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## Volenti Non Fit Iniuria? Contract Freedom and Labor Market Institutions\*

*Abstract:* Various writers point out that accepting the terms of a contract does not imply *consent* to the background conditions of this contract. This is an important critical insight allowing for a critical perspective on the *principle of free contract*, according to which the state should not interfere with what adult agents contractually agree upon. In this paper I argue that the practical relevance of this critical insight depends on the availability of answers to three questions: (1) Which are the *core features* of baseline background conditions supporting a well-ordered labor market enhancing economic welfare? (2) In which cases and for which reasons are *non-market institutions* needed in order to support these features? (3) Under which conditions and at which levels can collective mechanisms be expected to support adequate non-market institutions 'curing market failure'? Some of the *core properties of labor markets and labor contracts* are discussed which need to be taken into account in attempts to answer these questions, most notably problems of contract enforcement, market failure and collective action.

### 0. Introduction and Outline

“Our main conclusions [...] are that a minimal state, limited to the narrow functions against force, theft, fraud, enforcement of contracts, and so on, is justified; that any more extensive state will violate persons’ rights.” (Robert Nozick 1974, ix)

Early reasoning concerning justice in contractual labor relations has two concerns. The first concern addresses the situation-specific micro-circumstances determining the *extent of involuntariness of choice* in contractual labor relations. Scholastic thought tried to cope with suchlike problems using the Aristotelian idea of mixed will: for instance, Francisco de Vitoria (1492–1546) discusses the case of a master ceasing to pay recompense to his servant, putting the latter before the choice to stay and work for a zero wage or to leave. Here is Vitoria’s reasoning concerning this case: “I say that it would not have been simply voluntary but would have had something involuntary mixed with it, because he

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\* Parts of this paper were presented at a workshop on Labor Justice at the University of Zurich. Thanks to Gebhard Kirchgässner, Peter Koller, Carsten Köllmann and Anton Leist for useful comments. Of course, I am responsible for all errors.

was powerless to do more, seeing that he was about to die of hunger and had nowhere else to go.”<sup>1,2</sup>

Second, there is a (complementary and related) ‘systemic’ issue at stake in normative reasoning regarding the labor market. More or less explicitly, it is also an underlying concern behind much of the more popular normative discussion on labor and wages: how to prevent the market system and market-mediated labor relations in particular from developing parasitic (or exploitative) relations with respect to extra-economic (or extra-market) *spheres of social life essential for the reproduction of society*? Such *systemic parasitism* may be a problem for the system at large and a cause of crisis: sub-subsistence wages and/or degenerative labor market conditions (conditions incompatible with requirements of reproduction, education and civilization in the long run<sup>3</sup>) may obtain a systematic role for the working of the economy. Put another way, the structural conditions of market-mediated labor may be at odds with the sustainability of the economic system because their impact on spheres beyond the market tends to fire back in the long run. Suchlike problems even worried Adam Smith (1776, I.viii; V.i), both in his reproduction-oriented theory of wages and in his critical reflections on the drawbacks of the modern division of labor.

Be that as it may, the doctrine taught by Vitoria and others in the first half of the 16<sup>th</sup> century is subject to considerable vicissitudes until this day. A few decades after Vitoria, the mainstream of the late-scholastic Salamanca school seems to have included the issue of labor and wages in its endorsement of what, following Kaushik Basu (2007), I will call the principle of free contract (PFC), according to which public authorities should not interfere with what two or more adult agents contractually agree upon, as this agreement reveals their valuation of the outcome. With a few provisos, these late scholastics subsumed the working of the labor market under the principle of ‘volenti non fit injuria’, while Luis Molina attempted to establish an intermediate position based on a combination of reasoning along the lines of a ‘normal market wage’ as well as ‘(in)voluntariness’ (Langholm 134–6; Weber 1959, 136–42).

In this paper, I will sketch the circumstances in which PFC may be defensible even in the context of labor relations. But I will stress that these circumstances are based on rather extreme assumptions, far away from observable trends in socio-economic development. The complexities of contract-mediated production tend to produce institutions and patterns with an unavoidably public character. In particular, *problems of collective action and incomplete contracts* render the paradigms of pure private exchange insufficient for discussing relevant baseline conditions of exchange. Various writers (e.g. Zimmermann 1981; Scanlon 1988; Peter 2002) point out that accepting the terms of a contract does not imply *consent* to the background conditions, i.e. the pattern of constraints under which

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<sup>1</sup> For a thorough reconstruction of the way in which needs and power were central categories in the discussions on ‘the just price’ (including wage justice), see Odd Langholm 1998.

<sup>2</sup> Quote and translation by Langholm 1998, 134.

<sup>3</sup> An influential example of the articulation of such concerns is to be found in the view of labor and family in catholic traditions: first, they conceptualize labor as *bonum arduum* which must be prevented from becoming *pure* toil and burden. Second, the idea of a family wage addresses the problem of conditions of reproduction in the extra-market sphere.

the individuals choose, of the contract. Suppose that we find that some type of contractual terms is accepted by some individual, or by some class of individuals. This fact does not reveal any information about the degree of consent to the rules of the game, i.e. to the conditions shaping the environment of pre-contractual bargaining as well as of post-contractual contract enforcement, nor does it reveal any information about the overall efficiency of its outcome. As Scanlon (1988, 186) puts it, “the background conditions under which choices are made in a laissez-faire system are ‘arbitrary from a moral point of view’ [...]. All we know is that they will be conditions which arose from voluntary transactions, and this does nothing to ensure that they will be good conditions under which to choose.”

