

# Commerce and Community

Ecologies of social cooperation



Edited by Robert F. Garnett, Jr.,  
Paul Lewis and Lenore T. Ealy

  
ROUTLEDGE

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## 15 Classical liberalism and the firm

### A troubled relationship

David Ellerman

#### Introduction

Richard Cornuelle has forcefully raised an issue that has been rather neglected in libertarian, Austrian, or market-process economics, namely that "lacking any analytical device but market theory" ([1965] 1993, 186), the market-based approach has trouble giving a satisfactory account of social associative action or even an account of what goes on inside firms. The lacunae in the Austrian approach are shared with the new institutional economics of neoclassical economic theory: "A fundamental feature of the new institutional economics is that it retains the centrality of markets and exchanges. All phenomena are to be explained translating them into (or deriving them from) market transactions based upon negotiated contracts, for example, in which employers become 'principals' and employees become 'agents'" (Simon 1991, 26–27).

Cornuelle was writing at the time when the socialist experiments of the twentieth century were collapsing. This was widely seen as a historical verification of the Austrian critiques of a socialist economy in favor of a market economy, and, more broadly, the critiques of planned organizations (*taxis*) in favor of spontaneous orders (*cosmos*). This leaves a big problem; accounting for the "visible hand" of the organizations that are so important in, if not characteristic of, modern industrialized market economy.

As the dust settles on the ruins of the socialist epoch, a second crippling deficiency of libertarian thought is becoming more visible and embarrassing. The economic methodology that the Russians have lately found unworkable still governs the internal affairs of firms in capitalist and socialist countries alike. An economy presumably works best if it is not administered from the top; a factory presumably works best if it is.

(Cornuelle 1991, 3)

The overall topic of this volume is the relationship between commerce and community in various settings, with the focus in this paper on the

firm. The analysis will use a number of polarities involving contrasting Weberian ideal types. In addition to the overarching contrast between commerce and community, there are the polarities of markets and/or firms, extrinsic and/or intrinsic motivations, exit and/or voice, and the legal roles of employee and/or member in a firm. Polarities are analytical tools. Their use does not imply the assumption that everything must fit on one end or the other of the polarity. It should be recognized at the outset that real-world cases will almost always involve some mixture of the ideal types – in contrast to more “idealized” intellectual models. But that recognition should not be taken as a license for the homogenizing thinking that just presents everything as a mixture so that “all cows are gray” and thus there are only different shades of gray.

### Markets in the firm

Herbert Simon has perhaps done the most to integrate organizational analysis into neoclassical economics and has even argued that the “economies of modern industrialized society can more appropriately be labeled organizational economies than market economies. Thus, even market-driven capitalist economies need a theory of organizations as much as they need a theory of markets” (Simon 1991, 42).

Our representatives of the Austrian treatment of the firm, Cowen and Parker, agree that “Simon correctly recognises that the modern market economy is an organisational economy” (1997, 14, fn. 4). Moreover, Cowen and Parker agree with the lack of any serious theory of the firm in the neoclassical theory.

That the neo-classical “theory of the firm” is not a theory of the firm at all but rather a theory of perfectly competitive markets, is now well recognised. In this theory the firm is a ‘black box’ or void in which inputs are (somehow) frictionlessly converted into outputs. The theory does not address how these inputs are converted and under what decision-making process; instead, market participants react automatically and reliably to all price signals.

(/6)

This criticism is supposed to be addressed by the “new institutional economics” (e.g., North 1990 or Furubotn and Richter 1998). But Simon’s, as well as Cornuelle’s criticism was not simply that the neoclassical or Austrian theory fell short, but that the theory relied on essentially one analytical device, namely “market theory,” where all “phenomena are to be explained translating them into (or deriving them from) market transactions based upon negotiated contracts” (Simon 1991, 26). Hence, in Cowen and Parker’s survey and restatement of the Austrian view of the firm, one would expect some new analytical device. But as the

name, *Markets in the Firm*, of their booklet indicates, the focus is still on markets.

Wherein, then, does the Austrian theory of the firm (or, at least, in Cowen and Parker’s treatment) or the neoclassical theory fall short? We consider three basic problems: (1) the implicitly assumed universal efficacy of extrinsic (usually pecuniary) incentives, (2) the contrast between the institutional logic of exit, exemplified by arms-length markets, and the logic of commitment, loyalty, and voice, exemplified by organizations, and (3) the assumed compatibility of the standard firm organized on the “legal relationship normally called that of ‘master and servant’ or ‘employer and employee’” (Coase 1937, 403) with the underlying principle of classical liberalism “that individuals are the ultimate *sovereigns* in matters of social organization ...” (Buchanan 1999, 288).

### The assumed universal efficacy of extrinsic motivation

Paraphrasing J. L. Austin, one is “tempted to see the overestimation of external motivation as an occupational disease of economists – if it were not their occupation” (Ellerman 2005, 27).<sup>1</sup> Indeed, if pecuniary motivation was so efficacious, then the “management problem” in firms, schools, and other organizations would be a rather simple problem in “human engineering” and solved long ago.

Although economic rewards play an important part in securing adherence to organizational goals and management authority, they are limited in their effectiveness. Organizations would be far less effective systems than they actually are if such rewards were the only means, or even the principal means, of motivation available. In fact, observation of behavior in organizations reveals other powerful motivations that induce employees to accept organizational goals and authority as bases for their actions.

