

Radical political economy and the theory of contracts:
towards a one and only view of the origins and functions of hierarchy?***

IWGVT mini-conference
(EEA Annual Conference 2000)
Washington D.C.

1. Introduction

More than forty years ago, Paul Samuelson wrote : “*in a competitive market it really doesn't matter who hires whom; so let labor hire capital*”.¹ At that time, this point of view was shared by almost every mainstream scientists who believed that what happened inside the firm, the “black box”, was only a technical matter which could amount to a production function. This probably doesn't mean that they denied any existence to hierarchy or authority inside the firm but rather that they denied any *economic relevance* of those notions. Economists had hence nothing to say about hierarchy and authority. But today it would be very difficult for their epigones to agree with the assertion that “it really doesn't matter who hires whom”. The new microeconomic theories of the firm, such as transaction costs economics or principal agent analysis or incomplete contracts approach, did indeed profoundly change the way the dominant approach look at the notions of authority or hierarchy. The doctrinal evolution is so significant as several leading contemporary authors in this field, such as for example Hart [1995] or Rajan and Zingales [1998], are going further and use now

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*** An earlier version of this paper has been first presented at the Fourth Annual Conference of the European Society for the History of Economic Thought, Graz, Austria, 24-27 february 2000. The author would like to thank Ben Fine for his helpful comments.

¹ cf Samuelson [1957], quoted from Bowles & Gintis [1990].

the term “power”² to refer to and to analyse the employment relationship. Why and how could such a change of attitude be possible? A fully satisfactory answer to this question would of course require a detailed history of the theory of the firm for forty years but this is not the ambition here. Rather, it is possible to gain some knowledge of this evolution through an historical analysis of some debates which occurred about those notions between the mainstream and its opponents, in particular the radical political economics of the early seventies.

The debate between radical and mainstream scientists about the origins and functions of hierarchy in capitalist firms is probably as old as the socialist thought. Nevertheless, it is now well recognized that this subject has been recently put forward again with the development of the economics of organizations and firms and the upsurge of the theory of contracts. The birth of this new discipline is often referred to the contribution of Alchian and Demsetz in 1972³ which can be considered as a response to Marglin's article entitled "What do bosses do?". This one, which appeared only in 1974, was in fact circulating as early as 1971⁴. This contribution, that can be considered as one of the first serious outward sign of what Putterman [1986] calls "the radical challenge"⁵, suggests that capitalist hierarchy has nothing to do with efficiency but rather with rent seeking by capitalists whose domination is more related to the issue of power. At this time, the standard economic analysis of what happened inside the firm was virtually non-existent. That explains probably the success, among academic economists, of Alchian and Demsetz' contribution whose original feature was on the one hand to break with the old black box theory but on the other hand to continue to hold, following Samuelson [1957] and the walrasian tradition⁶, that power, authority, and hierarchy inside the firm are just an illusion.

Yet, despite this affirmation, the notion of hierarchy had become a fully subject of inquiry for many authors such as Williamson [1975], Stiglitz [1975], Mirrlees [1976] or Calvo and Wellisz [1979]. Later, the notion of authority, which is closely related to the concept of hierarchy as shown by Williamson's works, has been put at the centre of

² In spite of their acceptance of the theoretical relevancy of the notions of hierarchy and authority, Stiglitz [1993] and Williamson [1993] refuse to use the term “power”, which is supposed to be too much emotional or vague.

³ See the place of this article in readers, textbooks or surveys about the theory of the firm such as Putterman [1986], Barney & Ouchi [1986], Ricketts [1988], Archibald [1987], Holmström & Tirole [1989] and Milgrom & Roberts [1992]; and see my article about this subject, Tinel [1998].

⁴ cf Tinel [1996].

⁵ The idea of a “radical challenge” dates back at least to Bach [1972] p. 643.

⁶ see Dockès [1996].

the debate by the theory of Grossman, Hart and Moore⁷ on incomplete contracts and property rights⁸. This approach, which stems from both the hold-up problem *à la* Klein, Crawford & Alchian [1978] and the microeconomics of principal-agent, leads finally to the contribution of Rajan and Zingales [1998] who develop a theory of power and aims explicitly at reconciling Marglin's thesis with what is nearly a new standard view⁹.