This is an important critical insight: it is a pivotal element of a theoretical architecture which allows for a critical perspective on PFC. But how to determine the practical relevance of *non-consent* and its normative status? It seems obvious that nobody will be much impressed if my ‘complaint’ against the present background conditions of some exchange is, say, *merely* based on my tastes or the *mere* fact that I can imagine background conditions which would improve my bargaining position, or put another way, that *alternative* rules of the game would be more favorable for me. It is perhaps almost always possible to imagine some alternative pattern of conditions under which an individual would have *refrained from accepting* some terms of a contract. The obvious question is, How do we determine the ‘relevance’ of such counterfactual social states? Put somewhat loosely, it seems that the weight of complaints against some actual background conditions is not independent of the *attractiveness, sustainability, changeability, and legitimacy* of the actual and the counterfactual background conditions. Complaints against background conditions are likely to have a dubious status if one lacks a useful criterion of attractiveness, or if it can be shown that attractive reforms of background conditions are not practically feasible or extremely costly, or that practically feasible alternative background conditions are in no way better than those actually prevailing. Those complaints will have more weight if I can demonstrate that present background conditions are clearly unattractive compared to feasible alternatives. Hence the practical relevance of the critical insight just sketched depends on the availability of answers to a variety of questions such as: Which kinds of normative standards are available in order to assess the background conditions? Can we provide arguments showing that ‘better’ background conditions are theoretically possible and give conditions rendering them practically feasible? To which extent are those background conditions the subject matter of explicit collective choice? Which aspects of social institutions are *unavoidably* unintended consequences of myriads of contract-mediated private choices whereas rational collective choice is a mere chimera with respect to the aspects under consideration?

A final introductory remark concerns the target of the criticism entailed in the following arguments. Given the context and some characteristic features of labor markets, I take issue with a version of PFC suggesting that publicly enforced constraints should be tightly restricted, as mentioned in the introductory quote from Nozick (1974). Similar views are highly influential as a kind of everyday libertarianism and can be summarized as follows: ‘To be sure, we wish to rule

out one type of market-mediated allocation of labor: slave markets. We are aware of some additional problems justifying a few further constraints with respect to labor contracts. But let us strictly keep these constraints to a minimum.’ It is this point of view I will scrutinize and criticize in what follows.

The remainder of this paper has three sections. In *section 1*, I sketch a general structure for the evaluation of background conditions of labor markets basically including two elements: the *causes* of market failure and the properties of collective/political mechanisms on which the institutional *solutions* of problems of market failure depend. In *section 2*, I discuss various combinations of institutional arrangements in the search of plausible background conditions for labor markets. *Section 3* concludes with an observation summing up my arguments regarding libertarian views of the labor market in a specific way.

## 1. Coercion, Efficiency, and the Scope of the Political: Between Distortive Regulation and the Impossibility of Contractual Fine-Tuning

If a robber effectively constrains my choice set so that I ‘choose’ to give him 1000€, this is a coerced choice. Why? Because a morally relevant baseline (my rights to the 1000€ and to the integrity of my body) is unambiguously violated by the *actual background conditions* of the exchange. (A similar argument could be made in the case discussed by Francisco de Vitoria quoted by way of introduction.) My ‘complaints’ against the actual background conditions imposed on me by the robber (including threats and violence) can be justified by various kinds of *normative* arguments qualifying these conditions as unacceptable. But there are also three complimentary ‘*positive*’ arguments in support of suchlike complaints. These arguments were made explicit in the theoretical framework of Political Economy from Adam Smith (1776) onward and certainly play a role for the emergence of institutions implying the *legal* status of these complaints: (1) The background conditions of a well-ordered and prosperous market society include universal protection of property rights and the bodily integrity of persons. (2) Such protection will not spontaneously emerge as a result of contract-mediated private transactions. (3) Theory and empirical evidence support the claim that such protection can, in principle, be provided by public agencies in a reasonably attractive way.

I believe that questions related to issues analogous to (1)–(3) should be asked in a systematic way in the case of labor contracts. Here are these questions: (1) Which are the *core features* of baseline conditions supporting a well-ordered labor market enhancing economic welfare? (2) ‘Market failure’: In which cases and for which reasons are *non-market institutions* needed in order to support these features? (3) Under which conditions and at which levels can collective mechanisms be expected to support adequate non-market institutions ‘curing market failure’? For certain purposes, one might also be interested in a specific version of (3), namely (3’): Under which conditions will specific political forms of collective choice generate meaningful *consent* to background conditions? Pa-

raphrasing Scanlon (1988, 186), we could ask whether (and to which extent) participation in political mechanisms does something “to ensure that they will be good conditions under which to choose”.

In the remainder of this section, I will discuss some of the general problems which have to be dealt with when answering these questions. For the sake of simplicity, think of (1), i.e. the *core features of acceptable labor market conditions*, as ‘PFC cum constraints’. That is, PFC constrained by some widely accepted normative standards effectively restraining the scope of market-mediated utilization of labor, e.g., norms ruling out slave labor, restrictions of daily working-time, restrictions on child-labor etc. ‘Market failure’ (2) is related to circumstances where private market exchange fails to generate outcomes which generally correspond to acceptable patterns in accordance with (1). The general background of (2) will be discussed at some length in the final part of this section. A few brief remarks regarding (3), addressing the general role of collective choice mechanisms for the development of background conditions of labor markets, and (3’), concerning the role of certain normatively attractive mechanisms, are in order. Let me put the issue in a somewhat provocative way: Suppose we have diagnosed a clear-cut case of market failure in the sense sketched above. Hence collective mechanisms would unambiguously have a *functional role*. But will *actually available* collective mechanisms produce norms and institutions remedying this market failure, or will the cure be worse than the disease? Collective choice procedures may be distorted by rent-seeking and may have other drawbacks, as has been argued by influential strands of the literature.<sup>4</sup> As argued by some of them, the greater the regulatory scope of politics, the greater the danger of distortions (in the form of useless or even perverse regulations) entailed by the logic of political choice. What can we hence reasonably expect from collective mechanisms?