(Simon 1991, 34)

Simon goes on to explain how the new institutional economics fails to take these non-pecuniary motivations into account, and his remarks apply as well to Cowen and Parker, who do not differ from the new institutional economists in this regard. “The attempts of the new institutional economics to explain organizational behavior solely in terms of agency, asymmetric information, transaction costs, opportunism, and other concepts drawn from neo-classical economics ignore key organizational mechanisms like authority, identification, and coordination, and hence are seriously incomplete” (42). For instance, “identification” raises the question of community. How can a company get its staff to identify with and be loyal to the company as a workplace community engaged in a cooperative activity? This is no problem for Cowen and Parker;

just set up bonuses to reward loyalty, teamwork, cooperation, and identification!

People respond to the carrot as well as the stick and hence most firms appreciate the value of cultivating loyalty and high performance from their employees by using appropriate incentives. (1997, 47)

(B)usinesses should use bonuses for different purposes, including ... cementing loyalty to institutions, including customs that benefit the firm as a whole ... (Ibid., 66)

Collectively-based bonuses, which distribute some percentage of aggregate profits to managers and workers in the form of salary, encourage teamwork, co-operation, and identification with the goals of the firm. (Ibid., 67–68<sup>2</sup>)

However, any “loyalty” bought with extrinsic incentives would not be genuine but would only be “loyalty-displaying behavior,” and similarly for “teamwork, co-operation, and identification.”

Another example of this breezy economistic treatment of the serious problems of management systems and organizational design is the treatment of Deming and Japanese management methods in general – “Our approach to the market and organisations has been influenced by the management philosophy of W. Edward Deming ...” (Cowen and Parker 1997, 17), and to get those results, it is a matter of the “explicit application of market-based economic theory to managerial problems” (17). Yet Deming recommends precisely the *opposite* of this advice based on “market-based economic theory.” Deming recommends abolishing “incentive pay and pay based on performance” (1994, 28), e.g., to pay sales people by salary rather than by commission, and to replace a system based on monitoring and quality bonuses with a system using trust based on self-esteem and pride in the quality of one’s work.

Unfortunately, it is not simply a matter of extrinsic incentives being less effective than intrinsic motivation to motivate higher-order tasks and more subtle organizational virtues. Salient extrinsic incentives can override, crowd out, and atrophy the subtler forms of internal motivation. This type of phenomenon is sometimes called the “cost of rewards” and there is a large literature on it in social psychology (Lepper and Greene 1978), management theory (Follett [1926] 1992), and even in political theory (Grant 2012) – in addition to references in these and other fields. (Ellerman 2005).

Moreover, the manipulation of staff by external incentives poses a threat to autonomy and self-efficacy and creates a form of reactance or “push-back” due to the human source of the pressure. This dependence on other human wills is familiar in the classical liberal notions of oppression or coercion. “‘The nature of things does not madden us, only ill will does,’ said Rousseau. The criterion of oppression is the part that I believe to be played by other human beings, directly or indirectly, with or without the intention of doing so, in frustrating my wishes” (Berlin 1969, 123). “In this sense ‘freedom’ refers solely to a relation of men to other men, and the only infringement of it is coercion by men. This means, in particular, that the range of physical possibilities from which a person can choose at a given moment has no direct relevance to freedom” (Hayek 1960, 12).

In a similar vein, Mary Parker Follett emphasized the “law of the situation”; “Our job is not how to get people to obey orders, but how to devise methods by which we can best *discover* the order integral to a particular situation” (Follett [1926] 1992, 70). Then it is the impersonal situation, not the boss, that requires something to be done. This is part of the old classical liberal idea of the rule of law, not of men. It also might be compared to Michael Polanyi’s description of end-independence in a spontaneous order: “The actions of such individuals are said to be free, for they are not determined by any *specific* command, whether of a superior or of a public authority; the compulsion to which they are subject is impersonal and general” (1951, 159). The idea goes back to Rousseau’s theme that it is not coercion if the “necessity [is] in things, never in the caprice of men” ([1762] 1979, 91).

The more subtle intrinsic motivations cannot be manipulated by the salient pecuniary incentives under the control of managers; it is more a question of identity, culture, and community in the workplace (see Dore 1987 about the company-as-community). The over-reliance on extrinsic incentives becomes particularly pernicious when managers try to “train” staff members to respond to their manipulable incentives – but that only buys a few short-term effects on the “behavior” market (which may, however, trigger manager bonuses). This not only leaves the sources of staff commitment and effort untapped, but probably does longer-term damage to the firm through all the costs of rewards and reactance effects.

### Market logic of exit vs. organizational logic of commitment, loyalty, and voice

We have seen that both neoclassical theory and Austrian economics focus on markets, and even when they try to analyze the firm, the primary effort is to find “Markets in the Firm.” So far, we have focused on the inadequacy of essentially identifying motivation with extrinsic and

pecuniary motivation. But markets and organizations also have different institutional logics.

Albert Hirschman has made the well-known distinction between two logics: the logic of exit exemplified by markets, and the logic of commitment, loyalty, and voice that might be exemplified by organizations. The point is that we now have a whole "science of economics" where the market logic of exit is the only logic. "The economist tends naturally to think that his mechanism (exit) is far more efficient and is in fact the only one to be taken seriously" (1970, 16).

