European Journal of Law and Economics, 3:109–112 (1996)
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Book Review: *Property and Contract in Economics: The Case for Economic Democracy*

D.P. Ellerman, Blackwell: Oxford, UK and Cambridge, USA, 1992

Reviewed by Dr. Geert Woltjer

This book discusses the institutions of property and contract in Western market economies and argues that the whole capitalism-socialism debate was incorrectly defined because it was based on private versus public employment instead of the employment relation versus universal self-employment. According to Ellerman the labor contract should be forbidden because it denies the responsibility of human labor. Ellerman makes the case for a private property market economy where firms are owned by the employees. Everyone works for himself, individually or jointly. Decision making may be organized by representation, as an analogue to political democracy. Therefore, management should be responsible to the stakeholders rather than just the stockholders.

The book is divided into three parts: property, contract, and an application of those basic concepts to economics. In property theory the notion of the whole product replaces the notion of the residual or profit used in price theory or value theory. The ownership of the whole product implies that the owner is responsible for the inputs (capital and labor) as well as the output. In capitalism the role of residual claimant is assigned without much thought to the capital owner. Ellerman assumes that this is based on a fundamental myth according to which capital must bear the responsibility for the firm and therefore is the owner of the whole product. This *de jure* (legal) assignment of the whole product to capital is not consistent with the factual responsibility of labor; machines and tools are things and therefore cannot be responsible. Human beings are the only ones who can be responsible for a firm. According to this labor theory of property people should legally appropriate the positive and negative fruits of their labor. The ownership of the fruits of one's labor is a *natural right* that cannot be transferred by law, contract or otherwise.

Ellerman argues that the labor theory of property has not been correctly interpreted because of its intertwining with the labor theory of value. The confusion starts already by interpreting Locke as a defender of the labor theory of property. Locke assumed that a man's labor is so unquestionably his own property that he may freely sell it for wages. This is inconsistent with the assumption of the labor theory of property according to which a man's labor is his natural property right and therefore cannot be sold.

The second part of the book focuses on contract. Ellerman compares labor contracts with slavery contracts. There are only two important differences between these two contracts: voluntariness and the duration of the relationship. Why is slavery despised and the labor contract normal practice? According to Ellerman there is no rational reason for it. "The fundamental efficiency theorem of capitalist economic theory must assume that the self-sale or lifetime labor contract is legally valid, even though the contract is now legally invalid" (page 102).

Just as in economic theory, in political theory the argument of efficiency and free contract have been combined to defend dictatorship (Hobbes). The counterargument by Locke was based on inalienable natural rights. This was a foundation for political democracy. Ellerman argues that the same type of argument can be used against the labor contract and in favor of economic democracy—that is, universal self-employment.

The basic idea of the theory of inalienable natural rights on one's own labor is that a person cannot *in fact* consent to transform himself into a thing, so a legal contract doing this is invalid. According to positive law within the scope of lawful employment, an employee does not have the legal role of a responsible person, so the employer has all the legal responsibility for the results of the employees; the acts of the servants are assumed to be the acts of the master. The inconsistency of this employment contract becomes clear when an employee commits a crime. In that case the employee is regarded as a person who is responsible for his own behavior, even when the employer ordered him to do it. Therefore, the employee who is in practice always coresponsible for the results of voluntary joint activity with the employer should be dealt like that. "The employment firm provides a unified legal entity for the joint human activity of production, but it legally denies the employees' coresponsibility and their co-decision-making (for lawful activities). It is not 'their business' " (page 138).

The last part of the book applies the basic concepts of property and contract to economic theory, especially Marxist theory and general equilibrium analysis. Ellerman argues against using the net present value of capital assets because it implicitly assumes that the whole product is appropriated by capital while it should be by labor. He attacks Arrow and Debreu on their general equilibrium model in which positive profits are possible: "In the presence of positive pure profits in a productive opportumty, an arbitrageur could offer slightly higher prices to input suppliers and thus take over production with slightly lower but still positive profits" (page 254). But this is not allowed by Arrow and Debreu. Each productive opportunity is "owned" by a corporation, and only that corporation is allowed to demand the inputs necessary for the productive opportunity. Therefore, Arrow and Debreu assume hidden nonmarketed factors and prove Pareto-optimality given those hidden factors. If those hidden factors would have been state-owned sectors in a communist country, they would not say this!

