as working rules that govern what the individual can, cannot, must, must not, may, or may not do. The rules thus control, liberate, and expand the actions of individuals engaged in transactions within going concerns. These transactions are for Commons the fundamental units of economic activity, and he distinguished bargaining, managerial, and rationing transactions. The outcomes of all transactions, and bargaining transactions in particular, are influenced by the fact of scarcity, by considerations of efficiency, and by concern about the future. Limiting and complementary factors in each specific environment also influence transactional outcomes, and changes in, and establishment of, working rules can be part of the outcome of transactional processes. Bargaining transactions take place between legal equals and are carried out by means of persuasion and coercion. Managerial transactions take place between leaders and subordinates and are carried out by means of

¹⁰ Commons, John R., *Institutional Economics*, Ch. V, esp. pp. 158-62.

command and obedience. Rationing transactions take place between collective superiors and individuals and are carried out by argument and pleading. In all transactions the control sought by the parties is legal control, and the relations implicit in all of them are the fact of conflict, the fact of dependence, and the need to establish order.¹¹

Economics, jurisprudence, and ethics intersect in the analysis of working rules and transactions, and correlation among them is an integral part of Commons' institutional theory. Thus, his economics is inherently normative. He pointed out that Hume also had united economics, jurisprudence, and ethics "in the principle of scarcity" and the "conflict of interests" arising from this scarcity.¹² This contrasted sharply with Smith who, because of his assumption of abundance and the consequent absence of conflict separated economics from ethics and law. Neoclassical economics followed Smith. Institutional economics followed Hume. In *Institutional Economics* Commons summed up this merging of ethics, economics, and jurisprudence.

[B]usiness ethics deal[s] with the rules of conduct arising from conflict of interests... enforced by the moral sanctions of collective opinion. Economics deals with the same rules of conduct enforced by the collective economic sanctions of gain or loss. Jurisprudence deals with the same rules enforced by the organized sanctions of physical force. Institutional economics... [incorporates]... the relative merits of these three types of sanctions.¹³

Commons stressed the fact that transactions involve person-to-person relationships. They are not simply a form of individual behavior. For this reason, the essence of a transaction is not captured by thinking of it as a simple exchange of commodities in a market, the characteristic way of thinking about transactions in the orthodox economics of his era. The shift from a focus on commodities and individuals to a focus on transactions between persons and the working rules of collective action is what marks the difference between classical and neoclassical hedonic economics on the one

¹¹ *Ibid.* pp. xxv-xxvii, and pp. 52-93.

¹² *Ibid.* p. 71, also pp. 140-144

¹³ *Ibid.*

hand, and institutional economics on the other. The classical and neoclassical economists founded their theories on the relation of man to nature. Commons focused on the relation of man to man. The smallest unit of classical economics was a commodity, produced by labor. The smallest unit of neoclassical or hedonic economics was a commodity enjoyed by the ultimate consumer. The first was the objective side, and the other the subjective side, of the same relation between the individual and nature. The outcome, in either case, was pictured in mechanical terms as the result of an automatic market equilibrating process. The smallest unit of institutional economics is a unit of activity, a transaction, and the focus is on the participants in the transaction and the way in which the conflicting wills of the participants are resolved.¹⁴

Thus, transactions intervene between the “the production of labor, of the classical economists, and the pleasures of consumption, of the hedonic economists.” Transactions are not the exchange of commodities. Since society controls access to the means of production transactions “are the alienation and acquisition, carried out in bargaining and negotiations between and among individuals, of the rights ” of property and liberty established by society. These rights must be negotiated between the parties to a transaction “before labor can produce, or consumers can consume, or commodities can be physically’ exchanged.”¹⁵

[I]n the language of ethics and law... collective acts establish rights [and] duties.... In the language of individual behavior they... require performance, avoidance, [and] forbearance.... [I]n the language of economic status... they provide..... security, conformity, liberty, and exposure... In the language of cause, effect or purpose there are the principles of scarcity, efficiency, and futurity, the working rules... the limiting and complementary factors considered [by orthodox economics]. [I]n the language of... working rules collective acts are expressed by [such words as’ can, cannot, may, may not, must, and must not].¹⁶