An often-suggested element of attractive background conditions for labor markets is the democratic postulate that *people should have a say in the decisions that importantly affect them*, viz. certain conditions of deliberative democracy supposedly generating meaningful consent (cf. Dahl 1985; Peter 2002, 168).<sup>5</sup> The power of this argument hinges on the workability of collective choice mechanisms in general and deliberative democracy in particular. This depends on properties related to two levels: the properties of the *agents* involved and the properties of the *agenda*. As the theories of social and public choice suggest, collective choice mechanisms are more likely to produce reasonable results if the agenda is simple rather than complex, if the electorate is not too heterogeneous (e.g., divided into antagonistic classes), and if the envisaged regulation is general rather than casuistic. Mechanisms including elements of deliberative democracy depend on the extent to which an old idea is empirically relevant: individuals

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<sup>4</sup> While the discussion goes back to authors such as Hobbes, Kenneth Arrow’s Social Choice framework and the Virginia School of Public Choice are the most influential contemporary paradigms.

<sup>5</sup> Some catholic scholars argue along similar lines, stressing that treating labor as a mere resource like capital would violate the dignity of human individuals and suggesting various forms of *giving workers a say* in the labor process as a remedy (cf. Nell-Breuning 1983, 11.9 and IV.16–23).

are self-interested, but they are not always ‘rational fools’ who forego benefits of extended projects requiring cooperation and foresight. Avoiding rational fool-behavior requires what Hume (1739, III.ii) calls “judgment and understanding”, overcoming the confines of “partiality” and “contiguity”. More precisely, this requires two things: (1) Agents are able to distinguish between deliberation at the *rules-of-the-game* level and particular *moves within a given game*. (2) As members of political bodies, agents are in a position to suspend the prosecution of immediate (first-order) desires and allow ‘political’ preferences to be determined by somewhat more encompassing considerations. The capacity to transcend first-order preferences is sometimes regarded as an ingredient of agency and freedom.<sup>6</sup> Political procedures may be thought of as an institutionalized way of ‘suspending desires’ and providing leverage for second-order preferences. These considerations can be used in order to answer two kinds of questions: First, do we have reason to believe that collective choice is workable at all? (Or is it a hopeless case, due to partiality/myopia of agents or complexity of agenda?) Second, at which levels should a certain agenda be collectively decided? I give an example: If most public regulations concerning labor markets are of a one-size-fits-all nature, there is a strong case for dealing with them at a centralized level of collective choice. If one-size-fits-all does not work because local circumstances need to be taken into account, the agenda would become complex and casuistic at the centralized level. Hence it may be better to provide a constitutional framework delegating certain specific regulatory powers to lower institutional levels. Indeed, suchlike issues are at stake regarding the pros and cons of economic democracy of the labor management type vs. the social-liberal welfare state, to be discussed in the next section.

I conclude this section with a few remarks on ‘market failure’ and concomitant limits of PFC. Market failure in the sense used here implies arguments in support of norms and institutions constraining PFC. PFC provides a powerful *and simple* heuristic bringing to the fore possible pitfalls of political *regulation* of market exchange. Regulation implies coercion by imposing norms and institutional patterns *restricting voluntary exchange* between individuals, thereby constraining the scope of contractual fine-tuning according to the interests and judgments of the individuals. Most people, including everyday libertarians, agree that some such restrictions are defensible. But it is also widely believed that we are on the *safe side* (in terms of market efficiency as well as of non-coerciveness) if we try to keep these restrictions to a minimum, possibly not going far beyond those suggested by Nozick (1974) in the introductory quote. Along these lines, PFC has been particularly influential in discussions concerning the regulation and the institutional environment of labor markets in the past decades. In the following, I show that minimizing regulations does not guarantee that we are on

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<sup>6</sup> “For, the mind having in most cases, [...] a power to suspend the execution and satisfaction of any of its desires, and so all, one after another, is at liberty to consider objects of them, examine them on all sides, and weigh them with others. In this lies the liberty man has; and from the not using of it right comes all the variety of mistakes, errors and faults [...]. To prevent this, we have the power to suspend the prosecution of this or that desire [...]; in this seems to consist that which is (as I think improperly) called free will.” (Locke 1689, II.xxi.47; see also 48–52).

the safe side. This discussion is essential for a *constructive critique of PFC* which avoids pouring out the baby with the bathwater, i.e., which takes on board one of the most powerful ideas of economic liberalism expressed by PFC: the potential of market-mediated exchange for a fine-tuning of social processes according to individual profiles of needs, preferences, creativity and information—in other words: to give people ‘choice’ and to prevent over-regulation suffocating freedom, innovation, and the productive dynamism of diversity and specialization.

