John R. Commons’s Criticism of the Classical Economics

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Abstract: Commons criticized three limitations of the classical theory of value, namely the elimination of scarcity, ownership and money, and attempted to construct new concepts and theories to overcome these limitations. The purpose of this article is to reveal Commons's theoretical progress by analyzing a recently discovered manuscript written in 1927 titled "Reasonable Value: A Theory of Volitional Economics." Specifically, I compare this manuscript with several other published works by Commons.

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A recently discovered manuscript written in 1927 titled "Reasonable Value: A Theory of Volitional Economics" (called the 1927 manuscript hereafter)[1] roughly corresponds to Chapters 2–8 of *Institutional Economics* (Commons 1934). In both texts, Commons explained the areas where his theory of value differed from the theories of the major economic theorists from John Locke to Carl Menger, and the areas where his theory descended from earlier theories, focusing on the classical theory of value. [2] In doing this Commons proposed his original concept of value called "reasonable value," referring to the historical and institutional development of capitalism.

Commons also developed his criticism of the classical theory of value in *the Distribution of Wealth* (Commons 1893), *Legal Foundation of Capitalism* (Commons 1924) and *Reasonable Value* (Commons 1925). This article attempts to reveal his theoretical progress and limitations, as represented in the newfound 1927 manuscript, by comparing this manuscript with these other published works.

This article is structured as follows. The next part clarifies Commons's theoretical progress and the third part identifies theoretical limitations of the 1927 manuscript and considers how to overcome them.

Theoretical progress in the 1927 manuscript

Conceptualization of proprietary scarcity

In the 1927 manuscript and the first half of *Institutional Economics* (Chapters 2–8), Commons focused on scarcity and efficiency. Commons defined efficiency as the ratio of output to input. When input is measured by the amount of labor, efficiency is identical to physical labor productivity. In the 1927 manuscript, the term "productivity" was often substituted for "efficiency."

Thus, Commons corrected some confusion regarding efficiency, but did not innovate on the concept. As an institutionalist, his innovation involved the understanding of scarcity by the various schools. In the 1927 manuscript, for the first time, Commons named a concept himself, namely "proprietary scarcity." The origin of "proprietary scarcity" is "scarcity of proprietors". [3]

For Adam Smith, scarcity was psychological and subjective, based on human pleasure and pain. Ricardo explained scarcity based on the strength of nature's resistance to human beings, as shown in the unproductiveness of land. His scarcity was objective natural scarcity (Commons 1927, Chapter 5, 49). However, while Commons's scarcity is also objective, it is defined by the relationship between the supply and demand in a particular society at a particular time.

Commons emphasized that, whether in the case of general commodities or labor power, the power of sellers to limit or withhold supply has been authorized and strengthened historically by the development of institutions of ownership and labor rights. Therefore, proprietary scarcity is closely related to custom and sovereignty.

Commons and Smith had different understandings of the regulator of value, about which Commons explained that, “Smith […] required a natural regulator of supply and demand in place of collective regulation, and he found it in the breast of every industrious and thrifty manufacturer and merchant” (Commons 1927, Chapter 5, 50). For Commons, “the leading constituents of reasonable value” are “collective action, scarcity, money, custom and collective opinion” and “the practices of courts, juries, commissions, arbitration arrangements, and so on” are also regulators of value (Commons 1927, Chapter 5, 57).

Although the term “proprietary scarcity” first appeared in the 1927 manuscript, the above idea of Commons regarding the cause and regulator of value was constructed over many years following the publication in 1893 of Commons’s first theoretical book *The Distribution of Wealth*. In this book, Commons considered the behavior of suppliers who profit by withholding supply, and criticized the profit theory of Böhm-Bawerk from this perspective. Moreover, he considered such supplier behavior a cause of wages exceeding subsistence levels, and criticized the wage theory of classical economists, which could not explain wages exceeding subsistence levels. However, Commons (1893) did not clearly distinguish reasonable and unreasonable monopoly privileges. In *Legal Foundations of Capitalism*, published in 1924, based on analyses of historical changes in customs and laws regarding rent bargain, price bargain and wage bargain, Commons distinguished between goodwill and privileges by whether any public purpose was served by suppliers’ withholding supply.

