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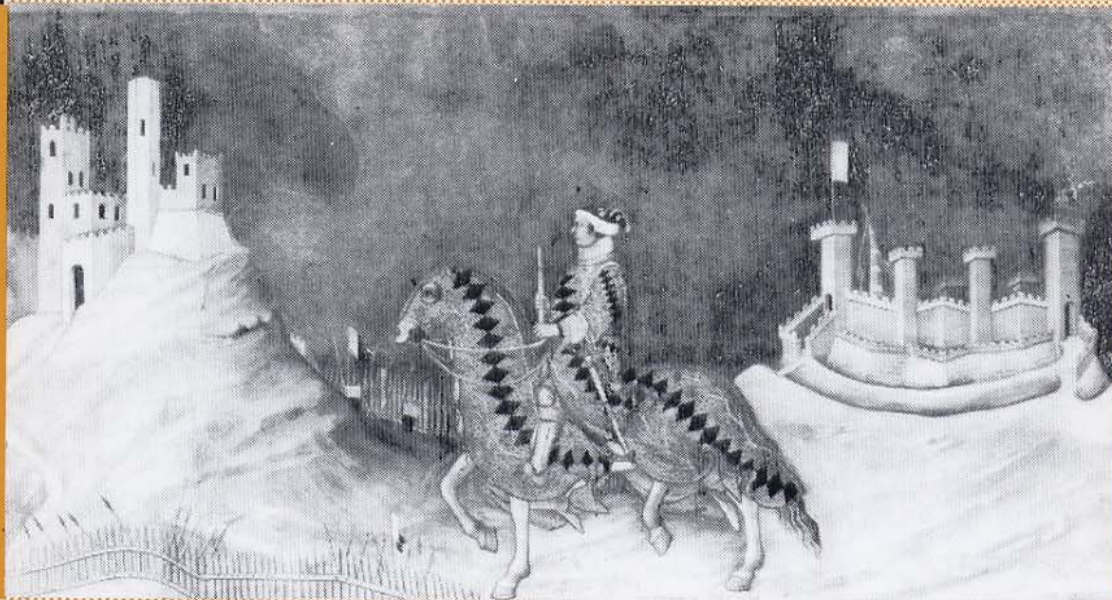


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Minimum Wage, Public Employment Offices and
Unemployment Compensation: John R. Commons's View

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Abstract - In accordance with the concept of transaction as introduced by John R. Commons we will investigate the contractual and market remedies which labour law may implement to make 'order' in the employer-employee relationship.

In this view, one of the most important contractual remedies is the minimum wage. It demarks an inalienable default point under which wage bargaining can not drop. Unlike, employability represents the most important concept in order to take into explicit account market dynamics. In this respect, employment compensation and public employment offices, involving parties' outside options, are widely treated.

Lastly, we will prove that these two kinds of legal intervention (contract and market regarding) are derived from Commons distinction between liberty and freedom.

JEL Classification: B25, B52, J38, J65, K31.

Keywords: John R. Commons, employability, labour law and economics.

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1. Introduction

Commons' (1924, 1931, 1934, 1950) notion of *transaction* is one of the most important contributions of Institutionalism¹. Accordingly, the transaction is composed of at least five parties: an agent, its competitor, its counterparty, its alternative counterparty and a fifth agent acting as public authority or jural enforcer². In other words, two buyers, two sellers and the judge are the basic elements in Commons' transaction. Therefore, in a transaction, each person ought to consider

“the alternatives open to himself, the existence of actual, potential, possible or impossible rivals, and the degree of power which he can exert within the limits of these alternatives [...] A transaction, then, involving a minimum of five persons, and not an isolated individual, nor even only two individuals, is the ultimate unit of economics, ethics and law. It is the ultimate but complex relationship, the social electrolysis, that makes possible the choice of opportunities, the exercise of power and the association of men into families, clans, nations, business, unions and other going concerns. The social unit is not an individual seeking his own pleasure: it is five individuals doing something to each other within the limits of working rules laid down by those who determine how disputes shall be decided”.

Commons, 1924:67-69

In this way individual actions are really *trans*-actions rather than individual behaviours or exchanges of commodities (Commons, 1931:652).

Despite John R. Commons is considered one of the most important authors of the Old Institutionalism, the more recent literature on contractual

¹ As Williamson (1985) recognizes, J. R. Commons was the first modern economist who defined a transaction as the minimal unit of analysis for institutional economics.