Here is a brief sketch of two types of arguments justifying the scope of political regulations interfering with PFC. The first argument is related to circumstances triggering collective action. Suppose first that the status-quo is inextricably intertwined with co-ordination failures (such as a prisoners’ dilemma) *which can be dealt with at a collective level only*. In this case, my actual market choices reveal close to nothing in terms of information concerning my beliefs and preferences with respect to the norms and institutions required for the solution of such problems. *If collective action is needed, PFC degenerates into a tool blocking discussions of efficient reforms which would be required in order to eliminate co-ordination failures closely intertwined with the status-quo*. One can also look at this kind of problems from the opposite perspective: Suppose that some legislation constraining contractual labor arrangements has been enacted, such as rights to join a trade union, rights to parental leave, restrictions regarding the exposure to certain kinds of hazards, or child-labor, or working-time regulations. In many suchlike cases it will be possible to show that this legislation violates PFC, i.e. prevents particular contracts which would make both parties better-off. One can now ask: Is this sufficient for advocating abolition of this legislation? As already anticipated in Mill’s (1848, V.xi.12) argument concerning working time regulations and unionization, this is not necessarily true: It may be the case that an arrangement including pertinent legislation is, taken on the whole, in the ‘general interest’ of those who supply labor services or even in the long-run interest of society at large.

But why not allow for contractual fine-tuning to individual preferences by bilateral contracts? Why not enhance flexibility and diversity by permitting such rights (such as yellow-dog contracts waiving the right to join trade unions) to be waived by those who do not care about them?

Fine-tuning may be impossible, impracticable or ‘too costly’. Here is an example illustrating some of the causes of suchlike impracticability: given prevailing politico-economic mechanisms (such as various forms of competition), waiving the right to join unions by some fraction of the workers (‘those who don’t care’) may not be stable. We rather may end up with a situation where waiving the right is standard and no other contracts are available. As put by Mill (1848), the ‘local’ advantages motivating some type of deals in the first place may be annihilated if this type of deal becomes general practice in a competitive environment. More generally, Mill (1848, V.xi.12) argues that for certain kinds of individual interests the following is true: individuals are “unable to give effect to it except by concert, which concert again cannot be effectual unless it receives validity and sanction by the law”.

Mill's (1859, V.11) ingenious argument on voluntary slavery can be reconstructed as an example of a second class of cases in which *observable market behavior may fail to reflect the preferences of individuals* in a meaningful way: once enslaved, the market behavior of an individual (who by definition has no opportunity to engage in voluntary market transactions regarding her human capital) provides no evidence that his continuing slave status is desirable or acceptable to him. Hence, extending PFC to contracts that *establish* 'voluntary slavery' is self-defeating. The case of slavery illustrates a second general aspect rendering the presumption that PFC implies attractive contractual fine-tuning dubious: the *factual circumstances of contract enforcement* may render contract-mediated choices non-revealing if those circumstances practically annihilate the opportunities of employees to consider 'alternative uses' of their time. Expressed in the jargon of economics, the presumption that choices of an employee reveal her preferences implies that the scope of relevant *opportunity cost calculations with respect to her own time cannot be arbitrarily narrow*. Here is the sketch of an argument suggesting that this type of reasoning may be extended beyond Mill's point regarding voluntary slavery. Notice that the value of family production is an important determinant of labor opportunity costs, but in the first place for the individual and her family (and perhaps the society at large in terms of long-run sustainability). *Contract partners* are not likely to care *directly* about such non-market related opportunity costs. Enforcement conditions of labor contracts may severely restrain workers with respect to their factual opportunities for responding to the demands of their family life or their own health, rendering market-choices non-revealing with respect to their true preferences. This is not a marginal problem since it relates to the core of modern production: modern production tends to require restrictions of individual time sovereignty ('labor discipline'). In the light of the above arguments, it is more than plausible that the effective scope of these restrictions should be an issue of public choice. It should not depend on the vicissitudes of relative scarcities and market power, but rather on the outcome of collective decisions. Merely ruling out slavery may not be enough. As the person-related scope of tradability of labor power increases (with tradability of the individual 'as a whole' on slave markets as a border case), the person-specific opportunity costs that are conditional on value created in non-market spheres tend to disappear from any locus of decision.

In this section, I have given a very rough sketch of the issues which must be considered when looking at the background conditions of labor markets. All things considered, it suggests that a standard derived from an analysis of *individual transactions* (such as the absence of force and fraud), while disregarding problems of collective action and enforcement, may be insufficient for a morally sound definition of labor market background conditions. Instead of elaborating on this sketch, I will now discuss various scenarios of background conditions for labor markets. Two of these scenarios are clearly unrealistic, one is unattractive, and the remaining two scenarios may provide the co-ordinates of problem-oriented discussions on acceptable background conditions. In the context of these scenarios, some characteristics of *contract-mediated co-operative production processes* will come to the fore. These characteristics concern the *core of market-*



*mediated labor* and must be considered when talking about *desirable properties* of labor market institutions (which is why I kept the pertinent passages brief and illustrative in the present section). Moreover, they are the basis of a deeper discussion of the labor-specific scope, relevance, and status of various market failure arguments, suggesting that a *few simple constraints set once and for all* will not solve the problems. They mainly address complexities (contract enforcement and fraud, e.g., are difficult concepts within labor contracts) and public features of the contract-mediated sphere of production; complexities which seem to lurk in the background of Mill's position concerning voluntary slavery, including in particular the idea that in a society valuing individual freedom the individual's choice to trade away her liberty is *not* a purely self-regarding choice, Abraham Lincoln's *House-divided speech* (1858)<sup>7</sup>, Basu's (2007, 567) analysis of power in triadic contract relations, and arguments of feminist economists concerning the position of women in labor markets.

## 2. Reasonable Baselines for Labor Markets: Democratic Welfare Capitalism and Economic Democracy

In this section, I will discuss various scenarios of labor markets and embedding institutions. The discussion of these scenarios has two heuristic purposes. First, it brings further reasons to the fore in support of the view that, in general, we should expect collective institutions and labor-specific regulations to be part of the background conditions of labor markets (or, put differently, that completely disembedded labor markets are implausible). Second, this discussion addresses questions which are related to the form and level of collective institutions and regulations.

