A Tale of Two Cities: *A Priori* Assumptions and *A Priori* Conclusions

Abridged Version

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A. Ariadne's Thread: Camouflaging A Priori Conclusions by Means of Deductive Reasoning

> It is always necessary to begin somewhere, but where one begins can have great influence on where one ends up (Jacob Viner quoted in Van Horn 2011: 291ftn.41).

Despite some attempts, notably by Ronald Coase (1995), the marketplace for ideas has remained largely an unexplored country. If, as Coase does, you start by treating this market like any other competitive market then it must be composed of numbers of sellers of economic ideas trying to convince potential buyers, members of the profession, to accept these varied creations. In this model competition over the long term will select out the best of the wares that are marketed. Coase approvingly quotes Edwin Canaan:

> However lucky Error may be for a time, Truth keeps the bank and wins in the long run (Edwin Cannan 1894: 392).

Akin to evolutionary theory, what survives and flourishes is that which is most closely attuned to the prevailing environment. Markets under the most optimistic conditions deliver what consumers want, or are convinced they want. They don't pretend to deliver some sort of ideal good. In the same sense a market for economic ideas can't be expected, as a market, to deliver truth unless we are willing to assert that economist that economists have infallible methods for recognizing truth and that this is their goal. I we instead start with the view of markets formulated by Stigler and Becker (1976) then the focus settles on marketing, trying to persuade potential buyers that what is on offer will satisfy their perceived needs and desires.

> You've got to sell what you are doing. It may be that in the long run good ideas do surface but they surface faster, if written in a persuasive fashion. Moreover, bad ideas may be put persuasively. And they may gain the necessary threshold. However, taking that same analogy in competition among ideas, there is a presumption, although not a certainty, that in the longer run, the good ideas are going to compete out the bad ideas. But that may take a long time and may not even always operate. There's nothing necessary about that. (Gary Becker conversation with Craig Freedman, October 1997).

If Cannan is largely correct then current issues like conflicts of interest and ideological motivations are no more than trivial distractions. In the long run only true theories will survive. In which case, bogus or dubious origins would simply not matter. An appropriate case in point is the often unacknowledged practice of choosing starting assumption in order to achieve a desired result.

> It seems to me that when you get to his (Stigler's) later work, say with Becker, you know what the conclusion is going to be before you start the argument. In a sense, you're assembling arguments to support a conclusion. I mean, that may be unkind and untrue, but it's an impression. And, it's even more so in the work of Richard Posner. Have you read any of that? It seems to me that the plot is always the same, and the characters stay fixed (Conversation with Ronald Coase, October 1997).

Two thought provoking papers both analyze exactly the same subject but reach diametrically opposite conclusions by starting from assumptions that strangely mirror and contradict each other. Each paper is in turn driven by different ideological positions.

> He [George Stigler] was interested, I would say primarily, in a particular sort of puzzle and it's a typical Chicago puzzle. And I don't mean that in any bad way, it's the sort of puzzle that the Chicago School's presuppositions require. Show me an apparent anomaly, something that does not seem to be explicable using the Smithian apparatus and the Marshallian apparatus and I will show you that it can be explained that way. That was exactly the sort of thing that George went

looking for. And that's not a bad thing. I'd have to say that it can actually be very good (Conversation with Robert Solow, November 1997).

B. The Zen of Tuna: A Shopkeeper's World View

My personal view is that if someone holds a view it cannot be dislodged by any conceivable empirical data. Evidence from a data system doesn't convince them. These people have made their decisions already. They've become true believers and no amount of empirical evidence will ever convince them by definition (James Kindahl conversation with Craig Freedman, November 1997).