² Which guarantees a perfect fit between the entitlements of the different agents (see Pagano, 2002); see also (Bromley, 2006).

incompleteness, deriving from the New Institutional Economics (hereinafter NIE), dispenses many implications of the Commonsian notion of transaction (Nicita and Vatterio 2007a; 2007b). The limits of NIE's theories of transactions and organizations mainly stem from the exclusive focus placed by NIE's economists on bilateral bargaining and from the implicit assumption of considering relevant markets as if they are always in equilibrium, with parties' exogenous outside options – at least during the period covered by parties' contractual relationship. In particular, Coase (1937, 1960), Williamson (1985) and GHM³ seem to neglect the role played by third parties' externalities on contractual enforcement. A transaction is mainly deemed as a bilateral transaction (between, say, a buyer and a seller) which needs, in order to be carried out, an appropriate enforcement structure when contracts are incomplete and assets are specific to some extent.

This assumption is clear in Coase's (1960) famous Rancher-Farmer example. The problem of an externality between the Rancher and the Farmer does not affect at all any other Rancher-Farmer relationship. Moreover, parties take prices in the market as given and external effects between them do not change the market price. The reason for that is the implicit assumption according to which, outside the specific relationship under investigation, the remaining world is characterized by perfect competition and, consequently, it is not possible for economic agents to influence other agent's behaviour as well as the market price.

Following Coase's perspective, most of the theories on incomplete contracts are generally based on the assumption that agents' outside options (i.e. the degree of market competition) are exogenously given⁴. Indeed, Williamson (1985) has confined his analysis to the case of a 'fundamental transformation', for which an ex-ante competitive transaction is ex-post transformed into a monopolistic one.

In GHM, the level of ex-ante parties' outside options acts as a default point in the ex-ante contracting and as a threat point in the ex-post bargaining over the joint surplus.

³ Grossman and Hart (1986), Hart and Moore (1990), and Hart (1995).

⁴ Only some recent papers are explicitly concerned with investment decisions in a market environment, as K. Chatterjee and Y. S. Chiu (1999) and de Meza and Lockwood (1998).

In both cases, according to the related literature, outside options are never affected by the investments made by parties. In other words, investment decisions are affected by the ex-ante market configuration, but they do not affect each agent's ex-post competitors. The 'market' is implicitly supposed to be an *equilibrium market* and hence for contractual parties it is not possible to affect (and to be affected by) competitors' strategies. Thus, in most of these analyses, 'fundamental transformation' acts only in one way: from market exchange to bilateral monopoly, whereas the opposite direction of causality is almost neglected.

The main consequence of this approach is that of ideally reducing the complex interactions among the several institutional domains exclusively to the voluntarily private orderings arrangements set by the parties in a bilateral contract. This partial equilibrium analysis, which is at the heart⁵ of the NIE, has had the merit of underlining the emergence of private orderings in the governance of incomplete contracts, as well as the role of vertical and horizontal integration and the optimal allocation of property rights in minimizing enforcement costs.

However, one of the major weaknesses of this approach has been that of neglecting a fundamental interdependence that could occur between the contract and the level of competition, at least in those institutional settings in which, contrary to the perfect competition ideal-type, parties may influence the emergence and the structuring of market equilibria.

Referring to a 'transaction *à la* Commons, we can shift from the traditional paradigm of bilateral transaction as the unit of analysis towards a more complex notion of transaction in which market dynamics (which we will analyze by the notion of employability) are explicitly taken into account (Nicita and Vatterio, 2007b).

We will use this theoretical approach denoting as seller(s) (of spare time) the worker(s) and as buyer(s) the employer(s). In such a transaction, we will investigate the contractual dynamics between one seller and her counterparty (namely, one buyer), and we distinguish them from the market dynamics deriving from taking into account *potential buyers* and *potential sellers*.

⁵ In this respect, Williamson (1997:3) argues that the Coase Theorem is in essence a partial equilibrium analysis.

In our opinion, such transaction should be applied to any study concerning employee-employer relationship.

2. Improving employment and ‘employability’

For the time being, let’s start from two aspects of the concept of liberty as showed by Sen (1992; 2002).

The first aspect of liberty is concerned with the possibility to achieve, rather than with the process through which that achievement comes about: in this meaning, “more freedom gives us more *opportunity* to achieve those things that we value, and have reason to value” (Sen, 2002:585). The second one concerns the process through which those things happen. In this second meaning, for example, “the procedure of free decision by the person himself (no matter how successful the person is in getting what he would like to achieve) is an important requirement of freedom” (Sen, 2002:585).