Parallel to this move by the standard analysis towards those notions that were considered before as outside of its agenda, several of the radical economists moved in the opposite direction and took the tools of the standard approach with which they tried to find marxian results¹⁰ and develop a theory of power¹¹. Finally, this reciprocal acculturation, where some appropriate the main themes of the others and the latter uses the tools of the former, is due to the fact that in spite of appearances each protagonist tried to change its own views because the other both had good objections and was changing himself. In other words, several radical and mainstream economists did play a trust game¹² together during the last 25 years which has led them to a possible consensus about the notion of hierarchy. But is this really a common view or does it hide some others sharp divergences? In other words, does it still remain a radical approach of those concepts and how should or could an heterodox theory of power, hierarchy, and authority look like?

Before going further, it is necessary to carry out a brief methodological clarification : this paper is built upon the idea that oppositions and interactions between different trends of opinion among economists can be decisive factors in the evolution of ideas at certain moments of history. But this does not mean that, at other moments, we deny any relevance to others factors of evolution such as for example the stimulus of a research program. This is probably one of the tasks, among many others, of the history of economic thought to identify the nature of the shocks which did influence the course of theoretical discussions and representations. The idea here is that the internal logic of the neoclassical research program would not lead solely from Samuelson to Rajan and Zingales, there must have been other forces which did oblige the mainstream to take into account new themes such as hierarchy. Some could say that the evolution from Samuelson to Rajan and Zingales is just the result of the progress of economics which

⁷ see Grossman & Hart [1986], Hart & Moore [1990] and Hart [1995].

⁸ For an analysis of recent works on the notion of authority, see Baudry and Tinel [1999].

⁹ About the debates on the theoretical foundations of incomplete contracts, see the special issue of the *Review of Economic Studies*, january 1999.

¹⁰ see Bowles [1985].

¹¹ see the references of the works of Bowles and Gintis at the end of this paper.

¹² Here trust means "to examine critically the other's work and to take in account their critical comments". For a simple presentation of the trust game, see Kreps [1990].

is supposed to incessantly become more scientific thanks to new analytical tools that are elaborated such as for example Arrow's works on information. This view of the production and the evolution of economic knowledge, that gives a very positive picture of academic work, is not satisfactory because it ignores 1) the conflicts, and their effects on the research path, that exist between different streams of thought and 2) the interweaving of economic research with social history. Others, who don't subscribe to the mainstream approach, argue that the neoclassical colonisation of the traditional radical themes of inquiry is not a reply or a "counter-attack" to radical political economy but the normal result of the general developments in the neoclassical microeconomic theory and particularly informational problems. But, if it is true that without those new developments neoclassical economics would not have been able to treat those new issues, the evolution of the neoclassical analytical framework doesn't imply *necessary* the colonisation of radical political economy. In fact, the new microeconomic theory is only the *condition* that did allow this colonisation. But the *condition* is not the *necessity*. The invention of a new technology doesn't imply its social necessity or usefulness¹³. The *necessity* or the reasons of this expansion are to be found notably in the interactions between the scientific research sphere and the history of society : this is not by accident if mainstream economics did involve itself from the seventies onwards in such issues as hierarchy, authority and power. As a matter of fact, the deep transformations that arose in modern capitalists countries, and in particular in America, at the end of the sixties brought about repercussions, which are still running, on the slightest social interstice. Is it really possible to argue that the anti-authoritarian movement, which did in particular contest capitalist hierarchy legitimacy, produced no effect on neoclassical economics? This is all the more dubious that on the one hand the contestation introduced up to academic world through radical political economy and on the other hand neoclassical economics is often considered as playing a role of justification of capitalist relations of production.

The paper is organized as follows : second section surveys the main arguments of radical economists about why hierarchy matters; in the third section some answers to this challenge are briefly examined and we try to show the change in radical claims then, in section 4, the notion of authority in incomplete contracts theory is considered; finally, section 5 treats the question of the specificity of radical political economics.

2. The radical challenge

¹³ This is precisely what Marglin [1974], following the french historian Marc Bloch's works on water mill and hand mill, tries to show about the capitalist firm. He argues that this one did less rise up for technological reasons than for social reasons and in particular because of class struggle.

As noticed above, the neoclassical approach had no theory of the internal organization of firms until the beginning of the seventies. The only explanation of differences in rewards between workers was given by Becker who justified discriminations by objective differences in productive abilities i.e. in human capital. Hierarchies of remunerations were thus fair : nobody had more or less than its individual contribution. The analysis was the same to explain job structures which were reflecting differences in tastes and human capital. Concerning the employment relationship itself, the studies about its foundations and its functioning were almost non-existent apart from some lone attempts¹⁴.