### 2.1 A Reconstruction of Labor Markets à la Nozick (1974)

The exchange on perfectly competitive markets is a powerful model for the possibility of exploiting freely the advantages of cooperation. Because nobody is forced to buy or sell anything, the terms of exchange on markets do not add any additional constraints to those under which Robinson Crusoe chooses. Moreover, if determined by competition, these terms prevent everybody from being unfairly taken advantage of, and socially valuable efforts from not being duly compensated. Finally, the exploitation of all mutually beneficial opportunities for trade will eventually lead to an efficient equilibrium, i.e. no alternative allocation of resources will exist which would make anybody better-off without making someone else worse-off. There can be no doubt that this model of exchange captures important liberal ideas, namely that individuals do freely co-ordinate their actions in a socially beneficial fashion. With regard to its explanatory content, the problem with this model is that it seems to be ill-suited for explaining a

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<sup>7</sup> Abraham Lincoln 1858, 12, argued that (under conditions of mobility and interaction triggered by dynamic expansion) "a house divided against itself cannot stand [...] this government cannot endure permanently half-slave and half-free".

central aspect of capitalist governance, namely firms. Firms exploit the scale properties of production processes caused by technological indivisibilities. These properties are the reason why pooling of efforts is advantageous. However, it is not true that firms are necessarily absent from this model. Firms can be conceptualized as pure webs of contracts. The specificities of labor-related problems of *contract enforcement* (alluded to in the final passages of the previous section) can be assumed away by presupposing contractual exchange of ‘efficiency units of labor’ which are *ex ante* well-defined. I will come back to the problems of this assumption in more detail. Nonetheless, we can give a fairly accurate description of how the contractual exchange of labor services must look like in order to support Nozick’s minimalism concerning its institutional embedment. Of course, this model of the labor market and of firms does not capture essential features of *real* firms. Capitalist firms are distinguished from other conceivable types of firms in that residual control and claims to residual surplus streams is separated from the provision of labor services. This implies a particular solution to the enforcement problems connected with labor contracts. Nearly all great economists who worked with these models, such as Knut Wicksell and Paul Samuelson, felt obliged to point out that they consciously abstract from realistic features of firms, emphasizing that in these models it plays no role *whether capital hires labor or labor hires capital*. These abstractions may make sense for modeling the behavior of big interdependent market systems, but they are off the mark when considering the circumstances of labor contracts in order to deepen the understanding of existing or desirable constraints upon PFC. Hence let us have a closer look at the properties of labor which render the above-sketched models unrealistic.

## 2.2 The Ambiguity of Labor

Late scholastic authors discussed the problem of ‘hidden wage’: suppose that a master clearly violates fairness rules (e.g. the wage is too low). Can we give conditions rendering unobserved self-compensation by workers (‘shirking’) legitimate? The scholastics differed in their assessments, but this is not the point here. The point is that very early on in the history of economic thought notions capturing some of the distinct features of labor markets (as opposed to other markets) played a role; notions which again came to the fore quite recently in labor market theories such as efficiency wage theory. Which special features of labor and of labor markets give rise to those problems? In a moment, we will answer this question with a summary of the arguments by means of which the claim that ‘labor is different’ can be supported. But we should first take notice of the similarities to other markets, i.e. aspects which are the economic basis of tradability of labor. First, the traded services have the character of scarce private inputs. Time and effort spent in a particular labor process can’t be spent somewhere else. In addition, it is possible to exclude third parties (which didn’t contract with me) from the use of my labor services. Second, the output produced by firms is traded and priced on markets for private goods. Therefore the market valuation of produced output can be taken (in conjunction with marginal

productivity) as the basis for imputing values to the contributing factors. Third, the quality of labor can be meaningfully modeled as the result of an investment decision concerning human capital. These aspects underscore the view that labor power is a private resource which must be made or kept tradable if efficiency and liberty are to be preserved and enhanced. If *tradability* of an asset is inhibited or severely restricted, the value of market alternatives is no longer a basis for deciding on efficient use.

Even if all this applies, the above-sketched labor market model hinges on an additional assumption, presupposing that labor efficiency units can be traded without problems. Under this assumption, wages can be regarded as relative prices expressing scarcity like the price of other commodities. In reality, wages must be seen under further aspects. First, wages are the main source of subsistence and well-being for large parts of the population. Second, labor, sometimes even participation in a particular labor process, may constitute an important part of personal identity. Third, let us now come to the specific differences of labor *contracts*. They are *inherently incomplete* in the sense that it is impossible or too costly to foresee and specify all contingent duties they implicitly may be intended to entail. Moral hazard is endemic in labor markets: after contract conditions have been fixed, it is in the interest of the worker to provide as little effort as possible. The employer is interested in extracting as much productivity as possible. If she has an opportunity to shirk without risk, the worker has a clear incentive to do so. If the employer need not be concerned about negative reputation effects or other sanctions, she has an incentive to expose workers to toxic chemicals whenever it is profitable to do so.

Moral hazard occurs also on many other markets, most notably credit and insurance markets. But labor is not only no resource of known homogenous quality, but it also cannot be easily bought and sold in arbitrarily divisible quantities. Typically the nature of the service provided makes it necessary that the laborer is physically present at the workplace as an agent for extended periods of time. Often it will be efficient (because of hiring and training costs) that she spends a considerable span of her lifetime at a particular workplace or in a particular firm. This inter alia may cause further asymmetries, such as asymmetric costs of termination of labor contracts. Last but not least, labor conditions often will have a first-order impact on spheres like politics or the family. This may be an important reason for public concern in its own. Moreover, duties related to these other spheres may exacerbate problems of moral hazard as they may provide quasi-moral justifications of hidden action. Lack of family-friendly regulations of labor relations may provoke 'justified shirking' (a phone-call to the kindergarten during work-time) in a way reminiscent of late-scholastic discussions on the hidden wage. Altogether, the following general presumption is justified: what is actually traded in labor markets is better referred to as 'labor power', not as well-defined efficiency units of labor.