Thus, process is concerned with what we manage to accomplish while opportunity with the real alternatives that we have to accomplish what we value (Sen, 1992).

However, as Sen notes, the recognition of this distinction does not rule out the existence of overlaps between the two aspects. For example,

“if a person values achieving something through free choice (and not through the end-product being delivered to him by someone else), or through a fair process (for example, wanting to “win and election fairly”, rather than just achieving a “win” – no matter how), then the process aspect of freedom will have a direct bearing on the opportunity aspect, as well”.

Sen, 2002:586

Therefore, “[i]n making a distinction between two aspects of freedom, there is no presumption that these are disjoint concerns, with no interdependence” (Sen, 2002:586).

Indeed, we can draw a circular causation trajectory between opportunities and procedures.

Commons (1924:111) offers the same distinction. Liberty is the absence of

restraints, while freedom is participation in government. In this respect, liberty is the negative removal of outside *compulsions*, while freedom is positive provision of accessible *alternatives*. Then, these produce two different results; if the slave is given the ‘liberty’ it signifies merely a negative limit on the former right to the master. But it does not determine the ex-slave’s positive participation in all the possible transactions necessary to exercise his liberty. In other words, he could not gain the freedom of choice needed to complete his liberty. “In place of his former obedience to commands he gains only choiceless alternatives, and may be coerced to return to his master” (Commons, 1924:120).

We can illustrate this distinction by a game-theoretical framework. Senian liberty of opportunities or Commonsian freedom represents the type and number of counterparties versus which one agent could ‘play’. Instead, Senian liberty of process or Commonsian liberty defines the rules of each game, i.e. the strategy set and the payoff function.

In other words, in a Commonsian transaction Senian liberty of process or Commonsian liberty concerns the legal relationship between one seller and her buyer. Namely, given a bilateral relationship, in which modes this relationship is legally ruled. In our work, we will focus on inalienable norms⁶ which set *minima*. For minima we mean the regulation of individual employment relationship by setting minimum wages, maximum working hours, basic health and safety standards, and so forth. It is normal for these tools to take the form of a “floor of rights” or set of minimum provisions on which other conventional sources of terms and conditions can improve, but from which they may not deviate from, except under prescribed conditions (Wedderburn, 1992). Among minima we study minimum wage.

Instead, Senian liberty of opportunities or Commonsian freedom concerns the legal relationship between one seller and her alternative buyers. Namely, when opportunity costs are positive, what is the amount of switching costs? For our purposes, it regards the ability of an economic system to provide workers with exit (and entry) options (namely outside options), in order to allow them to switch from one labour relationship to another one. Consistently, Commons defines employability as the possibility of men (or women), who are willing and able to work, to find employment (Commons

⁶ As argued by Del Punta (2002) and Ichino (2004) the relation between Labour Law and Economics can be the opportunity for a reappraisal of unalienable labour law provisions.

and Andrews, 1936). This implies that an improving of employability determines an increasing of outside options.

Thus, in order to balance⁷ the employee-employer relationship labour law can act in two ways. On one hand it may extend the worker's set of alternatives, namely improving employability. On the other hand, it may establish a more 'fair' set of rules for surplus sharing (namely, improving employment)⁸.

3. Minimum wage

Minimum wage can be defined with words as 'the living wage' or 'the necessary cost of proper living'. These words may seem evanescent but there are many commonly used indexes (i.e. on poverty, level of education, etc.) that can be combined in order to establish a good proxy of the cost of a normal living.

In this respect, many elements should be considered in order to reach an adequate minimum wage.

The first, denominated *wage loss from unemployment*, refers to

“[w]hether or not a worker can secure steady employment in a given industry is the factor which determines whether the “living wage” prescribed in an award provides a “living income” throughout the year. Many low-paid industries whose wages rates are affected by minimum wage awards are notably irregular”

Commons and Andrews, 1936:63

Therefore, minimum wage should be really minimum in order to prevent irregular works.

⁷ Kahn-Freund (1938:18) writes: “[t]he main object of labour law has always been, and we venture to say will always be, to be a countervailing force to counteract the inequality of bargaining power which is inherent in the employment relationship”.

⁸ In this respect, during the Industrial Revolution, the primitive Labour Law developed Senian liberties of process because of the standardization of work did not make possible alternative conditions for workers.