Driven by the deep anti-capitalist contestation of the sixties that occurred in America and in Europe, radical political economists¹⁵ did publish many articles and books from 1968 onwards about many different subjects and in particular about the organization of the labor process. Roughly, the various contributions, which were always very critical of neoclassical economics and in particular of the beckerian approach, were as well historical as theoretical. Though the works on internal labor markets of Doeringer and Piore [1971] did strongly influence, at least at the beginning¹⁶, some radical economists through their notion of labor market segmentation¹⁷, they were especially inspired by the marxian analysis of the capitalist system¹⁸.

Despite the fact that radical political economics¹⁹ is far from representing an homogeneous and fully coherent set of approaches, it is possible to extract from the early contributions of the radical challenge, such as Braverman [1974], Marglin [1974], Stone [1974], Gintis [1976] or Edwards [1979], the idea expressed by Marglin that the capitalist hierarchy is at first a way to “divide and rule”.

Far from being a fairly way to adapt rewards and efforts, hierarchy is considered by radicals at first as a device used by capitalists to make more profit without even paying the full cost of this increase. The core idea is that hierarchy is an artificial mean to create differences between workers and thus to divide them. Those differences then restrict their ability to act collectively for their class interests, which gives more latitude to employers to exploit employees. The notion of exploitation used in radical political

¹⁴ such as for example Simon [1951] who was probably too much in advance of his time.

¹⁵ about the beginning of radical political economics, see Flaherty [1987], Fleck [1999], O'Hara [1995] and Arestis & Sawyer [1992].

¹⁶ cf Gordon [1972].

¹⁷ see Edwards, Gordon & Reich [1973], [1975] and [1982].

¹⁸ see for example Edwards, Reich & Weisskopf [1972].

¹⁹ For a broad introduction to radical political economics, see Sawyer [1989] and Arestis & Sawyer [1994].

economics doesn't utterly refers to the marxian theory of value²⁰ but rather to the general idea of an "unpaid labor". Hierarchy is hence 1) a mean to exploit workers because it is used to extract more labor inputs from the workers without paying them more, or even paying them less; and 2) it is considered as a mean to extract more labor inputs to give more outputs, which corresponds only to a shift along the production curve and not to a shift of the curve itself. According to radical political economics, this implies that capitalist hierarchy would be, from a neoclassical point of view, intrinsically inefficient²¹. Lastly, one of the favorite claims of radical political economy is that labor-managed firms are more, or at least not less, efficient than capitalist firms.

This presentation is of course very roughly done but it would be out the purpose of this contribution to go farther into details. What should stand out is that 1) radical political economy did show that hierarchy in firms matters in economics whereas the neoclassical approach of the firm had almost nothing to say about it until then; 2) hierarchy is not related to efficiency and competition but rather to exploitation, power and rent seeking. We understand why the mainstream couldn't leave radicals such a clear field, it had to build a theory of hierarchy in firms which would be reconciled with competition and efficiency.

3. The neoclassical answer and the evolution of the radical claim

Different contributions such as Stiglitz [1975], Williamson [1967] & [1975], Mirrlees [1976] and Calvo and Wellisz [1978] & [1979] intend to legitimate hierarchy in firms as useful devices which promote efficient incentives to work in presence of risk, asymmetric information or transaction costs. What is new in this paradigm is not only that authoritative relationships in firms are not denied, contrary to Alchian and Demsetz [1972], but although that they are considered as fair and desirable. Williamson, for example, suggests that the employee is voluntarily subordinated to his employer because he is supposed to know that this is more efficient than no hierarchy. Notice that there is no clear conceptual distinction between hierarchy and authority in Williamson's²² or Mirrlees' work. Some authors like Stiglitz and Williamson answer explicitly to radical political economics: labor-managed firms have to face to inextricable free riding problems which are supposed to be overshoot by hierarchy. This debate did invigorate until now the comparative approach initiated by Ward [1958]²³ and promoted by some authors like Vanek or Furubotn and Pejovich and the theory of

²⁰ On the recent debates about theory of value, see Janunkar [1994].

²¹ On efficiency, see Green [1988] and [1994].

²² see Baudry [1999].

²³ For an introduction to the theory of labor-managed economies, see Horvat [1987].

property rights *à la* Alchian and Demsetz in such reviews like the *Journal of Institutional and Theoretical Economics* and the *Journal of Comparative Economics*.