Bargaining transactions may be persuasive or coercive, depending on differences in

¹⁴ Commons John R., *The Legal Foundations of Capitalism*, pp. 1-10

¹⁵ *Op. cit.*, *Institutional Economics*, p. 58

¹⁶ *Op. cit.*, *American Economic Review*, pp. 649-50.

the economic, political, and moral power of the parties to the transactions. These differences are ruled out when it is assumed that every party is perfectly free, and equal to every other party. In the transactions controlled by collective action wages, profits, interest, rents, employment, unemployment, and the prosperity or poverty of the nation and its citizens are determined.

In his extensive study of the history of economics Commons discovered that in the orthodox economics of his era concepts relating to material goods were not kept sufficiently distinct from concepts relating to ownership and property rights. In classical and hedonic economics property was thought of primarily as physical property. Commons concluded that this obscured differences in the meanings of economic terms such as wealth and assets, output and income, efficiency and scarcity, and use value and scarcity value. For example, wealth was often identified with material output, and could be augmented by using inputs with greater efficiency in the engineering sense of increasing physical output per unit of input. But wealth in this material sense was not sharply distinguished from income derived from the ownership of wealth. This income was dependent on the ability ownership gave to the holder of wealth to withhold it from others. The use values of wealth considered as the accumulated output of physical goods is not affected by changes in the exchange value of these goods. Income, by contrast, depends on the exchange value received for property in goods sold by the owner. An owner can increase his income by the exercise of the right ownership gives him to withhold his property until others pay his price. Commons believed it was necessary to distinguish clearly the meaning of property in wealth as ownership for one's own use from the ability ownership gave to the owner to withhold the property from others who want it but do not have it. In other words, the proprietary meaning of wealth associated with ownership must be distinguished from the meaning of wealth as material goods.¹⁷

¹⁷ *Op. cit.*, *Institutional Economics*, Ch. V

Commons explained how United States courts in the 1870s made this distinction in a series of important legal cases. The reasoning in these cases allowed for the explicit recognition of the gradual evolution of the meaning of the institution of property from a purely physical concept to one that included incorporeal property in the form of debt, and intangible property in the form of future profits. The study of these cases was the source of Commons' notion of reasonable value, and a theory of the determination of reasonable value became for Commons the value question of institutional economics.¹⁸

Commons regarded the objective of transactional activity as the determination of reasonable values, and reasonable practices, and he was convinced that a theory of reasonable value had to be constructed out of the habits and customs of social life. He fitted the notion of reasonable value to a Malthusian concept of human nature as characteristically passionate, stupid, and ignorant. He believed these characteristics may lead men to act contrary to reason, but he also believed a considerable number of men are able to rise above the level of the least conscientious. The problem confronting institutional economics is the determination of rules of collective action that will bring reluctant individuals up to a reasonable practicable idealism. He was not sanguine about the alternatives for society if this could not be accomplished within a framework of democracy. In the United States of the 1930s he identified Communism, Fascism, and banker capitalism as the three alternatives to what he was proposing, and noted that in the experimental laboratories of Russia, Italy, and America all three were on display.¹⁹ He believed reasonable value was an attainable ethical ideal. He looked for a workable consensus, and he did not regard reasonable value as simply an intellectual concept. It was the term he gave to outcomes of collective action that control, expand, and liberate individual action. If action is sensible the result will be an improvement, but improvement was not guaranteed. Starting from the pessimism of Malthus rather than the

¹⁸ *Op. cit.*, *The Legal Foundations of Capitalism*, Ch. 2

¹⁹ *Op. cit.*, *Institutional Economics*, Ch. XI

utopian optimism of Malthus' adversary William Godwin, Commons believed there is a large amount of stupidity, passion, and mistake that can get in the way of determining the outcome of collective action. On the other hand, he described and accepted Malthus' belief that reason and moral character will be the result of a slow evolution out of overpopulation and conflict of interest. Commons believed people needed a government of law and order to regulate their conduct, and it was his hope that out of complexity and uncertainty reasonable practices and reasonable values may emerge.²⁰