A second element, *profits of the business*, concerns whether or not the financial condition of the industry should be taken in account. “Most often the problem comes up in connection with the struggling business which claims it cannot survive if its workers are paid a living wage” (Commons and Andrews, 1936:63). This can lead to exempt the industry or sector in crisis from paying the whole cost of maintenance of workers.

Finally, *substandard workers*, all minimum wage laws permit the fixing of *suitable* wages for young workers, apprentices and inexperienced workers.

Summing up, an optimal minimum wage should be consistent with the normal living standard of the place where it is applied, and should prevent the emergence of irregular work and crisis of industries, and should be discerned for age and skill.

4. Public employment offices and unemployment compensation

With economic development employer’s power is reduced in its *manifestation*, but not in its *capacity*. More recently, power of the employer rests on her lower difficulties in seeking a worker fitting her needs than the worker in seeking an appropriate job for his skills. A possible reason can be the fact that the employer ‘uses’ the labour market more often than the employee or that the employer has more resources for spending. As a result, labour law focuses its efforts on trying to offer tools and offices for reducing this asymmetry.

In this respect, labour law may, on the one hand, improve the worker’s capacity “to sell himself” in the market and, on the other hand, safeguard a minimal outside option.

Again, John Commons offers an illuminating study on these two issues.

Remedies in order to improve employability, as noted by Commons and Andrews (1936), may deal with the following points.

1) Regulated private employment agencies; perhaps the commonest method of seeking to bring about proper distribution is by unsystematic (i.e. by relatives and/or friends) individual search. Another common method is through the advertising media (i.e. by newspaper). Finally, a more systematic mean is the private employment agency; however, these private bureaus can

involve many abuses by imposing

“wages and conditions of work, exaction of extortionate fees, sending applicants to immoral resorts, and “splitting fees” with foremen and this inducing frequent discharges in order to get fees from men employed to fill the vacancies”.

Commons and Andrews, 1936:7

Therefore, a restrictive legislation should prevent fraud and extortion.

2) Public employment offices;

“[t]he agitation for public employment offices has been due partly to the search for a remedy for the abuses of private agencies and partly to a deepening conviction that it is a proper function of the state to help the unemployed find work”.

Commons and Andrews, 1936:12

3) Systematic distribution of public work;

“[a] well-developed system of employment offices cannot, of course, create jobs; but in addition to bringing the jobless workers quickly and smoothly in contact with such opportunities as exist, it can register the rise and fall in the demand for labor. This knowledge would make possible intelligent action for the prevention and relief of unemployment through the systematic distribution of public work and the pushing of necessary project when private industry’s demand for labor is at low level”.

Commons and Andrews, 1936:27

4) Regularization of industry; that is, to reduce, or better to adjust, the economic fluctuations, in order to preserve the employer-employee relationship as more as possible.

5) Social insurance; that is, “settled policy of cooperative action to distribute among a group the losses suffered by individuals arising from their inability to work and thereby earn a livelihood” (Commons and Andrews, 1936:225).

In particular, besides the normal activity of mediation between demand and supply (point 2), the role of public employment bureaus is relevant; it is significant because only by an effective performance, public employment

bureaus⁹ can compete with the services provided by private employment bureaus and reduce possible abuses of private employment bureaus (point 1). Moreover public employment bureaus can furnish excellent information to the policy-maker when deciding a project of development (point 3). In addition, the relevance of point 4) is weakened with respect to that experienced in the period in which Commons' wrote; the monetaristic Restoration tended to separate the activities of the central bank from those of the government and then the combination of monetary and fiscal policy – which is the main mean for adjusting the economic fluctuations – has diminished in strength. As a result, the role of public employment bureaus is again more relevant in absence (or weakness) of effective adjusting of economic fluctuations.

Point 5 concerns the wider issue of social security¹⁰. Mostly social security in labour law is related to forms of unemployment¹¹ compensation.

⁹ The situation of Italian public employment bureaus may be emblematic. The 80% of Italian unemployed are located in those regions where 75% of public employment bureaus are judged insufficient by the investigation of Isfol. Moreover, pc endowment is unsatisfactory and the internet cable and access is limited at only 50% of all public employment bureaus (see comment of Boeri 2002:33 on ISFOL report). This may explain the lack of adequate condition to fulfil their institutional task.