Both articles examined share some surprisingly common elements and points of agreements. Each intends to analyse the labor market as a means to ultimately evaluate capitalist firms. In each case the central players, employers and employees respond to market incentives, namely relative prices. We can easily pinpoint a key price distortion identified by the respective authors. The nature of the distortion is what dramatically separates the two papers, divided by an unbridgeable gulf. However, in neither exposition is there any resort to opportunism as a motive, or creator, of incentives. Every economic player performs honestly within the role allocated bereft of any desire to mislead. For their part, Alchian and Demsetz almost become obsessive in their insistence that the employer/employee relationship isn't defined by power but is rather a market exchange between equals. Without this assumption it will turn out that their core argument starts to crumble. So it is no surprise that they emphasize this balance in the labor market not only at the beginning of the article but then dredge it up toward the halfway mark only to make one last repetition as they conclude. Alchian and Demsetz' ploy is to make the opportunity cost of switching near zero for both employer and employee. Implicitly we are operating in a world where the transaction costs associated with labor market operations have for practical purposes nearly vanished. Without explicitly specifying the circumstances, Alchian and Demsetz have forcibly located their readers in an environment where markets can perform in an optimal fashion.

Before delving into the fundamental conflict that almost spontaneously leads to the development of a capitalist firm, we need to establish what is driving each one of those employees when entering into a contractual arrangement. In economic terms then it is crucial to grasp the exact choice each worker faces and how he or she maneuvers to maximize the utility to be gained from working. Given this mind-set, shirking for Alchian and Demsetz is not symbolic of any degree of laziness, dishonesty or irresponsibility, but rather exists as an expected (and fair) response to a set of distorted price signals.[1] In standard labor market analysis, workers as mentioned adjust the work they do according to the opportunity cost of enjoying leisure. More formally, they set their individual marginal rate of substitution of leisure for consumption to the prevailing market wage offered.[2]
Mathematically:
$(\partial U/\partial H)/(\partial U/\partial C) = w$
Where
U = utility; H = leisure; C = consumption and w = wage

However, a competitive wage must in equilibrium be equal to the value of the marginal product produced by labor; $w = MP_L$. From this we can conclude, in the absence of any external price distortion, workers will put in a level of effort up to the point where their marginal rate of substitution of leisure for consumption is equal to the value of the marginal product produced by their labor. (Notice that in both articles this represents a fair repayment for labor. The worker is repaid the value of his or her output.) Departures from this relative price or opportunity cost of leisure will lead to either more or less effort being expended. By making the opportunity cost

[1] The simple rule of thumb is that it is foolish to blame individuals for responding correctly to a given set of price signals. (If workers were given to ignoring the relevant opportunity cost of leisure, economists would be compelled to classify them as irrational and thus outside the analysis offered by the discipline.) The issue is whether or not such signals are in fact distorted.
[2] Labor itself produces only disutility. The advantage of working lies in the income earned which can be easily transformed in consumption. The act of consumption is assumed to be the source of utility enjoyed rather than the income itself.

of leisure cheaper, maximizing workers will have no acceptable alternative other than to expend less effort by consuming more leisure. Alchian and Demsetz label this condition as ‘shirking’. In direct contrast, by raising this opportunity cost higher than the undistorted level, workers will optimize by expending more effort than they would otherwise choose to commit.

The virtual abyss dividing these two papers will ultimately depend upon establishing whether firms distort or correct the relative opportunity cost of leisure. Making such an assignation must then determine whether these capitalist firms are the heroes or villains of the stories told. Having universalized labor contracts as being no different from any other market exchange, Alchian and Demsetz are then obligated to explain the derivation and existence of firms as a clearly superior institutional structure, one that corrects a price distortion. What they must demonstrate is the way in which an assumption of equal exchange between employer and employee leads to the required correction instituted by the capitalist firm. In this transition, property rights, particularly private property rights, provides the underlying linchpin of the model presented. The distinguishing characteristic chosen to accomplish this objective is what they define as the ‘centralized contractual agent’.

> Wherein then is the relationship between a grocer and his employee different from that between a grocer and his customers? It is in a *team* use of inputs and a centralized position of some party in the contractual arrangements of *all* other inputs. It is the *centralized contractual agent in a team production process* – not some superior authoritarian directive or disciplinary power (Alchian and Demsetz 1972: 777-78).

