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Critical Legal Studies, Economic Realism, and the Theory of the Firm

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ESSAY

Critical Legal Studies, Economic Realism, and the Theory of the Firm

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I. INTRODUCTION

Professor Fischl's recent survey of Critical Legal Studies (CLS)¹ is both informative and provocative. In it, he compares scientific jurisprudence with legal realism and discusses their relation to CLS.² Fischl raises several challenging questions regarding legal conventions but makes the point that CLS is a diverse literature.³ He further

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1. Fischl, *Some Realism about Critical Legal Studies*, 41 U. MIAMI L. REV. 505 (1987).

2. *See id.* at 510-13. As Fischl puts it:

CLS combines a progressive political critique with a skeptical jurisprudence. The political critique espouses the view that our society and its institutions fall dramatically short of our democratic and egalitarian ideals. The skeptical jurisprudence forthrightly embraces the indeterminacy argument and rejects the claim that the reasoning judges use to justify the results they reach can, in fact, *compel* those results.

Id. at 524 (footnotes omitted).

3. This diversity may come from the members of the CLS themselves. "Over 150 of us

remarks that CLS is noted, not for its "broad pronouncements," but for the "'details' of our scholarly treatments of the rich texture of moral values and ideological assumptions reflected in legal doctrine, our specific prescriptions for legal education, and, perhaps most importantly, what goes on each day in our classrooms."⁴ Thus, one who reviews CLS literature should focus on its details of legal doctrine, its prescriptions for legal education, and its employment in the law school classroom, rather than on its generalities.

This Essay addresses one of those details: a classroom example that Fischl uses to facilitate student discussion.⁵ In this example, a widget-factory laborer takes home, at the end of the day, the output produced rather than a wage. Fischl is concerned with exploring alternatives to the usual pattern of employer-owned output, but his example of labor-owned output has economic implications that he leaves largely unexplored. The discussion below examines the economic implications of what we call Fischl's "value-added-by-labor" approach⁶ to property rights. By exploring the economic theory of the firm,⁷ we show why even laborers probably will prefer the traditional employer-owned approach to product property rights. Examining some practical aspects of the economics of production and distribution will show conditions under which labor-owned output is an inefficient and unworkable alternative to employer-owned output.⁸

identify ourselves with the movement [CLS], and I suspect that there are about that many positions among us on any given concrete issue." *Id.* at 507 (footnotes omitted).

4. *Id.*

5. *See id.* at 527.

6. This term for the property-rights scheme is based on an exegesis of Fischl's example, in which property rights are transferred to labor, as value is added to raw materials or intermediate products. *See infra* Section IV(A).

7. The economic theory of the firm is a diverse literature. For a thorough discussion of the theory of the firm, see A. MARSHALL, *PRINCIPLES OF ECONOMICS* (1920); Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). For a later discussion on the theory of the firm, see Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972). *See infra* Section III.

8. According to Fischl, the "major aim of CLS . . . is to open up such subjects to democratic examination and debate." Fischl, *supra* note 1, at 528. It is an exaggeration, but nevertheless an illustrative one, to say that we view a debate on employee-owned versus employer-owned output in the same way we would view a debate as to whether the sun is the most efficient way to heat the earth. The point is that the scope of reasonable debate on this issue is probably much narrower than Fischl probably acknowledges. Where his scheme of assigning property rights could work, the market often provides for it without democratic intervention. In the majority of modern production processes, however, the scheme is simply unworkable and the debate is, to a great extent, irrelevant with respect to matters of practical policy.

II. FISCHL'S HYPOTHETICAL WIDGET-FACTORY WORKER

From an economic standpoint, Professor Fischl's classroom example involving the widget-factory worker is perhaps the most provocative part of his article.⁹ In the example, a widget factory worker takes home her widgets instead of wages and gives her boss "an amount in cash equal to the cost of the necessary materials and their procurement, the reasonable rental value of her workspace and tools, and the apportioned cost of other managerial expenses. She then leaves the shop . . . planning to sell them and keep the profit."¹⁰

Fischl uses this example to prompt classroom discussion of the underpinnings of labor law. When he asks the class what will happen to the worker, the students answer that the boss will sue the employee or have the police arrest her. Fischl continues his discussion:

I then ask why the *employer* is not guilty of the same misconduct when he pays the employee a reasonable "rent" for her labor, keeps the widgets for himself and sells them for his own profit. There is more stirring and murmurings until someone finally says, "Because the widgets belong to the employer—the law says that they're his property."