There is an almost automatic reflex that mobility, liquidity, and the absence of frictions are to be preferred over immobility, illiquidity, and the presence of frictions. But the point is that in organizations where the logic of commitment comes into play, then the mobility, liquidity, and frictionless nature of markets may well have negative effects.

Moreover, Keynes was much concerned with the adverse effects of stock market liquidity (i.e., ease of exit) on real investment and enterprise. Real investment in productive enterprise should be stable, and the management of enterprise requires a long-term commitment in order for the application of "intelligence to defeat the forces of time and ignorance of the future" (1936, 157). But when investment is securitized as a marketable asset on the stock exchange, then it "is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week" (151). The stock exchange panders to the "fetish of liquidity" and thus continually undermines the bonds of long-term commitment that are so important to problem-solving and productive enterprise. Keynes, of course, wrote this long before today's ultra-short-termism with quarterly reports, stock options, computerized trading, and the constant churning of mergers and acquisitions activity.

One way to make these points using a language of efficiency is to contrast the notion of X-efficiency (Leibenstein 1966) with the usual notion of allocative efficiency. Since the principal "factor" with variable characteristics is the people working in an enterprise, the "X" in X-efficiency is essentially "effort" (see Ellerman 2005). In the post-war era, the large Japanese firms have perhaps gone the furthest to develop the organizational logic of commitment and effort-efficiency and to contrast it with the market logic of exit. For instance, to one trained to think in terms of the logic of exit, any immobilities, frictions, rigidities, or barriers to exit would just seem inefficient and irrational. But Japanese economists have evoked the example of useful barriers to exit as in the maritime practice of a captain being expected to go down with his ship.

The way in which underpayment of wages in the early years of service and the acquisition of firm-specific skills create barriers to exit is obvious. These exit barriers perform several important functions for

the firm as an organizational entity. The first is the incentive function whereby the interests of the firm and the interests of the individual are linked. Unable easily to exit, people can only protect their interests by working to ensure that the firm prospers. ... The interlinking of interests means that when crisis looms, efforts are redoubled. The option of leaving the sinking ship is not freely available, either to the crew or the captain.

(Kagono and Kobayashi 1994, 94)

Barriers to exit can enhance identification, loyalty, and commitment, and thus effort-efficiency. As scholars of Japanese industry put it:

Many of the investments made by employees and the assets they have developed over the long term are realizable only within the firm, and these assets would not be fully appreciated in the market place. Hence there is greater commitment, though not necessarily happy, satisfied commitment. Where the "logic of exit" prevails, however, the freedom of exit of uncommitted shareholders, and the insecurity thereby induced in managers by frequent takeovers, has a knock-on effect to reduce commitment, as much on the part of senior managers as on rank and file employees.

(Dore and Whittaker 1994, 9)

In Japan, the takeover market is virtually non-existent and "It's not just that the labour market for executive talent is imperfect: over large areas of the economy it just does not exist" (Dore 1994, 380).

We have already noted how engineering market-based incentives falls far short of developing the more subtle organizational virtues of loyalty, commitment, and identification. The company-as-community uses the alternative "internal" or non-market solution of developing a corporate culture<sup>3</sup> of mutual commitment and cooperation that leads to a high-level virtuous circle. This cooperative culture is feasible because the managers and workers see themselves as members of a commitment-based community and will reap the joint fruits of their cooperative efforts.

One logic or the other ramifies through all the aspects and structures of a firm. Sometimes a firm organized on the logic of exit is stereotyped as the "American firm," and a firm organized on the logic of commitment is the "Japanese firm" or "J-firm" (Aoki 1988). We will summarize and compare in Table 15.1 some of the ways that the two logics (essentially *Gesellschaft* and *Gemeinschaft*) affect firm structure.<sup>4</sup>

The two advanced industrial countries that have done the most to restructure in the direction of the firm-as-community are the two countries that lost World War II, so the old owners of the major companies were removed, and what eventually emerged from that freedom to restructure ownership was some corporate form with greater de facto internal

Table 15.1 Two firms

	<i>Firm based on logic of exit, a.k.a. firm as nexus of market contracts</i>	<i>Firm based on logic of commitment, a.k.a. firm-as-community</i>
<b>Efficiency</b>	Allocative efficiency: moving resources to the use with the best return (high mobility).	X-efficiency: getting the best return from resources in the given uses (low mobility).
<b>Change strategy</b>	Replace what you have with something better. Problem is to improve choice among options with fixed characteristics.	Transform what you have into something better. Problem is the transformation of given option to improve its characteristics.
<b>Source of flexibility and change</b>	Exit (change takes place through entry and exit from the organization). Rather flight than fight. Error leads to replacement.	Voice (change takes place by transformation within organization). Rather fight than flight. Error leads to learning.
<b>Labor mobility</b>	High mobility so changes take place primarily by hiring workers embodying new knowledge.	Low mobility so changes take place primarily by workers learning new knowledge and skills.
<b>Contractual relationships</b>	Arms-length.	Relational.
<b>Shareholder interest</b>	Maximization of company profit (assumption that shareholders are normally unrelated to company).	Shareholding often representative of business relationships, the latter being the primary economic interest. Little attention to unrelated floating shareholders.
<b>Model of supplier relationships</b>	Competition between standardized producers with feedback through the market.	Cooperation with a small number of suppliers to continuously improve product through non-market feedback.
<b>Stability in relationships</b>	Low trust relationships ⇒ highly explicit contracts with competitive arms-length exit-oriented relationships so no need to invest in building trust ⇒ low trust relationships.	High trust relationships ⇒ incomplete relational contracts with voice-oriented relationships requiring investment in building trust ⇒ high trust relationships.
<b>Job definition</b>	Extensively specified job definition to limit opportunism since there is little commitment	Job flexibility and low monitoring based on worker commitment to company.