A team of workers must cooperate to produce a given output. Property rights of any production are owned collectively by the given team. Without any way of properly measuring individual contribution, returns are simply divided equally between the given team members. This essentially generates the moral hazard problem whereby individual partners of this given enterprise fail to meet their implied obligation. However, this failure simply stems from the inevitable under-pricing of leisure time (in this case time spent slacking off). If individual effort could be accurately measured, then team members would put in a level of effort up to the point where their marginal rate of substitution of leisure for consumption is equal to the value of the marginal product resulting from their labor. However, because of the prevailing property rights, any drop in output due to a measure of slacking off will be borne by each and every member of the team. But, the utility gained from this slacking off will be enjoyed just by the individual who decides to reduce his or her effort. With the opportunity cost of procuring additional leisure under-priced, a team member will rationally respond by consuming extra leisure. With each member acting accordingly, output will fall considerably. As a result, collective property rights are inherently inefficient under a wide range of circumstances. Team members themselves are assumed to view the situation as unsatisfactory and inequitable.

> One method of reducing shirking is for someone to specialize as a monitor to check the input performance of team members. But who will monitor the monitor? One constraint on the monitor is the aforesaid market competition offered by other monitors, but for reasons already given, that is not perfectly effective. Another constraint can be imposed on the monitor: give him title to the net earnings of the team, not of payments to other inputs (Alchian and Demsetz 1972: 781-782).

The logic is simple but more subtle than it would appear. A team must shift from being defined by collective property rights to private property rights. Someone must serve as a monitor to observe each member’s individual accomplishments. The monitor in turn must be provided with a sufficient incentive to perform effectively. This involves assigning certain property rights to that self-selected individual.

> It is this entire bundle of rights: 1) to be a residual claimant; 2) to observe input behaviour; 3) to be the central party common to all contracts with inputs; 4) to alter the membership of the team; and 5) to sell these rights, that defines the *ownership* (or the employer) of the *classical* (capitalist, free-enterprise) firm (Alchian and Demsetz 1972, 783).

Given a world where switching costs are either zero or negligible, a sorting process will precede in such a way that teams will rearrange themselves until each one has the optimal mix of members producing a cost efficient level of output. Opportunistic behaviour rapidly dwindles given the change in incentives. With leisure no longer undervalued, workers lack any reason to indulge in excess consumption of that particular good. The firm then in the form of private property corrects the inherent price distortions produced by the original presence of collective property rights. Since all are rewarded according to their results, each worker is allowed to put in the degree of effort that would produce a desired level of reward. The system is without question equitable since each individual only seeks to be paid for his or her actual contribution. The conclusion then is that not only does the firm by correcting the pre-existing price distortion create a world of efficient production, but also manages to achieve an equitable result as well.

At the conclusion of the article they allow themselves to indulge in what might appears as a bit of whimsical speculation, but on consideration does have much deeper implications. The firm has appeared in the guise of a private market. Individuals pursue accurate information in such a market because they are fully rewarded for any such efforts. The fruits of these endeavours need not be shared with others as may often be the case on public markets. Therefore the superiority of the firm over the market may lie in the fact that in one case, information remains private property, while in the other such information must be shared.

> We conclude with a highly conjectural but possibly significant interpretation. As a consequence of the flow of information to the central party (employer), the firm takes on the characteristic of an efficient market in that information about the productive characteristics of a large set of specific inputs is now more cheaply available. Better recombinations or new uses of resources can be more efficiently ascertained than by the conventional search through the general market. In this sense inputs compete with each other within and via a firm rather than solely across markets as conventionally conceived. … Could it be that the market suffers from the defects of communal property rights in organizing and influencing uses of valuable resources? (Alchian and Demsetz 1972: 794-795).