### **2.3 The Firm as a Web of Contracts in the Night-watchman State**

From the perspective of political philosophy, the problem with the incompleteness of labor contracts is that it reintroduces elements of the state of nature. To see this, consider an imaginary night-watchman state enforcing a regime of private property rights. Additionally, it provides arbitration when it comes to litigation about contract fulfillment. Efficiency-units of labor are not directly tradable; so the labor contracts do only specify wages and hours of work. They will leave open contract obligations in a great number of contingencies. Now remember that no labor legislation is enacted (we have a night-watchman state) and assume for a moment that giving authority to one side ('the capitalist firm') is ruled out, maybe because it is seen as a violation of self-ownership rights. Under such circumstances a lot of haggling about contract fulfillment will occur. As discussed above, things on the labor market are by no means settled when the parties have agreed on the hours to work and on a particular wage. The firm is not a place where (passive) resources are pooled. It is a production process where agents continuously decide to deliver effort, take risks and so forth. Parties will be under the continuous temptation to shirk. Unfortunately enough, they have a lot of opportunities to do so. Workers' laziness may lead to inadequate maintenance and destruction of valuable capital equipment or to huge output losses in interwoven production processes. Investment decisions may reduce the value of workers' human capital. Work may be hazardous in a way unknown to the worker. Courts won't be of much use as an instance of arbitration because in absence of labor legislation they lack standards to decide whether 'enough' effort has been delivered or whether imposing sanctions for 'shirking' is 'justified'.

It is not hard to see the underlying reason why the courts of a night-watchman state will hardly be well equipped to deal with competing claims in the sphere of labor contracts. The reason is that the rules of a night-watchman state are designed to protect private property domains as exclusive action space of individuals. Labor processes require a temporal, but often nearly complete suspension of privacy. They regularly require that the private sphere of the people involved is invaded in many ways. Workers are typically required to work together and thereby entertain social relationships with others. They are required to take extraordinary efforts and to do very unpleasant things at certain times. Labor contracts may require persons to dress in a special way, to use or not use make-ups and perfumes, to engage in extremely hazardous activities (like extinguishing burning oil-fields) and so on. For reasons that are rarely endorsed today but were widely endorsed in the heyday of economic liberalism, they may even include requirements regarding family status (remember the marriage bars for female employees). The more robust of the privacy-invading requirements of labor discipline are driven by the technical conditions of interwoven production processes. Important aspects of working conditions (not only the speed of the assembly line) are 'jointly consumed'. The effort a worker takes in these processes does affect the output of her co-workers. All this sets the stage for collectively binding decisions and some devices to enforce these decisions.

## 2.4 The Capitalist Firm in the Night-watchman State

The above considerations suggest that the web-of-contract firm in the night-watchman state is irrelevant as a baseline scenario because of its lack of institutional remedies against contract incompleteness. Let us now drop the assumption that one-sided authority is ruled out, but keep the assumption of the night-watchman state. This means that we move to the capitalist firm, as conceptualized by Marx and others. This firm does in fact amount to a Leviathan solution to the above described problem of labor contract incompleteness by giving to one side the authority to determine what the other side has to do if an unforeseen contingency occurs. As in our earlier story, courts lack suitable principles for assessing (il)legitimate coercion. The coercive power of the Leviathan-firm is of course restricted by competition on the labor market. Adam Smith (1776, I.x.c.61) believed that in the progressive state of society (going along with a growing economy) competition will impose sufficiently tight constraints, provided that some equity in labor market practices is established—mainly ruling out coalitions of employers and other privileges which tend to undermine competition in an unfair, one-sided way. But in a stationary or declining state, labor supply tends to be overabundant so that Leviathan is hardly tempered. Demand-and-supply conditions on the labor market would determine whether basic rights of workers as persons are respected, and whether labor conditions reflect basic preferences or needs of employees. Put another way, these labor market governance institutions render the scope of self-ownership rights contingent upon the vicissitudes of relative scarcity and market power.<sup>8</sup> Under such conditions, business cycles are likely to be accompanied by cycles of class warfare, exacerbating the instability of the system. A further troubling aspect of such a contract governance structure can be summarized in terms of long-run sustainability: market-mediated labor becomes *parasitic* in its relation to other spheres of the social life, as the rules of the governance institutions for labor-exchange may produce systematic conflicts with obligations which people have as parents, members of communities, citizens, and so on. I conclude that this scenario is more realistic than the previous but relatively unattractive and probably unsustainable in the long run. Hence it should not be accepted (neither officially nor implicitly) as a baseline scenario for the diagnosis of coerced choices on labor markets.

More generally, ‘libertarian’ background conditions exclusively described in terms of private ownership-rights are found insufficient for two main types of reasons: (i) They fail to capture asymmetries becoming relevant in cases of incompleteness of contracts and thereby fail to set a non-arbitrary limit concerning the contract-mediated use of human resources. (ii) They fail to conceptualize the rationale and the conditions of *legitimate* discipline within firms. Both (i) and (ii) imply a strong case in support of background conditions including specific collective regulations regarding contract enforcement, implying practices at the level of labor processes and workplaces.

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<sup>8</sup> This tends to be particularly troubling in cases of near-subsistence wage-levels combined with a backward-bending supply curve for labor.