Institutional economics takes transactions looking to the future as its fundamental units of analysis, and regards the man to man rather than man to nature nexus as the key element in these transactions, so it necessarily requires explicit consideration of the wills of the parties to the transactions. The core of economic activity requires a resolution of the conflicting wills of the parties on each side of all transactions. Commons believed recognition of this fact about the conflicting wills was missing from the older classical and hedonic economic analyses because they focused on the relationship between man and nature rather than man and man. Institutional economics also focuses on the purposeful nature of the relationships in which the wills of men looking to the future interact. It incorporates what he called a volitional theory of value, i.e., a theory of the will in action. It explains value by final causality, not efficient causality. The underlying psychology is a social psychology of negotiation and the transfer of ownership, with each participant trying to influence and modify the behavior of the other in determining the economic value to be transferred through the transaction. It is the psychology of business, custom, legislatures, courts, trade associations, and trade unions. It contains elements that will determine the outcome in the immediate and remote future. There are the personalities of the participants with all their differences in powers of persuasion responding to inducements and sanctions. There are the similarities and differences of

²⁰ *Op. cit.*, *Institutional Economics*, Ch. VII.

circumstances in which these personalities are placed. There is the scarcity and abundance of alternatives, and the skills in persuasion of the transacting parties, and there are the working rules and the limiting factors. The will of man acts in adapting to and controlling his environment. It is a will continuously acting. It does not choose to act or not act, but chooses between two degrees of power of acting. It chooses between actual alternatives in a world of limited opportunities. It can place a limit on its own performance. It can forbear, and it can be inhibited legally. Every transaction is a double-ended performance of avoidance and forbearance. It is not the passive will of Lockean psychology. It is not the hedonist's pleasure or pain separate from the world and forcing it to act. It is will in action, always performing, avoiding, and forbearing with a purpose, looking toward the future and overcoming resistance.

Commons' explicit recognition that transactions involve necessarily a person-to-person relationship has important implications for the study of labor economics. One of these implications is that labor market exchange cannot be described adequately as a simple exchange of the commodity labor for the money wage or for the real commodities that can be acquired with the money wage. The labor market from the perspective of institutional economics must incorporate explicitly the meeting of the wills of the parties. This is implied by the focus on the transaction as a person-to-person relationship. The mechanistic concept of the labor market as equilibrating automatically at a wage level determined by the forces of demand and supply omits explicit consideration of the conflicting human wills of individuals, operating under the collective influence of the going concerns within which they act, upon the resolution of the conflict. The smallest unit of analysis of institutional economics is a unit of activity, a transaction, and the analysis focuses on the conflict between the wills of the participants in the transaction. The transaction involves the alienation and acquisition, between individuals, of the rights of property and liberty created by society. The transactions must be negotiated between the parties concerned before labor can produce.

Institutional labor economics thus requires an analysis of the behavior of individuals while participating in transactions. Consider the question of the establishment of working rules. Mainstream economics focuses on what will best accomplish efficient resource allocation and economic growth. Institutional economics takes the position that given scarcity and conflict of interest the key question is to understand how the working rules are actually determined. In the classical economics of Smith and Ricardo as well as in the neoclassical economics of Alfred Marshall's *Principles* value theory offers an explanation of exchange value. But Commons argued that the exchange Smith, Ricardo, and their successors had uppermost in mind was the exchange of physical commodities, and the relationship focused on was between man and nature. Commons believed this focus obscured important features of what takes place when employers and workers meet in the labor market. He remedied for this deficiency in his theory of value by replacing the concept of exchange of commodities that characterized the economics of his era with the concept of the transaction. He directed his theoretical efforts at explaining what he called reasonable value defined as the outcome sought in transactions in which the wills of men meet and are resolved. His emphasis was on the activity in the transactions between men, rather than on the exchange of commodities. His value theory was a theory of the joint activity and valuations of individuals in all transactions through which the participants mutually induce each other to reach a consensus of opinion and action. In every labor market transaction explicit consideration must be given to the transfer of ownership of the commodity labor, the determination of the level of the money wage, the enforcement of the obligation to perform, and the payment of the wage. Institutional theory faces several basic questions. Where does the power to enforce the contract reside? How is the efficiency of the producing organization maintained? How are scarce resources and opportunities distributed? How is expected future performance ensured? How are working rules established and administered? These questions must be confronted in