Table 15.1 (cont.)

	<i>Firm based on logic of exit, a.k.a. firm as nexus of market contracts</i>	<i>Firm based on logic of commitment, a.k.a. firm-as-community</i>
<b>Worker motivation</b>	Individual pecuniary self-interest (non-cooperative strategy).	Members expected to identify with firm and shared interest (cooperative strategy).
<b>Organized worker representation</b>	Trade union (adversary relation based on workers versus company) – my jam or your jam.	Enterprise union (oppositional relation loyal to company) – our jam today or our jam tomorrow.
<b>Response to decline</b>	Reduce employment and other direct costs to maintain profits.	Maintain employment, reduce hours, and retrain workers for new product lines.
<b>Business ownership</b>	Stock market liquidity. Firm as “investment.”	Illiquidity of closely held business. Firm as enterprise.

ownership/membership. The Japanese idea of the company-as-community (Dore 1987), outlined in the table, is the basis for a fully competitive “employee-favouring” (as opposed to “shareholder-favouring”) model. Germany has also developed more responsible and even “employee-favouring” forms of enterprise. The German institution of *Mitbestimmung* or codetermination is harder to imagine in the American-style corporation, which sees the people in the firm as the labor-suppliers in an arms-length market relationship ruled by the logic of exit (Dore 2000).

### Classical liberalism and the hard cases of voluntary alienation contracts

We have so far contrasted the firm-as-market-nexus with the firm-as-community from the viewpoint of motivation (extrinsic versus intrinsic) and efficiency (allocative versus effort-efficiency). We would be remiss if we didn't also examine the legal structure of a firm from the viewpoint of classical liberalism (broadly speaking). One cannot analyze a firm, say, a cotton-producing farm, as a community independently of whether it is legally structured as a slave plantation or a kibbutz.

As a description of the core of classical liberalism, we might take James Buchanan's statement of the principles of normative individualism.

The justificatory foundation for a liberal social order lies, in my understanding, in the normative premise that individuals are the ultimate

*sovereigns* in matters of social organization, that individuals are the beings who are entitled to choose the organizational-institutional structures under which they will live. In accordance with this premise, the legitimacy of social-organizational structures is to be judged against the voluntary agreement of those who are to live or are living under the arrangements that are judged. The central premise of *individuals as sovereigns* does allow for delegation of decision-making authority to agents, so long as it remains understood that individuals remain as *principals*. The premise denies legitimacy to all social-organizational arrangements that negate the role of individuals as either sovereigns or as principals.

(1999, 288)

Buchanan contrasts the view of Plato (and Aristotle), who saw a natural inequality where certain adult persons were considered of diminished capacity, if not as human instruments, with the view of Adam Smith, who began with the classical liberal assumption of natural equality before the law. "To Plato there are natural slaves and natural masters, with the consequences that follow for social organization, be it economic or political. To Adam Smith, by contrast, who is in this as in other aspects the archetype classical liberal, the philosopher and the porter are natural equals with observed differences readily explainable by culture and choice" (2005, 67). Thus a liberal social order would rule out any assumption of people of a certain race or sex as being of diminished legal capacity on account of their race or sex. That takes care of the easy cases, but what about the *hard cases* where, for whatever reason, adults of full capacity voluntarily agree to a contractual arrangement where they take on the *legal* role of a person of diminished capacity or even a human instrument (even though they are, of course, still *de facto* a person of full capacity)?

A historically recent case of such a legal institution would be the coverture marriage contract wherein an adult woman of full capacity voluntarily agrees to give up her independent legal personality in favor of that of her husband. As Blackstone put it:

By marriage, the husband and wife are one person in law: that is, the very being or legal existence of the woman is suspended during the marriage, or at least is incorporated and consolidated into that of the husband; under whose wing, protection, and cover, she performs everything; and is therefore called in our law-French, a *feme covert*, and is said to be under the protection and influence of her husband, her baron, or lord; and her condition during her marriage is called her coverture.

([1765] 1959, 83; section on "Husband and Wife")

The *feme covert* could only make contracts or acquire property as an agent for her husband; she was not a sovereign or principal in her own name.

Thus the coverture marriage contract was clearly in violation of Buchanan's sovereign-or-principal statement of classical liberalism. But it was also a *voluntary* contract – unless one wants to argue that all marriages up to the beginning of the twentieth century in the liberal democracies (and many marriages elsewhere in the world today) were "not really voluntary" (an embarrassing attempt to dodge the hard case).