However, in these books, Commons did not use the term “proprietary scarcity,” or any other expression that combined these two words. “Proprietary scarcity” was a term Commons coined in the 1927 manuscript to clarify his criticism of Smith’s subjective scarcity and

Ricardo's natural scarcity. This is the first contribution of the 1927 manuscript, and the concept of "proprietary scarcity" would became a key concept in *Institutional Economics*.

Construction of a theory of value with multiple causations

Based on this concept of "proprietary scarcity," Commons tried to construct a theory of value using a complex of many principles, such as efficiency, scarcity, futurity, sovereignty, and custom. Although *Institutional Economics* contains a 150-page chapter titled "Efficiency and Scarcity," unfortunately it lacks an explicit quantitative description of the relationship between efficiency, scarcity and price. The 1927 manuscript contains an attempt at such a description, which can be found in Chapter 8, titled "Scarcity and Efficiency." Notably, the part of Section 2 of Chapter 8 from the 1927 manuscript that was not used in *Institutional Economics* contains Commons's quantitative explanation of the relationship between efficiency, scarcity, futurity, and price.[4]

In this part of the 1927 manuscript, which explains Ricardo's labor theory of value and Menger's marginal utility theory, Commons showed that prices are affected by multiple factors, such as "use value, property-rights, degree of scarcity, relative scarcity, and futurity" (Commons 1927, Chapter 8, 134).

According to Commons, regarding the cause of value, Ricardo focused on the supply side effects of increasing resistance from nature, or increasing embodied labor, while Menger focused on the demand side effects of reduction of scarcity, or diminishing utility. As Commons considered both supply side and demand side factors important, he criticized both of these approaches and proposed his own theory of value.

Commons considered Ricardo's assumption of constant demand for product per unit appropriate in an analysis to measure the effects of technological factors on price. However, Commons argued that factors on the demand side, such as Menger's decreasing scarcity, should be incorporated in general analysis of price determination. Moreover, Commons incorporate suppliers' withholding supply to realize profit.

Formulation of three types of transactions

The most remarkable theoretical progress in the 1927 manuscript is a formulation of three types of transactions, namely managerial transactions, bargaining transactions and judicial transactions.[5] Although, in Commons (1924) and Commons (1925), he had regarded transactions as the ultimate unit of investigation, in those earlier works he did not formulate this analytical framework of three types of transactions.

Transactions first appeared as a core analytical concept in Commons (1924). Although Commons (1924) distinguished two process types, namely the going plant and going business, he did not yet distinguish two transaction types, such as managerial transactions and bargaining transactions.[6] On this point, Commons (1925) is the same as Commons (1924).[7] Therefore, Commons first formulated managerial transactions and bargaining transactions in the 1927 manuscript, and these two concepts of transactions then appeared in *Institutional Economics*.

I think the reason Commons formulated the two concepts of managerial transactions and bargaining transactions can be found in his criticism of the analysis of Marx, who defined both these transaction types as a function of capitalists in the production process. Commons developed his criticism of Marx's analysis in Section 3 of Chapter 8 of the 1927 manuscript, titled "Fund and Flow." However, *Institutional Economics* devotes just a few lines to summarizing this criticism, with the result that readers exposed only to this work may not get a clear understanding of Commons's argument.

To solve the problem of how to formulate and analyze the processes controlling efficiency and proprietary scarcity, Commons critically examined the ideas of Marx. He approved of Marx taking into account both efficiency and proprietary scarcity, but criticized his merging both these processes into the production process. First, Commons pointed out that Marx, unlike Proudhon, attached importance to demand-side factors, quoting from The Poverty of Philosophy (Marx 1847), as follows: “Marx’s “producer” not only produces use-value but also limits its quantity in the process so that expected demand will give exchange-value to it. His use-value is already a scarcity-value” (Commons 1927, Chapter 8, 145).