For Sam Bowles, the key to denouncing capitalism, specifically when the system is encapsulated by the privately owned firm, is to demonstrate conclusively that leisure, when viewed correctly, is in practice deliberately overpriced under a regime of private property. Under this very same property regime, firms shift from being the saviours in the world constructed by Alchian and Demsetz to being something approximating the villains of classic melodrama. The cleverness of Bowles' (1985) constructed universe lies in how he manages to plot his course so as to reach his designated destination. Given the contrasting agendas of these authors, the revelation of diametrically opposed assumptions should come as no surprise. Remember that it was the imposition of collective property rights which generated the persistent moral hazard problem for Alchian and Demsetz. For Bowles, it is the institution of private property, the foundation of the capitalist firm, that generates similar problems. This property relation creates two categories that together compose any given firm, namely owner-managers (employers) and workers (employees). Such an arrangement must inevitably create a principal/agent problem. Namely without a shared objective, conflicts of interest will repeatedly occur. For Bowles, as was the case for Alchian and Demsetz, workers seek to maximize their utility according to the marginal conditions previously described. These conditions provide one of the building blocks of any microeconomic analysis of the labor market. Unfortunately there is no reason to expect that the utility maximizing effort desired by workers will coincide with the equivalent profit maximizing level demanded by the corresponding owners. The only constraint, from the viewpoint of employers, limiting these demands for increased effort which aim at producing more profits, is simply the cost of obtaining that extra effort. Only a surprising and rather random piece of good fortune would identify that sought after utility maximizing level of effort with an intensity which simultaneously maximizes profit. This irreducible conflict then is based on the institution of private property. Logically and in practice, ownership produces an undeniable power relationship.[3] Labor is hired to maximize profit in this analysis, not for the purposes of maximizing the welfare of the labor so employed.

> The distinctiveness of the Marxian microeconomics with respect to the neo-Hobbesian and Walrasian approaches, as we shall see, has little to do with the labor theory of value, however. Its primary focus

[3] The insistence by Alchian and Demsetz that no power relationship can exist between employer and employee is matched in intensity by Bowles assertion of the opposite.

is on the interactions between the voluntary relations of the marketplace and the command relationships of the workplace. Thus Marxian economists take strenuous exception to Paul Samuelson's assertion that "in the competitive model it makes no difference whether capital hires labor or the other way around (Bowles 1985:17-18).[4]

The lack of any serious opportunity cost to losing one's job rendered the employment contracts representative of the Alchian-Demsetz world as being devoid of any attendant power relations. However, if losing current employment represents a definite loss of income, for either a short or extended period, as in the case in the world constructed by Bowles, contractual relations must change. Transforming unemployment into a reality creates a world driven by fear. Workers are now forced to produce additional effort as now the cost of being discovered slacking off becomes increasingly serious. At this point, Bowles is obligated to explain the way in which unemployment is created as well as the method for discovering whether a worker is attempting to avoid putting in the required level of effort. (Doing so essentially explains the way in which employers artificially inflate the price of leisure for their employees.) Wages that are set above the market clearing level must create an excess supply of available and willing labor. The higher the wage, the larger the pool of unemployed workers will be, thus raising the cost of job loss. Workers will then exert greater effort since the price of leisure rises with every increase in the level of involuntary unemployment. This single factor is however insufficient. A potential loss is not an effective threat unless there is the possibility of being observed putting in less than the required level of effort. This necessity brings in the second factor of production, namely the surveillance that will yield the requisite information on work performance. Thus the more monitoring of this sort performed (by investing in equipment and surveillance staff) the greater the possibility that if a worker attempts to slack off, that worker will be discovered not fulfilling his or her contractual duty. Thus any combination of surveillance allied with a given cost of job loss will increase the cost of leisure and in as a result produce greater effort. In this way the relative price of leisure is distorted to produce higher profits for the employer.