achieving a regime of reasonable value and reasonable practices, and Commons believed they were not considered adequately in the simple model of commodity exchange applied to the labor market. Commons believed a negotiational theory and a negotiational psychology were required. The American economist Ben Seligman described Commons' fundamental view as a belief that

rational behavior was not necessarily characteristic of the mass of mankind. Stupidity and passion ruled all too often and intense conflict arose over the disposition of scarce goods..... [But, he also believed people] possessed the capacity to alter their environment and relax the normal rigidity of custom but the exercise of this capacity often result[ed] in conflict and...men [needed to] in seek ways of resolving the tensions of conflict. So collective action arose as a means of controlling individual action.... [this] interdependence and conflict of interest culminated in reasonable value... [in which] capitalism {was restructured} along reasonable lines.... Darwinism and natural science were of limited application [in understanding this process] because in economics selection was purposeful and looked to future results.....[Commons] was ensnared by the American pragmatic myth that human intelligence if only put on the right track could solve all the pressing issues at hand..²¹

Conclusions

Commons produced a theory of the development and operations of economic institutions. It complemented the orthodox theory of his era since that took the institutional structure of the economy for granted. It is not a substitute for the neoclassical economic theory of his era. Nor is it a substitute for contemporary neoclassical theory, which in many respects has moved far beyond the economics of a century ago. Many of Commons' insights into the nature of transactions are now part of the modern theory of the firm, and are integral to modern organizational theory.

²¹ Seligman, Ben B. "John R. Commons, "Transactions and Going Concerns.," Ch. 3, Part ii, *Main Currents in Modern Economics: The Revolt Against Formalism*, Volume 1, Quadrangle Books, Chicago, 1971, pp, 159-178.

Commons' institutional economics contains no comprehensive theory of the structure and operations of the market system. It contains no theory of labor supply or labor demand, and no theory explaining market interdependence. His theory has none of the strengths of neoclassical theory described in the first section of this paper. There is also in Commons no macro economic theory of growth and fluctuations. His institutional economics is best thought of as a complement to neoclassical theory.²²

Commons' theory lacks the normative aspect of neoclassical theory that enables economists to make judgments about efficient allocation. In fact, the focus of neoclassical economics on efficient resource allocation was not on Commons' plate. He viewed efficiency as an element that must be confronted in a given situation to produce the best transactional outcome, i.e., the most reasonable value. It is primarily an engineering efficiency concept relating to the connection between inputs and outputs in a physical sense, and it is considered from the perspective of the going concerns in each transactional situation, and not from the perspective of the economy in the large. The focus of Commons' work is clearly on problem solving and practice and not on building a general theory. The best solution in each instance depends on the complex set of facts and objectives in that situation. Commons' approach is clearly outside the Walrasian general equilibrium focus of contemporary economic theorizing. His conviction was the practical one that if going concerns in all or most instances of negotiated transactional outcomes can achieve reasonable values, the overall outcome in society will be the socially desirable and ethically correct aggregate outcome.

Commons' work is theoretical, but in a different sense from that in which modern economists normally think of economics as theoretical. It is theoretical in the sense that it aims at providing understanding, and at developing an analytical framework for

²² For an extensive treatment of the substitute complement question see Kaufman, Bruce E., "The institutional economics of John R. Commons: complement and substitute for neoclassical economic theory," *Socio-Economic Review*, V. 5, 2007, pp. 3–45.