## 2.5 The Capitalist Firm in Democratic Welfare Capitalism

Let me now outline the general strategy for obtaining criteria to choose among labor market regimes defensible as relevant baselines. The idea is to look for regimes based on regulatory standards and institutions permitting tradability of labor while dealing with issues of collective choice by giving people a say at the appropriate levels and in the right way. Of course, in the following I am assuming that collective choice mechanisms function sufficiently well in order to generate reasonable regulations. Total pessimism concerning any form and level of collective decision making would leave us with the capitalist firm à la Marx (probably implying that dynamic market economies are unsustainable in the long run). Attractive arrangements will balance the costs and advantages of over- and under-regulation, based on requirements imposed by the collective nature of some coordination and decision problems of co-operative production. These requirements are ignored by libertarian models of labor markets and addressed in an inferior way by a capitalist regime as described by Marx. Capitalist firms in welfare capitalism are no Leviathans in the sense that they have absolute power within the constraints fixed by competition. Firms are embedded in various types of non-market and market relations. Their behavior is subject to public laws including labor legislation and perhaps informal rules of conduct. They have to deal with the collective bargaining power of unionized workers. For good reasons, democratic welfare capitalism developed an extended set of regulatory policies beyond just ruling out slavery.

How attractive is the set of background conditions developed by democratic welfare capitalism? According to the main thrust of argument put forward in the present paper, it is not desirable to abolish markets for the exchange of labor services altogether. This would unambiguously reduce beneficial exchange opportunities. Exchange of labor should be possible, subject to the condition that adequate norms, governance structures and collective choice mechanisms are in place. Of course, this formulation is very general. I will not specify all implications fully in the remainder. A few sketchy remarks, complemented by a comparison of democratic welfare capitalism and what I believe to be its main alternative as a baseline scenario ('economic democracy'), may help to understand what is at stake here.

Democratic welfare capitalism has developed institutions suitable to attain the above-sketched vision in a certain sense, viz. making/keeping 'labor' tradable and at the same time dealing with the legitimacy of collectively binding choices and their enforcement. Modern capitalist ownership rights resemble the Leviathan firm insofar as residual control rights and rights to residual surplus streams are separated from workers (not necessarily from all employees, as exemplified by models of managerial capitalism). The labor legislation of democratic states is designed to protect the human resources of workers on the basis of their participation in collective choice procedures: the rules are not imposed by dictatorship, but are negotiated in democratic processes and collective bargaining. The consequence of all this is a *bundle of public regulations, distributive policies and provisions effected by collective bargaining* which jointly modify the charac-

ter of hierarchical capitalist firms. This bundle is quite well-suited to protect employees from excessive dirt, excessive heat, excessive health hazards, and so forth. Moreover, it gives rise to various policies (whose suitability in the face of new challenges is hotly contested these days) with the goal of reconciling the demands of market-mediated production with reproduction in families.

It has been subject to two main kinds of criticism. First, it infringes upon contract freedom by imposing constraints at highly centralized levels. It may well be that the web of constraints imposed by state legislation and collective bargaining on a macro-level does not exploit all *existing* opportunities for fine-tuning, as its mechanisms for accommodating vast ranges of different preferences, different abilities, different dispositions, and different tasks are naturally limited. Second, adherents of emphatic concepts of democracy also resent the paternalistic aspects of centralized and unavoidably bureaucratized schemes of regulation: they do not always enhance the collective autonomy of agents in local contexts of particular labor processes. The hierarchical character of the firm is only modified in that constraints on permissible procedures are superimposed, but it is not altogether altered. Nonetheless, one can imagine technical conditions which, in conjunction with workers' preferences and socio-cultural conditions, lead to the conclusion that a suitably amended model of democratic capitalism is the best we can hope for. But there is a respectable tradition of a different model emphasizing the potential of democracy at the decentralized level of firms<sup>9</sup>, including employee ownership and control of firms otherwise operating in competitive markets. Some pros and cons referring to this model will be sketched in the following.

## 2.6 Conditions for Economic Democracy

To put the following in perspective, an introductory remark is in order. Centralized and more decentralized levels of collective decision making could be seen as complimentary, raising the question of an optimal institutional mix providing answers to collective action problems of different scale and scope. Some matters need to be dealt with at more centralized levels, most notably the constitutional option for economic democracy itself. Many supporters of economic democracy are keenly aware of this. An intelligent model of economic democracy would reflect this and would avoid excessive decentralization.

But for sake of clarification of the issues and values involved, it makes sense to discuss laboristic economic democracy as a distinct model. Both democratic capitalism as well as economic democracy are paying tribute to the fact that, for good economic and extra-economic reasons, most people do not want their livelihoods to be governed totally by atomistic competition. Industrial democracy is the regime which presumably would take into account the agency-related faculties of workers in a more direct and activity-enhancing way. It may be in a better position to accommodate concerns raised by communitarians and by adherents of more emphatic 'participatory' conceptions of democracy. By giving agents a say with regard to collectively binding decisions at the firm level, which concern

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<sup>9</sup> For a summary of motivating ideas, see Dahl 1985.

matters that most importantly affect them on the particular decentralized level as a community of producers, it could enhance diversity and experimentation. It could also enhance and broaden entrepreneurial agency and mitigate tendencies of *excessive bureaucracy, excessive uniformity and firm size 'too big to fail'*. But what about tradability of labor? It seems that tradability would be restricted and channeled in a very specific way which is not straightforwardly attractive. Incumbent workers of successful firms might tend to form stable groups and would be reluctant to admit newcomers as members with full rights to vote and residual claims. One might end up with a system where stable cooperatives trade on output markets, with an extremely restricted market for labor and, put cautiously, a very specific capital market. To be sure, there is one institutional arrangement which could cope with these problems: making membership rights of cooperative firms tradable (Fehr 1993). Tradable membership rights would enable members to leave firms without giving up their share of expected residual income streams to which they have contributed. They could sell membership rights at a price equal to the capitalized value of that income stream. This arrangement is not without peculiarities. It seems to combine aspects of market-mediated labor mobility with aspects of to-days market for corporate control. Moreover, buying a membership right will be a risky transaction, with few direct possibilities of diversification. Markets for such rights may be thin and thus not competitive, which, in turn, would make it necessary to establish an institution that solves the bargaining problems occurring in the negotiations about the proper price.