The coverture marriage contract was by no means the first example of a legal institution based on a voluntary contract for a fully capacitated adult to take on the *legal* role of a person of diminished or no capacity. For instance, only the crudest defenses of slavery, even in antiquity, were based on some notion of natural inequality (as in Plato and Aristotle). In the *Institutes* of Justinian, ancient Roman law provided three legal ways to become a slave, and all were explicitly or implicitly contractual. "Slaves either are born or become so. They are born so when their mother is a slave; they become so either by the law of nations, that is, by captivity, or by the civil law, as when a free person, above the age of twenty, suffers himself to be sold, that he may share the price given for him" (Lib. I, Tit. III, 4).

In addition to the third means of outright contractual slavery, the other two means were also seen as having aspects of contract. A person born of a slave mother and raised using the master's food, clothing, and shelter was considered as being in a perpetual servitude contract to trade a lifetime of labor for these and future provisions. Manumission was an early repayment or cancellation of that debt. In the early modern era, Thomas Hobbes clearly saw a "covenant" in the ancient practice of allowing prisoners of war to plea bargain their death penalty into a lifetime of servitude. It would be a "hard choice," but a voluntary one given the circumstances.

And this dominion is then acquired to the victor when the vanquished, to avoid the present stroke of death, covenants either in express words or by other sufficient signs of the will that, so long as his life and the liberty of his body is allowed him, the victor shall have the use thereof at his pleasure. ... It is not, therefore, the victory that gives the right of dominion over the vanquished but his own covenant.

([1651] 1958, Bk. II, Chap. 20)

Thus *all* of the three legal means of becoming a slave in Roman law had explicit or implicit contractual interpretations.

The other major hard case is the undemocratic constitution wherein people voluntarily give up and alienate their rights of self-governance to a sovereign person or group who rules in their own name (i.e., not as a delegate or representative of the people). Again we may start with Roman law. The sovereignty of the Roman emperor was seen as being founded on a contract of rulership enacted by the Roman people. The Roman jurist Ulpian gave the classic and oft-quoted statement of this view in the *Institutes* of Justinian

Whatever has pleased the prince has the force of law, since the Roman people by the *lex regia* enacted concerning his *imperium*, have yielded up to him all their power and authority.

(Lib. I, Tit. II, 6, quoted in Corwin 1955, 4)

Hobbes made the best-known attempt to use this calculus of consent to found non-democratic government on the consent of the governed. Without an overarching power to hold people in awe, life would be a constant war of all against all. To prevent this state of chaos and strife, men should join together and voluntarily alienate and transfer the right of self-government to a person or body of persons as the sovereign. This *pactum subjectionis* would be a “covenant of every man with every man, in such manner as if every man should say to every man, I authorize and give up my right of governing myself to this man, or to this assembly of men, on this condition, that you give up your right to him and authorize all his actions in like manner” (Hobbes [1651] 1958, 142).

The American constitutional scholar, Edward S. Corwin, noted that questions arose even in the Middle Ages about the nature of the *lex regia*. “During the Middle Ages the question was much debated whether the *lex regia* effected an absolute alienation (*translatio*) of the legislative power to the Emperor, or was a revocable delegation (*cessio*). The champions of popular sovereignty at the end of this period, like Marsiglio of Padua in his *Defensor Pacis*, took the latter view” (1955, 4, fn. 8). It is precisely this question of *translatio* or *cessio* – alienation or delegation of the right of government in the contract – that is the key question, not consent versus coercion. Consent is on both sides of that alienation (*translatio*) versus delegation (*cessio*) framing of the question. The alienation version of the contract became a sophisticated tacit contract defense of non-democratic government wherever the latter existed as a settled condition. And the delegation version of the contract became the foundation for liberal democratic theory.

The German legal thinker Otto Gierke was also quite clear about the alienation-vs.-delegation question.

This dispute also reaches far back into the Middle Ages. It first took a strictly juristic form in the dispute ... as to the legal nature of the ancient “*translatio imperii*” from the Roman people to the Princeps. One school explained this as a definitive and irrevocable alienation of power, the other as a mere concession of its use and exercise. ... On the one hand from the people’s abdication the most absolute sovereignty of the prince might be deduced. ... On the other hand the assumption of a mere “*cessio imperii*” led to the doctrine of popular sovereignty.

(Gierke 1966, 93–94)

In view of this history of apology for autocracy based on consent, the distinction between coercion and government based on the “consent

of the governed” was *not* the key to liberal democratic theory. The real debate was *within* the calculus of consent, and was between the alienation (*translatio*) and delegation (*cessio*) versions of the basic social or political constitution. Late medieval thinkers such as Marsilius of Padua (1275–1342) and Bartolus of Saxoferrato (1314–57) laid some of the foundations for modern democratic theory in the distinction between consent that establishes a relation of delegation and trusteeship versus consent to an alienation of authority.

The theory of popular sovereignty developed by Marsiglio (Marsilius) and Bartolus was destined to play a major role in shaping the most radical version of early modern constitutionalism. Already they are prepared to argue that sovereignty lies with the people, that they only delegate and never alienate it, and thus that no legitimate ruler can ever enjoy a higher status than that of an official appointed by, and capable of being dismissed by, his own subjects.