theorizing in the investigation of concrete aspects of human behavior. Commons aimed at understanding the genesis of the rules developed by human interaction in the process of resolving conflicts of interest that arise in a context of scarcity. He sought to provide a theoretical understanding of the institutional structure of a market economy. It is a focus on providing a theoretical understanding of certain aspects of human behavior. One purpose of a science of human behavior is to understand why beings like ourselves act as we do. In conventional neoclassical economic theory economists seek answers to questions of what will be produced and how much will be produced, and for whom it will be produced, and what we may expect from interventions in the system of production and distribution, and all these questions are dealt with in a manner similar to questions posed in the physical sciences, but in a science of human behavior we want to go further and ask why we do things as we do. We look for values, motives, emotions, and purposes. We want to understand, as well as to classify, measure, and mechanize. Commons recognized that economics is a science of human activity, and in this sense is different from sciences that study mechanisms and organisms that are external to the investigator. His institutional economics is not scientific in the sense of how and how much, but in the volitional sense of why. Thus, Commons' work is not theoretical in the sense in which economists generally use the term theoretical. For most economists theory is only theory if it yields testable hypotheses that can be validated or falsified by empirical investigation. Commons' theory does not yield testable hypotheses. It is a theoretical framework for understanding why the practices we engage in are as they are. It yields an understanding that is necessary if we seek to evaluate the possibility of improvement in those practices or outcomes that necessarily involve the reconciliation of human wills. From the perspective of the logical positivism that undergirds standard economic theory Commons' work may be regarded at best as a weak or primitive form of theory. It may be thought of as simply a framework that isolates the factors that are important in constructing specific theories to explain what is, but it represents an

important theoretical undertaking if we think of the purpose of theory as understanding the why of things.

Commons made two important contributions to modern labor studies. The first concerns his proposition that individual persons act collectively and with purpose as members of a group expressing a group will, rather than as isolated individuals. This contrasts sharply with the methodological individualism of neoclassical economics in which all actions are explained in terms of individual utility maximization with everything affecting motivation subsumed into the individual actor's subjective utility function. The second is his rejection of the proposition that certain economic processes can be studied usefully when separated from other social and cultural influences. He believed ethical, psychological, and legal elements interpenetrate the economic and must be integrated explicitly into any useful social analysis that involve conflicts of human will. The consequence of these two contributions is that his model of the labor market is specific to the situation, e.g., to the industry or occupation. It is based on the existential pattern of the actual market being studied in contrast with the highly formal model of neoclassical economic theory. His purpose was to provide a model useful in describing specific labor markets in a way that could be useful in resolving conflict in reasonable ways. His aim was not to describe an abstract model that could be easily fitted into a comprehensive abstract highly formalized neoclassical model of the economic system.

What practical gain is realized by incorporating this less abstract, more complex, and more realistically descriptive market model into the study of labor economics? Commons' theory of the labor market meshes well with the focus of industrial relations described by John Dunlop in *Industrial Relations Systems*.²³ Dunlop was one of four prominent American labor economists who collaborated in the 1950s in the study of the labor problems of newly industrializing areas funded by the Carnegie Foundation.²⁴

²³ Dunlop, John T., *Industrial Relations Systems*, Holt-Dryden, 1958.

²⁴ Clark Kerr, John Dunlop, Frederick Harbison, and Charles Myers, *Industrialism and Industrial Man*,

Industrial Relations Systems was one of the many products of this study. A major conclusion of the Carnegie Foundation funded study was that the fundamental labor problem facing all newly industrializing nations was the structuring of the network or web of rules, both substantive and procedural, that are necessary to making the transition to modern industrial societies.²⁵ The key point was that every industrial society requires a complex structure of occupations and industries, and for this complex system to work, and especially for it to work effectively, a complex structure of rules is necessary. Structuring this web of rule was the labor problem these developing nations faced. Dunlop described the industrial relations system as a subsystem of the general social system, analytically similar to, but distinct from, other subsystems, such as the economic and political systems. The rules students of industrial relations focus on are the product of the interaction of human beings. Dunlop's conceptual framework is useful for making sense of the structure of substantive and procedural rules at the levels of the firm, the industry, and the national economy. The rules can be evaluated from the perspective of economic efficiency, but also from many other perspectives. For example, they can be evaluated from the perspective of the contribution they may make to the structuring of democratic political society. The link between Commons' *Institutional Economics* and Dunlop's *Industrial Relations Systems* is obvious. Dunlop's long career as one of the most prominent American labor economists from the mid 1930s to the close of the 20th century was devoted to resolving labor conflict and striving for consensus.²⁶

In the language of contemporary economics one of Commons' fundamental insights was that labor market transactions are incomplete. This is a central preoccupation of what is called the New Institutional Economics, which examines institutions using

Oxford University Press, 1964.