As I mentioned in the second part of this article, Commons believed that the center of power in bargaining transactions lay in the ability of suppliers to withhold supply based on property rights. Commons positively evaluated Marx’s theory of value for recognizing the withholding of supply. However, he criticized Marx’s ideas with regard to proprietary scarcity for containing contradictions (Commons 1927, Chapter 8, 149). One contradiction was “confusion of income and outgo with output and input.”[8] Commons insisted that these two relations should be distinguished because “[t]hey involve two entirely different types of transactions.”[9]

Thus, Commons strongly criticized Marx’s idea that both physical processes controlling efficiency and proprietary processes controlling scarcity merged into the production process controlled by capitalists. This criticism of Marx’s method of analysis led Commons to conceptualize the managerial transaction and the bargaining transaction as “two entirely different types of transactions.”

Theoretical limitations in the 1927 manuscript

Limitations in the concept of judicial transactions

In the 1927 manuscript, Commons divided the concept of transaction into bargaining, managerial, and judicial transactions. In *Institutional Economics*, he divided it into bargaining, managerial, and rationing transactions. Commons's explanation of bargaining and managerial transactions was almost identical in both texts. However, judicial transactions in the 1927 manuscript differ considerably from rationing transactions in *Institutional Economics*, not only in name, but also in content. To summarize the difference, rationing transactions were much broader in content than judicial transactions.

Commons explained judicial transactions as relationships between a superior and an inferior in Chapter 1 of the 1927 manuscript. It is important that Commons uses "the political transactions between citizens and policemen, executives, judges, legislatures or supreme courts" as examples of judicial transactions, and that "the political transactions are known as process of law" (Commons 1927, Chapter 1, 12).

Stated more generally, judicial transactions mean activities that apply general social rules to individual cases to correct failures of transactions at the micro level, such as contract defaults in workplaces and markets. In this sense, judicial transactions "supplement" bargaining and managerial transactions at the micro level.[10]

However, rationing transactions in *Institutional Economics* include not only such "judicial decisions," which must be supplemented at the micro level, but also the other four activities: "log-rolling," "dictatorship," "cooperation," and "collective bargaining" (Commons 1934, 68, 753).

This explanation contains the following two important points. First, rationing transactions include the formation of tax policy that affects income distribution and redistribution. This policy-making activity is not that of applying general social rules to individual cases at the micro level, but of making general social rules at the macro level for the entire country. Furthermore, the purpose of such activity is not to correct failures in bargaining and management transactions at the micro level, but to remedy the so-called “fallacy of composition,” such as a decrease in aggregate demand resulting from the paradox of thrift, by government activity. The second important point is that rationing transactions include “collective bargaining” between an employers’ association and a labor union and “trade agreements” between associations of buyers and sellers. These activities are intended to determine wages or prices across industries by negotiations at the industry level (meso level).

By including institutional economic adjustments at the macro and meso levels, the concept of the rationing transaction as described in *Institutional Economics* is expanded significantly compared with the concept of judicial transaction in the 1927 manuscript.[11]

Coordination of managerial and bargaining transactions

In Section 3 of Chapter 8 of the 1927 manuscript, titled “Fund and Flow,” Commons described the coordination of managerial and bargaining transactions as follows: “The two, while entirely different, are not allowed to fly off separately, for they are coordinated, more or less successfully, by the business policy of a going concern” (Commons 1927, Chapter 8, 164). However, he did not explain how to successfully coordinate the two transaction types. His explanation in *Institutional Economics* was similarly rough and general, as follows: “Efficiency and scarcity are separable in analysis but not in reality, since they operate functionally upon each other in making up the going concern.” (Commons 1934, 644)

I think that this insufficient explanation of the coordination of managerial and bargaining transactions was caused by a theoretical defect that he did not explicitly examine oligopolistic competition between companies with unequal efficiency.