The radical works essentially of Bowles and Gintis but although of Reich and Devine [1981], Pagano [1991] & [1992], Putterman [1984], Jossa & Cuomo [1997] and others, using analytical tools similar to the dominant approach, try to reply to the new microeconomics of the firm about hierarchy. One of the main argument in favour with labor-managed firms is that the absence of authoritarian hierarchy is itself an incentive to work harder. In fact, this idea is a way to often evade the question of free riding. Nevertheless, some radical authors did advance the idea that the matter is not hierarchy itself but is about the modes of control of hierarchy by other stakeholders. This led to the themes of market socialism²⁴ and of “democracy in firms” in which the manager should be accountable not only to shareholders but although to employees for investment decisions and organization of work process²⁵. On the other hand, Bowles and Gintis²⁶ did show inside the efficiency wage framework that the property of the means of production gives market power (“short side power”) to the employeurs, which means that old socialist questions, about which modern economics has been totally silent, like the origins of property or the exploitation of labor force matter even inside the dominant paradigm. The main feature of this second period in the radical tradition consists thus in the fact that they did “steal the neoclassical clothes”²⁷, which means that they were converted to methodological individualism. This implies that they did abandon investigation in history and that social phenomena are now only considered through the lens of neoclassical reductionism. In particular, the social is only understood in terms of the actions of individuals. As Milonakis [2000] writes: “all structural and collective factors affecting social behavior are totally absent. If, however, one is to get from individual choices to historical processes, the intermediation of structural factors is indispensable. This way the individual action is located within its historical and social context and individual motivation becomes a function of structures and collective interests. (...) [S]tructure takes precedence over agency at the level of the individual and the social is incorporated into the analysis as a point of departure rather than emerge as a consequence of the actions of individuals. This does not mean that individual behavior is totally *determined* by these collectivities. Only that individual

²⁴ see J. Roemer’s publications; for a critical assessment of new market socialism models, see Milonakis [2000].

²⁵ See Bowles, Gintis & Gustafsson [1993].

²⁶ Bowles [1985], Bowles & Gintis [1990] & [1993].

²⁷ Watts [1983].

action is necessarily *filtered through* and *conditioned by* these structural and social factors and institutions” (emphasis by the author, p. 18-19).

4. The authority in incomplete contract theory

Though they don't usually quote any radical author, it is probably not by coincidence if the theory of incomplete contracts²⁸, which steams both from standard microeconomics of contracts and transaction-costs framework such as Klein, Crawford & Alchian [1978], explores in its turn the sources of the authority of the employer on the employee. The main point is that GHM recognize that the property of the means of production is the basis of the exercise of authority inside the firm. As a matter of fact, contrary to Alchian and Demsetz who tried to show that the firm is not fundamentally different from the market, Grossman and Hart consider that an “employee” is someone who doesn't possess any mean of production other than its own labor-force : “*we do not distinguish between employees and outside contractors in the case in which the firm provides all the tools and other assets used by the contractor*” (GH [1986], p. 694). Defining “*ownership as the power to exercise control*” (*ibid.*), the main idea of the property rights approach is that control over non-human assets gives authority over employees and their human assets. The owner's ability to exclude others from the use of his assets implies that “*control over a physical asset (...) can lead indirectly to control over human assets*” (Hart & Moore [1990], p. 1121). Hart and Moore point out that “*the reason the manager of Alchian and Demsetz's grocery store will be more likely to follow their wishes if they employ him than if they are customers is that in the former case, his future livelihood depends on them (they control the assets the manager intends to work with), whereas in the latter case it does not*” (p. 1150, fn. 29). Finally, Hart [1995] will state the facts more precisely : “*Individual i is more likely to do what individual j wants, if j can exclude i from assets that i needs to be productive than if i can take these assets with her (...)*. In other words, control over nonhuman assets leads to control over human assets” (p. 58, emphasis by the author).

This author uses equally well the terms “control” and “power”. He notes that “*Given its concern with power, the approach proposed in this book has something in common with Marxian theories of the capitalist-worker relationship, in particular, with the idea that an employer has power over a worker because the employer owns the physical capital the worker uses (and therefore can appropriate the worker's surplus)*” (p. 5, fn. 5).