²⁵ Clark Kerr and Abraham Siegel, "The Structuring of the Labor Force in Industrial Society: New Dimensions and New Questions," in Clark Kerr, *Labor and Management in Industrial Society*, Anchor Books, 1964.

²⁶ Kaufman, Bruce E., Reflections on Six Decades in Industrial Relations: An Interview with John Dunlop, *Industrial and Labor Relations Review*, V. 55, No. 2, {Jan. 2002}, pp. 324-348.

tools of contemporary microeconomic theory, in particular, game theory and principal-agent theory.²⁷ Among other things the new institutional economics is concerned with linking the firm to the labor market. It involves a new theory of the firm to understand how firms deal with problems of co-ordination, incentives, and bargaining. Employment is an intra firm phenomenon and not simply a relationship understood by market exchange. The point focused on is that labor contracts are incomplete, and transactions costs arise because of the incompleteness of these contracts, and a governance structure is needed to fill contractual gaps. The informational requirements of traditional competitive markets may not be met because of informational asymmetries at the time a contract is made (adverse selection) or may arise after a contract is made and begins (moral hazard). There also may be problems that arise over time as employees become specialized to the relationship (asset specificity). From the perspective of standard economic theory there is a gap in the work of the new institutional economics regarding judgments of economic efficiency, i.e., about the whether the ways in which the issues connected with incomplete contracts are dealt with are Pareto efficient. Commons' institutional economics ignored the question of whether what is worked out in a given instance is Pareto efficient. New institutional economists confronted with the Pareto efficiency question may assume that the employment practices that are developed are efficient, but they really do not know whether this is true. Institutional economists working in the Commons tradition did not think of maximizing the size of the economic pie in the Pareto sense. Their theoretical roots were in Malthus and they may have simply assumed that men are not rational actors.

Finally, it is important to note that for those in the Commons tradition work was viewed differently than it was in the orthodox economics of Commons' era. The purpose

²⁷ Gregory K. Dow, "The New Institutional Economics and Employment Regulation," in Bruce E. Kaufman, Ed., *Government Regulation of the Employment Relationship*, Industrial Relations Research Association, 1997, pp. 57-90.

of economic activity was not simply the maximization of consumer satisfaction. Work was viewed ideally as a means to facilitate each person's quest for self-improvement and self-realization, reminiscent of Pope John Paul II's encyclical letter on human work,²⁸ in which he explained that labor had a subjective importance in the life of the worker, and was not valued simply for its objective value as a productive input. Work instead of being viewed as something that had only negative utility was viewed as an opportunity for self-development and self-realization. Work was not just a commodity input valued by its output, but an activity of human beings whose welfare as producers is important, and from this perspective competitive market outcomes may not be optimal. In addition the security of one's person and livelihood was important to self-development and to human cooperation and flourishing. In many ways laissez-faire might be detrimental to human self-development and self-realization.²⁹

Boston College.
June 2010

Works read in preparation of this paper

Commons, John R., "American Shoemakers, 1648-1895 A Sketch of Industrial Evolution," *Quarterly Journal of Economics*, V. 24, Nov 1909, pp. 39-83.

Commons, John R. *Legal Foundations of Capitalism*, MacMillan, New York, 1924, pp. 1-394.

Commons, John R., "Institutional Economics." *American Economic Review* V. 21, No. 4, Dec. 1931, pp. 648-657.

Commons, John R., *Myself*, MacMillan, New York, 1934, pp. 1-200.

Commons, John R., and Associates, *History of Labor in the United States*, MacMillan, New York, 1918 and 1935.