As a general fact, Commons believed that different companies producing the same product would have different efficiency (productivity) levels. Furthermore, Commons strongly criticized Marx for ignoring efficiency differences and equating the social value of a product with the weighted average of labor embodied in that product (Commons 1927, Chapter 8, 152–154; Commons 1934, 269).[12]

In Commons (1924), Commons (1927) and Commons (1934), Commons explained bargaining transactions using a formula that consisted of two sellers (S offered a lower price than S1) and two buyers (B offered a higher price than B1). Although Commons did not show this explicitly, the difference in offer price between two sellers is mainly based on an efficiency gap between them. Commons (1934) used this formula to explain the "limits of coercion" and "bargaining power." For example, the gap between the offer prices of S and S1 affects the bargaining power of S relative to buyers, and the offer price of S1 becomes the "limits of coercion by S to buyers." Commons explained as follows: "In our formula it is evident that seller S cannot force buyer B to pay more than $120, since above that margin his competitor S1 would take his place as the seller" (Commons 1934, 331). This explanation seems to mention the effect of supplier efficiency gap on price determination. However, in this formula, if S can sell, S1 cannot. That is, Commons did not assume the coexistence of transactions involving both S and S1. The efficiency gap assumed in this formula was that between a supplier that monopolized the market and a supplier that was expelled from the market.

The coordination of managerial and bargaining transactions is important not in such monopoly but in oligopolistic competition between companies with unequal efficiency. Let us consider a case where the leader company, to grow its market share, reduces the price to a level at which the marginal company cannot continue in business.[13] Consequently, the marginal company is eliminated and the leader company increases its supply. This supply increase occurs through either increased use of existing equipment or investment in equipment that embodies a new technology. Therefore, the result of bargaining transactions to control price and quantity of supply depends on the progress of managerial transactions that deal with technology and equipment constraints. Conversely, a change in the quantity of supply resulting from bargaining transactions leads to a change in the scale of production, which usually follows an increase in efficiency as a result of economies of scale and the introduction of new equipment or technology. Therefore, the result of managerial transactions depends on the progress of bargaining transactions. Managerial and bargaining transactions thus have a complementary relationship. Unfortunately, Commons did not explicitly examine oligopolistic competition in either the 1927 manuscript or *Institutional Economics*. This oversight led him to insufficiently explain the coordination of managerial and bargaining transactions.

Concluding remarks

Commons's original concept of "reasonable value" was built as an alternative to classical and marginalist concepts of value. In the 1927 manuscript, Commons showed three premises of "equal opportunity," "fair competition," and "equal bargaining power," which were formulated gradually by consolidating rules, laws and regulations. In *Institutional Economics*, "reasonable idealism" is presented in the following dynamic context. "[A] reasonable idealism is the highest practicable idealism, as shown [...] by investigation of those institutions that practice it, and yet survive. There are always individuals and concerns above the average, and the problem of social idealism through collective action consists in bringing the "average" and those below the "average" up to the level of those above the average" (Commons 1934, 743). And, in Chapter 10, Commons discussed institutions in regard to income distribution and redistribution assuming unequal efficiency between industries and companies. This argument was based on a new concept of “rationing transaction.” However, since Commons could not develop the formula consisting of two sellers and two buyers to a model that can analyze oligopolistic competition, Commons’s theory of multiple causation remained unfinished.

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Footnotes

1 This manuscript was discovered by the author in the Kyoto Prefectural Library. See the preface of Uni (2017) about its provenance and overview. Charles Whalen also found the same manuscript together with a manuscript written in 1928–29 in the National Agricultural Library in the United States.

2 In the last section of Chapter 8 of *Institutional Economics*, Commons identified three limitations of the classical theory of value (Commons 1934, 376–387).

3 Commons explained as follows: "[F]or the business man, working man, creditor, debtor, landlord, tenant, scarcity is a scarcity of proprietors. These proprietors are buyers, sellers, lenders, borrowers, landlords, tenants, who own, or have the prospect of owning, the food, clothing, shelter and land. It is this proprietary scarcity for which prices are paid, [...] Scarcity, as an immediate fact of business and the subject-matter of economics, is scarcity of those who have legal control, not scarcity of goods" (Commons 1927, Chapter 5, 17).