(Skinner 1978, vol. I, 65)

To secure these rights for democratic theory, the task was to develop arguments that there was something inherently invalid in the alienation or *translatio* contracts, and thus to decide always in favor of “delegation of decision-making authority to agents, so long as it remains understood that individuals remain as *principals*. The premise denies legitimacy to all social-organizational arrangements that negate the role of individuals as either sovereigns or as principals” (Buchanan 1999, 288).<sup>5</sup>

### Inalienable rights theory: treating the hard cases

With some anticipations by the Stoics, the notion of inalienable rights descends through the Scottish and German Enlightenments from the Protestant Reformation’s notion of the inalienability of conscience. As the great English liberal, Lord John Morley,<sup>6</sup> put it:

To what quarter in the large historic firmament can we turn our eyes with such certainty of being stirred and elevated, of thinking better of human life and the worth of those who have been most deeply penetrated by its seriousness, as to the annals of the intrepid spirits whom the protestant doctrine of indefeasible personal responsibility brought to the front in Germany in the sixteenth century, and in England and Scotland in the seventeenth?

([1874] 1928, 91–92)

Secular authorities may try to compel belief but they can only buy some external conformity on the market for behaviors. “For no matter how much they fret and fume, they cannot do more than make people obey

them by word or deed; the heart they cannot constrain, though they wear themselves out trying. For the proverb is true, 'Thoughts are free.' Why then would they constrain people to believe from the heart, when they see that it is impossible?" (Luther [1523] 1942, 316).

Martin Luther was explicit about the de facto element; it was "impossible" to "constrain people to believe from the heart." In Morley's terms, their "personal responsibility" for their beliefs is "indefeasible."

Furthermore, every man is responsible for his own faith, and he must see it for himself that he believes rightly. As little as another can go to hell or heaven for me, so little can he believe or disbelieve for me; and as little as he can open or shut heaven or hell for me, so little can he drive me to faith or unbelief. Since, then, belief or unbelief is a matter of every one's conscience, and since this is no lessening of the secular power, the latter should be content and attend to its own affairs and permit men to believe one thing or another, as they are able and willing, and constrain no one by force.

(Luther [1523] 1942, 316)

In the Scottish Enlightenment, the notion of the inalienability of conscience was translated into the doctrine of inalienable rights by Francis Hutcheson, Adam Smith's teacher and predecessor in the Chair of Moral Philosophy in Glasgow. Although intimated in earlier works, the inalienability argument is best developed in Hutcheson's influential *A System of Moral Philosophy*.

Our rights are either *alienable*, or *unalienable*. The former are known by these two characters jointly, that the translation of them to others can be made effectually, and that some interest of society, or individuals consistently with it, may frequently require such translations. Thus our right to our goods and labours is naturally alienable. But where either the translation cannot be made with any effect, or where no good in human life requires it, the right is unalienable, and cannot be justly claimed by any other but the person originally possessing it. (1755, 261)

Hutcheson contrasts de facto alienable goods where "the translation of them to others can be made effectually" (like the services of a shovel) with factually inalienable faculties where "the translation cannot be made with any effect." For instance, we may employ a shovel for our own purposes or we may alienate and transfer it to someone else to use it for their purposes. But the same cannot be said of our selves. We may act in our own name as "sovereigns" (to use Buchanan's phrase) but we cannot in fact alienate or transfer the employment of our selves to another person or persons, and thus, where "the translation cannot be made with any effect," the right

is inalienable. Between persons, there is no alienation, only Buchanan's delegation where the person remains the principal.

In the American Declaration of Independence, "Jefferson took his division of rights into alienable and unalienable from Hutcheson, who made the distinction popular and important" (Wills 1979, 213). It is this theory of inalienable rights, which descends from the Reformation through the Scottish Enlightenment, that finally allowed classical liberal democratic thought to deal with the hard cases. A *pactum subjectionis* would pretend to alienate that which is inalienable; a democratic constitution would only sanction a delegation of powers to the people's representatives; the people remain the principals. And when slavery was abolished, it was both involuntary and voluntary slavery that was abolished. As the economist Paul Samuelson put it in his economics primer: "Since slavery was abolished, human earning power is forbidden by law to be capitalized. A man is not even free to sell himself: he must *rent* himself at a wage" (Samuelson 1976, 52, his italics).

### Classical liberalism and the employment firm

Samuelson brings us back around to the original question of the compatibility of hard-case classical liberalism, i.e., the Smith-inspired classical liberalism together with the Hutcheson-inspired theory of inalienable rights, with the legal structure of the conventional firm based on the "legal relationship normally called that of 'master and servant' or 'employer and employee'" (Coase 1937, 403).

A conflict immediately arises with hard-case classical liberalism, which rules out alienation contracts where "the translation cannot be made with any effect." We may employ a shovel and be de facto responsible for the results, and then we can rent out the shovel to another person and turn the shovel over to them to be employed by them and they will be responsible for the results. But the same "translation cannot be made with any effect" when the rental concept is applied to persons.