²⁸John Paul II, *Laborem Exercens*

²⁹ For an extensive discussion of the content of this paragraph see Kaufman, Bruce E., "Labor Markets and Employment Regulation: The View of the Old' Institutionalists," in *Government Regulation of the Employment Relationship*, Industrial Relations Research Association Series, Kaufman, Bruce, editor, 1997, pp. 11-55

Commons, John R., *The Economics of Collective Action*, edited by Kenneth Parsons, and with a Biographical Sketch by Selig Perlman, The University of Wisconsin Press, Madison, Milwaukee, and London, 1970, first published in 1950.

Commons, John R., *Institutional Economics: Its Place in Political Economy*, V. 1 with a New Introduction by Malcolm Rutherford, Transaction Publishers, New Brunswick and London, 1990, pp. 1-648, original publisher Macmillan, New York, 1934.

Commons, John R., *Institutional Economics: Its Place in Political Economy*, V. 2 with a New Introduction by Malcolm Rutherford, Transaction Publishers, New Brunswick and London, 1990, pp. 649-922, original publisher Macmillan, New York, 1934.

Dorfman, Joseph, "John R. Commons," *International Encyclopedia of the Social Sciences*, V. 3, Collier-Macmillan, pp. 22-23.

Dow, Gregory K., "The New Institutional Economics and Employment Regulation," in *Government Regulation of the Employment Relationship*, Industrial Relations Research Association Series, Kaufman, Bruce, editor, 1997, pp. 57-90.

Dunlop, John T., *Industrial Relations Systems*, Holt-Dryden, 1959.

John Paul II, *Laborem Exercens*, 1981.

Kaufman, Bruce E., "Labor Markets and Employment Regulation: The View of the 'Old' Institutionalists," in *Government Regulation of the Employment Relationship*, Industrial Relations Research Association Series, Kaufman, Bruce, editor, 1997, pp. 11-55.

Kaufman, Bruce E., "John R. Commons on Industrial Relations Strategy and Policy," *Industrial and Labor Relations Review*, V. 7, No. 1, October 2003.

Kaufman, Bruce E., "The institutional economics of John R. Commons: complement and substitute for neoclassical economic theory," *Socio-Economic Review*, V. 5, 2007, pp. 3-45.

Kaufman, Bruce E., "The organization of economic activity: insights from the institutional theory of John R. Commons," *Journal of Economic Behavior & Organization*, V. 52, 2003, pp. 71-96.

Kaufman, Bruce E., Reflections on Six Decades in Industrial Relations: An Interview with John Dunlop, *Industrial and Labor Relations Review*, V. 55, No. 2, {Jan. 2002}, pp. 324-348.

Kerr, Clark, John Dunlop, Frederick Harbison, and Charles Myers, *Industrialism and Industrial Man*, Oxford University Press, 1964.

Kerr, Clark and Abraham Siegel, "The Structuring of the Labor Force in Industrial Society: New Dimensions and New Questions," in Clark Kerr, *Labor and Management in Industrial Society*, Anchor Books, 1964.

Knight, Frank H., "Review of John R. Commons' Institutional Economics," *Columbia Law Review*, May 1935, pp. 603-805.

Mitchell, Wesley C., "Commons on the Legal Foundations of Capitalism" *American Economic Review*, Vol. 14, No. 2, Jun., 1924, pp. 240-253.

Mitchell, Wesley C., "Commons on Institutional Economics," *American Economic Review*, 1935.

Parsons, Kenneth H., "John R. Commons' Point of View," *Journal of Land and Public Utility Economics*, August 1942, pp. 245-266.

Ramstad, Yngve, "Commons' Institutional Economics: A Foundation for Industrial Relations Theory," *Industrial Relations Research Association Proceedings*, January, 1998, pp. 308-319.

Rutherford, Malcolm. "Wisconsin Institutionalism: John R. Commons and his Students." unpublished, April, 2005, pp. 1-53.

Seligman, Ben B. "John R. Commons, "Transactions and Going Concerns.," Ch. 3, Part ii, *Main Currents in Modern Economics: The Revolt Against Formalism*, Volume 1, Quadrangle Books, Chicago, 1971, pp. 159-178.