The train of logic in Bowles' model becomes inescapable at this point and very familiar to anyone conversant with second year microeconomics. Different combinations of surveillance and cost of job loss will yield the same work effort. A lesser possibility of being observed slacking can be counterbalanced by a greater cost of job loss and vice versa. This line of thought enables the theorist to construct isowork (isoquant equivalent) curves as well as combinations that will attract the same cost for the employer (isocost curves). To maximize profit, no matter how much labor will ultimately be needed, the employer needs to produce that given level at the minimum cost possible. Lining up all minimum cost combinations for every level of labor effort produces the familiar expansion path that torments every undergraduate student. Bowles produces a simple graphical representation (figure 1.) to serve as a compelling visual aid. Remember that his objective, as stated initially at the beginning of the article, is to provide a rigorous condemnation of capitalist firms based on private property. The constructed figure is meant to offer substantiation for his claim.

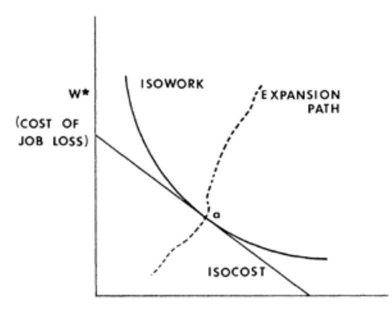

Figure 1. (Bowles 1985:28)

[4] Both articles assume competitive markets, so the opposing viewpoints are never confounded by the distractions produced by market imperfections. The difference lies in whether or not labor markets are based on an intrinsic conflict of interest or not.

Bowles has essentially already assumed the basic injustice of labor relations under the sway of the capitalist firm. The fundamental conflict of interest must mean that owners prosper at the expense of their employees. Forcing them to put in more effort than would maximize their utility defines a world of inequity. Prevailing property relations yield an environment where workers are squeezed so that capitalists may profit. Where his cleverness shines is by demonstrating the implications of a model built on conflict. Namely, not only are the property relations that provide the foundation of such firms inequitable, but they are also inefficient. To manage this logical twist, Bowles must focus on the idea of technical efficiency, namely producing any given output using the least amount of scarce inputs. The graphic model above clearly demonstrates that capitalist firms sacrifice efficiency for profit. Thus due to the primacy of private property rights, a capitalist economy fails to reach its productive capacity. As Figure 1 reveals, given the costs of spending another dollar by increasing surveillance inputs, or spending another dollar to increase the cost of job loss by increasing wages, a capitalist owner will seek to minimize the cost of producing any level of work effort by choosing point ‘a’ on the figure above. Bowles now strikes by claiming that though cost efficient, such a choice is not technically efficient.

Bowles presents a perfect mirror image of the model so carefully constructed by Alchian and Demsetz. For those two economists, collective property ownership distorts the relative prices of labor and leisure. Establishing private property rights (and thus establishing a private market place) corrects this distortion and yields an environment where both employers and employees are free to choose. The result is an economy that is both efficient and equitable. Monitoring is done to gather information, not to exert control since under private property arrangements the labor contract does not embody any conflict of interest. Given their beginning, Alchian and Demsetz can only arrive at this desired conclusion. For Bowles however, private property rights are the nub of the problem by creating an inherent conflict of interest that distorts the relative prices of labor and leisure. The result is a system that is neither equitable nor efficient. Institutional change, shifting to collective property rights, could correct the relative price distortion and yield improved results both in a technical and just manner. What is striking and perhaps tips the hand of the respective authors are the inevitable policy implications. If labor markets largely reflect the conditions constructed by Alchian and Demsetz, any government intervention into the bargaining process could only lead to regrettable results. Constructing arguments in reverse, making the appropriate assumptions to reach desired results, can be dismissed as yet another effective form of rhetoric. Selling logically tight arguments is the essence of effective marketing. Or from a slightly different perspective, both papers are producing the strongest cases possible and allowing the market place for ideas to adjudicate the optimal resolution of these conflicting visions. There is, unfortunately, a less sanguine way to look at the dilemma posed by these two papers. They merely provide ammunition for those with a priori positions, failing to cause any serious reconsideration due to the partisan nature of their contrived initial assumptions.

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