Rajan & Zingales [1998], trying to complete Hart's approach, elaborate a theory of power in firms which put forward the power of not only the employer but although

²⁸ see Grossman & Hart [1986] and Hart & Moore [1990]; we write now “GHM” for Grossman, Hart and Moore.

the employee : this article can thus be considered as an implicit reply to Bowles and Gintis' theory of power based on wealth. Roughly, Rajan and Zingales do not consider that power stems only from ownership of physical assets but also from *access*²⁹ to every kind of assets. Workers can get power over their employer by specializing their human capital to the assets they have access in order to become essential. Thus, they will be able to threaten their boss to exclude him from the access to their human-assets.

5. Towards a one and only view?

It could be argued that radical political economics and the dominant approach are converging towards a one and only view which considers that hierarchy and authority in firms matter. Each approach recognizes indeed 1) that the property of the means of production is crucial to understand the employment relationship, 2) that power is a relevant notion in microeconomics and in particular in the theory of the firm and 3) that standard modern microeconomic tools represent a good framework to analyse what happens inside firms. The third point is maybe as problematic as it is difficult to define clearly what standard micro is. However, a distinction between radical and standard analysis is still possible beyond resemblance. As noticed by Green [1988], more than ten years ago, the breaking point is still about efficiency (p. 309) : *“In the neoclassical view, capitalist forms of work organisation are still the most efficient. In the Marxian approach, no general statement can be made as to what forms of work organisation will be efficient, as the issue is contingent upon social norms”*.

Neoclassical economics, before the emergence of organization theories, was indeed simply ignoring such issues as hierarchy, authority and power, now those questions are obviously incorporated into the standard research agenda but the aim of legitimating the capitalist organization of work remains the same. For radical economics, at the beginning of the 70's, the main purpose was only to show the economic relevancy of those notions, which were more or less implicitly considered as antagonistic to efficiency. But after the neoclassical reply, it has become necessary to prove this implicit assertion of inefficiency. This led some authors to switch to related questions such as power accountability and democracy in firms with the idea that democracy is intrinsically more efficient than autocracy. Some other radical authors emphasized the fact that the neoclassical notion of efficiency is never satisfactory because it fails to take into account all relevant aspects of social life, which depends in particular upon history. But the marriage between radical political economy and neoclassical microeconomic theory has not been balanced. As noticed by Fine [1998], “however much [radical political economy] may claim to have transformed [neoclassical orthodoxy], the marriage is undoubtedly an incorporation of a few

²⁹ They define access as “*the ability to use, or work with, a critical resource*” (p. 388).

structural insights into the orthodoxy and the casting aside of those methodological and theoretical elements offered by radical political economy that prove incompatible with the new orthodoxy” (p.4).

At last, it should be noted that the theory of incomplete contracts is facing a methodological problem which raises the old question of the origins of property. One of the most important issue of Hart & Moore [1990] is indeed : “who should own which asset”? Roughly, they argue that it is more efficient to give ownership rights over nonhuman assets to the most productive individuals. This is clearly a normative statement which is not itself problematical. But what is logically unacceptable is that they suppose implicitly that, in the real world, ownership rights are allocated among agents according to this principle and in fact the authors are afterwards distorting their reasoning for example as follows : “if the employer is the owner it is because he is more productive than the employee who owns nothing else than his human capital”. This amounts to say that the real world works as it should according to their theory but they didn’t show how³⁰ and why ownership would be *actually* allocated according to individual productive features.

If we ignore however this objection by applying the friedmanian “as if” and accept this rationalization of the unequal allocation of property among individuals, there still remains a theoretical contradiction. The principle of ownership allocation according to individual productive features supposes that the formation of those features is independent of ownership allocation. Nevertheless, the work of Rajan and Zingales shows that nonhuman asset ownership acts upon the formation of human capital, which means that this is not possible to hold that asset’s ownership should be allocated according to individual productive features precisely because ownership influences the formation of productive features³¹. Finally, GHM have thought that they could avoid the old question of the origins of ownership and the famous debate about “property is theft” by rationalizing once again the issue of initial allocation of property but their reasoning amounts simply to break the circular (and not very interesting) causation that we find also between the chicken and the egg... This contradiction derives directly from methodological individualism. The only two ways to go beyond this circularity is either 1) to take something as given, but as we have just showed, the theory of incomplete contracts failed to do it; or 2) to take history seriously and this is the root of the radical approach. How should or could an heterodox theory of power, hierarchy, and authority look like? Surely, it has to turn its back on methodological individualism.

³⁰ There is no study of the ownership rights allocation process.

³¹ It would otherwise amount to hold that “the ownership allocation has to be made according to the ownership allocation”, which means nothing.

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