These problems notwithstanding, economic democracy is interesting as a candidate for a baseline scenario. It seems to provide an institutional alternative to democratic capitalism accommodating a plausible balance of markets and collective choice mechanisms, given the characteristic problems of the production sphere. This model becomes more interesting, the more relevant the shortcomings of existing models of democratic capitalism turn out to be. One may speculate (cf. Sturn 1994) that the advantages of economic democracy are related to the importance, the distribution, and the degree of specialization of human capital, along with the technological possibilities of external control of labor processes and the nature of co-operation-related interdependencies at the workplace. Even if one comes to the conclusion that a full-fledged model of economic democracy has too many drawbacks for putting it on the agenda for institutional reform, it should be taken seriously as a source for critical reflection of relevant baseline conditions for the exchange of labor.

By contrast, an arrangement combining private ownership and markets (cf., e.g., Nozick 1974, 187) with the minimal state has exhausted its potential in terms of sharpening our thinking on baseline background conditions of labor markets. According to Nozick, the framework for a libertarian ideal includes the minimal state as an ideal protective arrangement. Now in a 'first-best' world without any of the frictions which are known to challenge the paradigm of mutually beneficial exchange, it may be difficult to justify the minimal state and (public enforcement of) private property rights and contract enforcement. In such a world, PFC and the Coase theorem must be expected to hold in an all-encompassing sense (cf. e.g. Sturn 1997, III.2). People could achieve any real



improvement by means of spontaneous negotiations: a Golden Age anarchy. The Nozickian argument *in favor* of the minimal state and *against* any other form of state presupposes a very specific profile of public coordination problems, i.e., a second-best world; Nozick's 'ideal' is meaningful if and only if these problems *exactly coincide* with the interdependencies justifying provision of public goods by the minimal state—and in particular do not include the above-sketched complexities of labor markets. In absence of this unlikely coincidence, legitimate collective institutions are characterized by a web of public norms and regulations which is *more complex, more subtle and less static* than is implicit in the vision of a state 'limited to narrow functions'.<sup>10</sup> More specifically, given that the production-related agency problems are empirically mediated by the institution of the capitalist firm with asymmetric authority, adherents of individualist rights in a broadly Lockean tradition can hardly recommend—everything else remaining equal—a move from welfare capitalism towards a minimal state as an attractive political reform. Even though a move towards a minimal state enhances contract freedom, it is likely to make things worse in terms of non-justified privacy-infringing tendencies at the workplace. Given a capitalist organization of production, the minimal state fails to be second best because the amount of illegitimate coercion must be expected to increase. The incidence of such coercion is diagnosed on the basis of reasonable baseline conditions of exchange which include workable solutions of the problems regarding labor market governance. These problems are assumed away in Nozick's scenario thus triggering the minimization of constraints upon PFC. Notice though that I do not argue that the underlying contractual reasoning is not amenable to powerful insights and much less that it is nonsense. Quite to the contrary, PFC is a powerful heuristic elucidating pitfalls of over-regulation, including the case of labor markets. The crucial mistake (not only by philosophical libertarians such as Nozick, but also by more wide-spread and more pragmatic everyday libertarianism) is to treat PFC as a presumption assumed to be valid either in general, or (in a more pragmatic version) valid unless *conclusive empirical evidence* concerning the detrimental effects (e.g. of some types of labor contracts) becomes available. This implies a problematic and unwarranted asymmetry in the onus of argument and empirical support. What I called 'the ambiguity of labor' leads to the suggestion that PFC is dramatically misleading *as a general presumption* in the case of labor relations.

### 3. Concluding Remark

Nozick believes that a libertarian regime is best suited to promote respect for persons "who may not be used in certain ways by others as means [...] or resources", as he paraphrases a Kantian concern (Nozick 1974, 333). Indeed, market-mediated employment of labor is not necessarily accompanied by treating laborers as *mere* means. But contrary to Nozick's paraphrase of the Kantian concern, *totally* ruling out an instrumental dimension of individual contributions

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<sup>10</sup> Cf. Child 1994 for discussions of related problems.

in modern production processes altogether amounts to unrealistic romanticism, given their essentially interwoven and open-ended nature: part of my agency will typically become a *means* of production in processes which I *do not control*. A more reasonable position is to address this concern by embedding labor contracts in institutional settings in which agency-related powers of workers as humans become effective, while acknowledging the unavoidably instrumental aspect of the use of human resources in co-operative production processes on the basis of *produced means of production*. In a way, Nozick asks for the wrong thing to start with (unconditional non-instrumentalism), and eventually ends up with an approach that offers no sufficient resources to cope with characteristic problems of labor markets, problems which *cannot* be solved by making private (self-)ownership rights more rigid but only by engaging market participants in collective decision mechanisms and public regulations. Ironically, the libertarian approach lacks the resources to diagnose cases of *merely* instrumental treatment of human labor partly *because* the inescapably instrumental aspect of labor in co-operative production is under-conceptualized.

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