A person factually cannot stop "employing" themselves and voluntarily turn over that employment to another person as their "employer," who would then be responsible for the results. At most, the "employee" voluntarily cooperates with the "employer" by following the latter's instructions, but then they are both inexorably co-responsible for the results. This is, of course, legally recognized when the joint activity is criminous so the legal authorities have grounds to intervene to see who is de facto responsible so that the legal or *de jure* responsibility can be imputed accordingly. "All who participate in a crime with a guilty intent are liable to punishment. A master and servant who so participate in a crime are liable criminally, not because they are master and servant, but because they jointly carried out a criminal venture and are both criminous" (Batt 1967, 612). Since it can hardly be argued that "employees"

suddenly become de facto non-responsible instruments when their actions are not criminous, exactly the same joint de facto responsibility for the results of the joint activity with the working employer holds in the conventional firm.

It is the reaction of the legal system that changes when no crime or tort is involved. Then there is no occasion to hold a trial to see who is de facto responsible. It is only a matter of the voluntary employment contract being fulfilled on both sides. On the employer's side, it is a matter of the payment of wages and the fulfillment of any other contractual obligations. But on the side of the rented persons, since the "employment" of the employees cannot in fact be transferred (unlike the rental of a thing like a shovel), the legal authorities in the human rental system accept a surrogate performance as "fulfilling" the contract, namely obeying the employer (even though the legal authorities are well aware from the hired criminal example that "obeying the employer" does not effect any translation of de facto responsible agency from employees to employer). Then with both sides of the employment contract "fulfilled" (and the same for the other input contracts), the employer has paid all the costs of the used-up inputs to production and thus has the undivided legal claim on the product that is produced.

Thus by violating the inalienable rights part of classical liberalism, i.e., by validating the human rental contract (for non-criminous activities), the employment system legally authorizes the type of firm where the people working in the firm are inexorably de facto co-responsible for the (negative and positive) results of their voluntary activities, and yet the "employees" have zero legal responsibility for the negative results (the input liabilities and thus costs of the used-up inputs) and zero legal ownership of the positive results (the assets that are the produced outputs). Thus fully capacitated de facto responsible human beings end up, by virtue of the voluntary contract for the "renting" or "employing" of persons, in the legal role of having zero legal responsibility for the negative or positive results of their inexorably co-responsible actions within the scope of their "employment," i.e., in the legal role of a rented instrument like a shovel.<sup>7</sup> A legal institution where fully capacitated adults have zero legal responsibility for the positive and negative results of their actions is a canonical violation of the "Kantian ethical precept" (Buchanan 2005, 15) that persons are always to be treated as ends in themselves and never simply as a means or as a thing.

The underlying juridical norm of imputing *de jure* responsibility in accordance with de facto responsibility when applied to private property rights gives the legitimation basis for the appropriation of property rights, namely people getting the fruits of their labor (which applies equally well to bearing the negative fruits of their labor by getting the legal or *de jure* responsibility for those liabilities). The mismatch between de facto and *de jure* responsibility in the employment firm shows that such a firm is

based on violating the legitimate basis for appropriating private property; private property being the basis for the classical liberal order defining the natural system of liberty. As the Austrian economist, Friedrich von Wieser put it:

The judge ... who, in his narrowly-defined task, is only concerned with the *legal imputation*, confines himself to the discovery of the legally responsible factor, – that person, in fact, who is threatened with the legal punishment. On him will rightly be laid the whole burden of the consequences, although he could never by himself alone – without instruments and all the other conditions – have committed the crime. The imputation takes for granted physical causality. ...

If it is the moral imputation that is in question, then certainly no one but the labourer could be named. Land and capital have no merit that they bring forth fruit; they are dead tools in the hand of man; and the man is responsible for the use he makes of them.

([1889] 1930, 76–79)

Thus in a firm implementing the juridical principle of responsibility, the people working in the firm would have the "whole burden of the consequences," including the legal liabilities for using the "dead tools" of land and capital as well as the legal ownership of the positive fruits of their jointly co-responsible labor.

The Conservative diplomat and public servant Lord Eustace Percy summarized the situation well.

Here is the most urgent challenge to political invention ever offered to the jurist and the statesman. The human association which in fact produces and distributes wealth, the association of workmen, managers, technicians and directors, is not an association recognised by the law. The association which the law does recognise – the association of shareholders, creditors and directors – is incapable of production and is not expected by the law to perform these functions. We have to give law to the real association and withdraw meaningless privilege from the imaginary one.

(Percy 1944, 38, quoted in Goyder 1961, 57)

Such a firm, where the legal members are the people working in the firm, would thus implement the responsibility principle at the foundation of private property and would generalize the self-"employment" of the family farm or proprietorship to larger firms to make up the productive sector in the natural system of liberty implied by the deeper principles of classical liberalism. Examples of such firms include industrial cooperatives such as the Mondragon system of cooperatives in the Basque region of Spain (Whyte and Whyte 1991).

The same conclusions are obtained if we follow the governance principles of classical liberalism based on being a sovereign or principal, never just a subject (as in the *pactum subjectionis* that transforms people from citizens into subjects). "The postulate of natural equality carries with it the requirement that genuine classical liberals adhere to democratic principles of governance; political equality as a necessary norm makes us all small 'd' democrats" (Buchanan 2005, 69). Governance in the liberal democratic order cannot be based on an alienation contract but only on a delegation contract where the people remain the principals. "The premise denies legitimacy to all social-organizational arrangements that negate the role of individuals as either sovereigns or as principals" (1999, 288).