Ellerman also attacks the Clark-Wieser marginal productivity theory according to which "each factor gets what it produces." First, marginal productivity theory assumes that each unit of a factor produces a marginal product, while according to Ellerman only responsible persons can produce. Second, it is assumed that in a competitive economy each factor gets its share in the product according to marginal productivity, while according to the labor theory of property the owner of the firm owns both the inputs and the outputs. Therefore, although the distributive shares picture in marginal productivity theory may be correct as a description of value relations, it is false as a description of property relations. In the capitalist economy labor gets a share of the value, not of the property rights.

Ellerman's attempt to develop another than mainstream approach is courageous. An attack on mainstream economic theory is always challenging and helps you to become aware of the weak and strong points of economic theory. In that sense the book is successful. Ellerman relates his view carefully to classical authors like Locke, Marx, Hegel, and Ricardo and tries to refute a lot of possible arguments against the labor theory of property in the

chapters about misinterpretations of the labor theory of property and the *de facto* theory of inalienable rights. These chapters are illuminating and very useful.

Despite these qualities Ellerman's main argument that the employment contract is not valid because it is inconsistent with the *de facto* inalienable rights is not convincing. First, his argument that a thing like capital cannot be responsible is not valid because it is not capital itself that is held responsible, but the owners of capital who by their investment decisions determine who can continue to operate and who not. When neoclassical economists assert that capital is responsible for production this is only a metaphor implying that the capital owners, also human beings, are responsible. The problem of the distribution of responsibilities can be defined as an agency problem where responsibilities are assigned according to efficiency arguments. One may argue that subjects who influence the outcome most must bear most of the risk. To a large extent this should be the managers, for a smaller part the workers. But it may be that managers are not able or do not want to bear all the risks of entrepreneurship. They may insure themselves against a fixed premium. The standard labor contract assumes that labor is not able and/or does not want to bear the risk of entrepreneurship and therefore allows the capital supplier to appropriate the positive and negative profits—that is, to own the firm. There is a tradeoff between risk sharing and optimal profits.

Ellerman's comparison of the labor contract with slavery is not convincing. Perhaps you can argue that slavery is comparable with dictatorship, while the labor contract is comparable with a representative democracy. In slavery and dictatorship there is no opportunity to correct fraudulous or incapable decision makers, while in both democracy and the labor contract there are opportunities for correction (by voting respectively leaving to another employer). In an uncertain world it can be useful to forbid long-term contracts like slavery where the terms of the contract are not very clear. This is inconsistent with a simple general equilibrium theory but not with a market economy in the free world. In contrast to slavery, in the labor contract you are always free to leave. This is an essential difference. And this difference may also explain why democracy is more important in states than in firms: it is more difficult to leave a state than to leave a firm. Therefore, the correct line of argumentation about contracts and democratic requirements is one of freedom and power, not one of a natural property right on labor.

In Ellerman's line of argumentation I miss an explanation of the emergence of the labor contract in history. Why do people become involved in this type of contract? It seems to me that differences in capacity to bear risks between capital owners and labor suppliers is a sound explanation and I did not find a counterargument in the book. Also the imputation of rights and responsibilities according to the extent one can influence the results may be an argument.

The assumption that labor has to be responsible instead of capital is repeated numerously without making the argument more clear. It is surprising that Ellerman focuses on general equilibrium theory and marginal productivity theory while neglecting the institutional theories about the labor contract. Furthermore, while the book is an attack on the labor contract, it is very vague on the organization of the self-employed firm. Ellerman sees trends toward the self-employed firm in large companies in Germany and Japan. Employee stock ownership plans are a tendency in the correct direction. Ellerman refers to Yugoslav self-management firm as an example of self-management in socialist economies. But this

system missed the part of hard budget constraints, including the risk of bankruptcy. And this risk of bankruptcy may be the reason why labor prefers the employment contract instead of bearing the risk of entrepreneurship themselves.

In conclusion, Ellerman's book is a brave attempt to develop a nonorthodox theory. The book is challenging in that it brings in unconventional interpretations. It relates political philosophy and economic theory in a useful manner. But the main line of argumentation according to which the employment contract attacks the basic human right of self-determination is disappointing and not convincing.

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