4 According to Harter (1962), "Commons lost his way when he tried to use increasing costs and practically admitted as much," in Commons (1893). Consequently, "Not only did the interesting part of the analysis in *the Distribution of Wealth* fail to survive its bad reception from economists, but it failed to sustain Commons's interest. Never again did he attempt to approximate the type of analysis which interested his fellow economists" (Harter 1962, 214–215). However, in the 1927 manuscript, Commons tried a quantitative analysis using a framework similar to that in his earlier work of 1893. Incomplete aspects of his analysis are

mentioned in the third part of the present article.

5 Commons wrote the following, "[f]inally, transactions are the modern substitute for the older physical idea of exchange of commodities, and, in their three-fold aspect of managerial transactions, bargaining transactions and judicial transactions, they are the behavioristic units of investigation modified in their dimensions by the five variable dimensions, scarcity, futurity, efficiency, sovereignty and custom" (Commons 1927, Chapter 1, 7).

6 Commons (1924) classified transactions into "authorized transactions" and "authoritative transactions." An authoritative transaction seems to correspond to a "judicial transaction" in the 1927 manuscript, as I explain in the footnote 10. Although an authorized transaction seems to include both managerial transactions and bargaining transactions, Commons (1924) did not formulate these two terms separately. Moreover, although Commons (1924) identified managerial ability, he did not conceptualize managerial transactions.

7 Commons (1925) did not use the antonyms "going plant" and "going business," but rather the similar pair of terms "engineering economy" and "business economy" (Commons 1925, 38).

8 The term "confusion" may be incorrect, because Marx distinguished efficiency (relation of output and input) and scarcity (relation of income and outgo). Commons criticized Marx not for his distinguishing these two relations, but for his idea that these two processes were controlled in the production process by capitalists. In fact, Commons (1934) correctly noted that "Social Man-Power [...] is intended to distinguish [the] engineering economy from [the] proprietary economy, which Marx was the first clearly to distinguish" (Commons 1934, 267).

9 In Commons (1934), after the criticism on Marx, Commons explained his own method of analysis, writing: "[o]ur method is different. We separate each by a 'virtual' elimination of the

other, and then combine them on the principle of limiting and complementary factors" (Commons 1934, 374). This explanation indicates that the reason Commons formulated two types of transactions can be found in his criticism on Marx.

10 In this sense, the concept of the judicial transaction in the 1927 manuscript is the same as the authoritative transaction in Commons (1924). Commons explained the authoritative transaction as follows: "[w]e have seen that unauthorized transactions are likely to fail in the two respects of lack of correlation and insecurity of expectations. For this reason a government or judiciary, with its rules regarding transactions, is needed to intervene with the double purpose of correlating rights, exposures, liberties, duties, and of maintaining the correlation even if the parties prove false or change their minds." (Commons 1924, 100)

11 Because Commons included varied activities in a single category of rationing transaction, his characterization of rationing transactions exhibited some weaknesses. For example, according to Commons (1934) the psychology of rationing transactions is "arguments and pleadings," but the psychology of judicial decisions is "commands and obedience," as general social rules are applied to individual cases. In fact though, in Commons (1950), the psychology of a rationing transaction is explained as "commands and obedience" (Commons 1950, 57).

12 In explaining "extra surplus value," Marx obviously assumed a productivity gap between producers. Marx's theory of value therefore did not consider only the social average of productivity. Kühne (1979, Chapter 18) recognized this characteristic of Marx's theory of value, and called Marx's theory of value based on the social average of productivity "the static theory" and that based on the productivity gap among producers "the dynamic theory." Shaikh (2016, Part II) developed a theory of "real competition" based on Marx's argument.

13 I assume that the leader company ultimately controls the price by setting it at a level that excludes new entrants, as described in the entry-deterring price theory of Sylos-Labini (1956).