Here again we see that the social-organizational arrangement of the employment firm directly violates the principles of the classical liberal democratic order. The employment contract is a contract of alienation, not delegation. The employer is not the delegate or representative of the employees; the employer manages the workplace in his own name, not in the name of the people being managed as the ultimate principals.

Thus the legal structure of the firm that is consistent with classical liberal democratic theory is again the firm where the legal members or citizens of the firm are the people working in the firm (who are the ones being managed), and where the managerial power exercised by the managers is delegated to them from the workplace-citizens who are the principals in accordance with the sovereigns-or-principals doctrine of classical liberalism (see Ellerman 1992). A firm of member-owners would better exemplify the idea of the firm-as-community than a firm of employees.

### Concluding remarks

The results of applying the hard-case principles of classical liberal democratic theory to the human rental firm are, in a certain sense, shocking – just like the application of the principles of the American Founding Fathers to the "peculiar institution" of their day. We find it hard to understand how the Founding Fathers could, for the most part, avoid this issue, which was clear even at the time to other observers.<sup>8</sup> But when there is such a clash between the espoused principles and the dominant institution of the day, then there surely is almost complete cognitive dissonance.

At the outset, we noted that both neoclassical and Austrian economics indeed have something of a blind spot concerning the firm. The strength of both types of economics is the theory of the market. We also saw at the outset two other reasons for the neglect of the firm. Intrinsic motivation plays an important motivational role in any type of work that goes beyond the exercise of brute muscle power. Yet the market operates primarily on the basis of extrinsic motivation, so a market-oriented economics is

inclined either to essentially ignore firms as human organizations (e.g., to model them as "production functions") or to primarily view the "markets in the firm."

In the Hirschmanian contrast between the logic of exit and the logic of loyalty, commitment, and voice, markets tend to operate by the former logic and organizations by the latter logic. While markets can foster "sweet commerce," firms can under the appropriate circumstances (e.g., with member-owners rather than employees) be a source of community, a community second only to the family and typically stronger than the residence-based community of political life.

When the underlying hard-case principles of classical liberal economic and political theory are applied to the typical employment firm, then we found the surprising results that such a firm directly violates those principles. Any hint of this discord leads to the cognitive dissonance that results in a certain incuriosity in applying the deeper (hard-case) liberal principles to the firm, a reluctance that echoes the Founding Fathers' reticence in applying their principles of inalienable rights to slavery. The relationship of classical liberalism to the (employment) firm is much troubled indeed.

### Notes

- 1 See Ellerman (2005), *Helping People Help Themselves*, where the shortcomings of the overestimation of extrinsic motivation are treated at book length – so only the main points can be made here.
- 2 Cowen and Parker have no doubt heard of the "1/N problem" but ignore it here.
- 3 On the question of the shortcomings of economic theory and game theory in dealing with the culture of organizations, see Kreps (1990).
- 4 See Dore (1987) for a similar table.
- 5 See Skinner (1978) for an extensive history of the alienation-vs.-delegation theme.
- 6 Friedrich Hayek lamented that Morley's liberalism was not better appreciated in his own country: "Men like Lord Morley ... who were then admired in the world at large as outstanding examples of the political wisdom of liberal England, are to the present generation largely obsolete Victorians" ([1944] 2001, 188).
- 7 It should be noted that the size of the rental payments or wages plays no role whatsoever in this analysis. Moreover, the analysis of the human rental contract, like the analysis of the coverture marriage contract, assumes the contract is perfectly voluntary.
- 8 As Dr. Johnson famously asked: "how is it that we hear the loudest yelps for liberty among the drivers of negroes?" ([1775] 1913).

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Since the end of the Cold War, the human face of economics has gained renewed visibility and generated new conversations among economists and other social theorists. The monistic, mechanical “economic systems” that characterized the capitalism vs. socialism debates of the mid-twentieth century have given way to pluralistic ecologies of economic provisioning in which complexly constituted agents cooperate via heterogeneous forms of production and exchange. Through the lenses of multiple disciplines, this book examines how this pluralistic turn in economic thinking bears upon the venerable social-theoretical division of cooperative activity into separate spheres of impersonal *Gesellschaft* (commerce) and ethically thick *Ge-meinschaft* (community).

Drawing resources from diverse disciplinary and philosophical traditions, these essays offer fresh, critical appraisals of the *Gemeinschaft* / *Gesellschaft* segregation of face-to-face community from impersonal commerce. Some authors issue urgent calls to transcend this dualism, while others propose to recast it in more nuanced ways or affirm the importance of treating impersonal and personal cooperation as ethically, epistemically, and economically separate worlds. Yet even in their disagreements, our contributors paint the process of voluntary cooperation – the space of commerce and community – with uncommon color and nuance by traversing the boundaries that once separated the thin sociality of economics (as science of commerce) from the thick sociality of sociology and anthropology (as sciences of community).

This book facilitates critical exchange among economists, philosophers, sociologists, anthropologists, and other social theorists by exploring the overlapping notions of cooperation, rationality, identity, reciprocity, trust, and exchange that emerge from multiple analytic traditions within and across their respective disciplines.

**Robert F. Garnett, Jr.** is Professor of Economics at Texas Christian University, USA.

**Paul Lewis** is Reader in Economics and Public Policy at King’s College London, UK.

**Lenore T. Ealy** is President of The Philanthropic Enterprise, USA.

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