¹⁰ On this point, Hayek (1944:89) writes:

“[i]t will be well to contrast at the outset the two kinds of security: the limited one, which can be achieved for all, and which is therefore no privilege but a legitimate object of desire ; and the absolute security which in a free society cannot be achieved for all and which ought not to be given as a privilege – except in a few special instances such as that of the judges, where complete independence is of paramount importance. These two kinds of security are, first, security against severe physical privation, the certainty of a given minimum of sustenance for all ; and, secondly, the security of a given standard of life, or of the relative position which one person or group enjoys compared with others ; or, as we may put it briefly, the security of a minimum income and the security of the particular income a person is thought to deserve”.

Hayek, 1944:89

In other words, Hayek distinguishes “the security which can be provided for all outside of and supplementary to the market system, and the security which can be provided only for some and only by controlling or abolishing the market” (Hayek, 1944:89). Surely, we prefer the first kind of security.

¹¹ Unemployment is a problem not only for the losses in wages and the resulting distress, but also (and equally) for the loss in the “weakening of morale which comes with

We can distinguish two forms of unemployment compensation: the Ghent System and compulsory unemployment insurance. In the former unemployment insurance is originated among labor organizations.

“In order to encourage insurance, a plan was devised by which governments, most often municipal, granted subsidies to trade unions furnishing unemployment insurance. This is the principle of the famous Ghent System, which was first introduced in the city of Ghent in Belgium in 1901. The Ghent idea was rapidly adopted [in many European country (and also in Italy)] [...] before the World War”.

Commons and Andrews, 1936:203-4

This system stimulates provision against unemployment (see, Gibbon, 1911:104-5), but failed in order to

“attract a sufficiently large number of workers [...] [Moreover] [t]he exemption of employers from any direct share in the cost of insurance, with the consequent loss of a valuable stimulus to unemployment prevention, is another serious disadvantage of voluntary subsidized scheme”

Commons and Andrews, 1936:294

Instead, the compulsory unemployment insurance is based on the fact that the employer, the employee, and the government all contribute to the insurance fund (Commons and Andrews, 1936:295). Unemployment insurance must be a pro-tempore subsidy, and, therefore, employee, employer and government must “invest resources” in order to re-create a

uncertainty [...] Unemployment is a culture bed for pauperism and all of its accompanying evils”¹¹ (Commons and Andrews, 1936:3). And again:

“[b]esides the losses to the worker and his family, there are other costs of unemployment affecting both employer and the entire community [...] Unemployment and fear of unemployment, moreover, impair the efficiency of workmen; and labor turnover, requiring the hiring and “breaking in” of new employees, has been shown to be expensive to the employer [...] From the public point of view, unemployment represent a vast waste of productive capacity and, more directly, places a heavy burden upon public and private charity. It is one of the chief causes of destitution and often leads to *crime*”.

Commons and Andrews, 1936:4 (italic is added)

new labour relationship¹². But, what we want to emphasize at this point is that the so-called Ghent experiment can be run along with the compulsory scheme; in this way we can involve trade unions (along with the employer unions) in safeguard of unemployed workers in a more significant way. Undoubtedly, unemployment compensation resources are saved when employability runs in an effective manner.

5. Re-assessing and concluding remarks

We use the notion of transaction as originally introduced by John R. Commons in order to render more accurate the analysis of employer-employee relationships. Indeed, such transaction allows us to distinguish between employment and employability improving. The former regards legislative intervention for regulating surplus sharing process, while the latter can be interpreted as a set of legal tools for which a minimal outside option is granted and worker's capacity to choose is widened.

In our work the former is represented by the minimum wage, while the latter can be made possible by an effective system of public employment offices and employment compensations.

In particular, an optimal minimum wage should be consistent with the normal living standard of the place where it is applied. Moreover it should prevent the emergence of irregular work and crisis of industries, and should be discerned for age and skill. An effective employability, instead, rests essentially on efficient public employment offices and on a coherent system of social security, in which minimum wage – properly set – is the most important component.

In this way we guess to fulfil D'Antona's (1999:22-3) request of more active workers' safeguards labour law *before* the stipulation of the labour contract. Therefore, the purpose should be a wider¹³ – although less deep – labour law.

¹² On this point the best model in our opinion is the mechanism of welfare as implemented by the so-called Danish 'flexicurity' where active policies effectively stimulate the entry or re-entry of workers in a labour relationship.

¹³ The point of view of D'Antona (1988, 1989, 1998) runs in this direction.

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