Why should that be, I ask. After all, there is nothing "necessary" about permitting the employer to "rent" the worker and keep the widgets; why not structure the relationship the other way around? When someone objects that, if we did that, "then we wouldn't have capitalism," I reply that's exactly my point.^[11] The law reflects and enforces a core assumption about the relationship between employer and employee in a market economy: the employee's legally protected interest in his job is limited to his wage, while the employer is accorded the exclusive right to both the widgets and the profits to be earned from their sale.¹²

This example illustrates a main contention of CLS adherents: that in Fischl's words, "[W]hat we think of as 'natural' forms of

9. Fischl, *supra* note 1, at 527; see *Challenging the Law's Unstated Assumptions*, N.Y. Times, Aug. 30, 1987, § 4, at E6, col. 3.

10. Fischl, *supra* note 1, at 527.

11. Fischl believes that a value-added-by-labor approach to property rights in production would lead to the breakdown of capitalism. What is really at stake, however, is the breakdown of modern economies, because all modern economies are based upon systems of production that depend on specialization and a division of labor.

12. Fischl, *supra* note 1, at 527. Actually, the employer has the right to *either* the widgets or the profits; as Fischl's statement recognizes, one must be traded for the other. The statement also assumes that the firm actually will earn a profit. But the right to earn profits also includes the responsibility for loss and the potential for delays in sales and revenues due to seasonal or cyclical fluctuations in demand. If the key issue is the right to the profits, then it is crucial also to consider the possibility of loss and the worker's willingness to bear such losses. See *infra* Section VI.

human association are often simply a reflection of unexamined social conventions or constructs that are, in turn, embodied in and reinforced by the law."¹³ The premise, therefore, is that the law "conceals the removal of important social issues from the arena of democratic choice."¹⁴ Supposedly, CLS is concerned with exposing and exploring these issues.

In CLS, no underlying assumptions regarding legal entitlements are immune from attack.¹⁵ Fischl states: "We might want to consider the current arrangement [of legal entitlements] in light of our democratic and egalitarian aspirations and ask whether it exacts too great a cost in terms of the self-determination and the bargaining power of working people." From an economist's perspective, it is to Fischl's credit that he then goes on to say, "Or we might conclude that employer ownership provides advantages in terms of investment incentives and transaction efficiencies, and therefore decide that we prefer to leave things the way they are."¹⁶

III. PRODUCTION, THE THEORY OF THE FIRM, AND LABOR CONTRACTS

Fischl implies that the traditional economic structure of labor law regarding property rights is an "unexamined social convention . . . embodied in and reinforced by the law."¹⁷ Because of the practicality of these social conventions, it is easy for both the employer and the laborer in the modern and complex environment of production and distribution to take them for granted. The point is that modern production is increasingly complex because of specialization, the division of labor, and team production. Specialization and the complexity of production make employer-owned output an efficient arrangement, as will be shown. These factors also contribute to the efficiency of producing that output by what we call firms.¹⁸

The firm is not the only way to organize modern production. One alternative is a subcontracting process in which no ongoing relationship between the inputs is expected once production is complete.

13. Fischl, *supra* note 1, at 526.

14. *Id.* at 531. Apparently, Fischl is willing to allow laborers to take the products home, as long as this is negotiated by the employer and employee. But Fischl also seems ready to go further than this, perhaps by interfering with freedom of contract in the name of "democratic choice." To what extent and for what purpose should such interference be allowed?

15. *Id.* at 528.

16. *Id.*

17. *Id.* at 526.

18. See A. MARSHALL, *supra* note 7, at 240. Marshall notes that Adam Smith gave new life to the ancient doctrine that organization among the productive inputs increases efficiency.

Id.

Another alternative is for one worker to do the job from start to finish. Thus, for the consumer attempting to build a house, he has several options for organizing production. The consumer could do the work himself, or he could subcontract for the various tasks and the necessary materials. Alternatively, the consumer could hire an agent to gather the materials and to organize the workers and other inputs. This agent could then subcontract the work, or the agent could organize—or may already have organized—a firm with long-term relations with input suppliers to build a number of houses.

The distinction between the occasional subcontracting associations and the longer-term associations of the firm is an important one. Coase was the first to suggest that firms are distinguished by the long-term contracts they enter into with suppliers of raw materials, land, labor, and capital.¹⁹ Faith and his co-authors explain Coase's neoclassical view of the firm:

The firm is seen as an institution that economizes on transactions costs. It is defined as a collection of contracts between input owners and the owner(s) of the firm where multilateral contracting among resource owners is replaced by bilateral contracting between each resource owner and the firm. This . . . reduces transactions costs because it reduces the number of formal contracts required for productive activity.²⁰

With respect to the firm's use of labor, the firm offers and prefers to pay a wage over the long term, in exchange for the right to assign the worker to different jobs over the life of the contract.²¹ Why can a firm with the right to assign a laborer to different tasks produce more cheaply than production by subcontract? In increasingly complex production processes, the degree of specialization is high, and the number of subcontracts would be large. The negotiation costs associated with numerous and frequent subcontracts would be expensive for the final buyer. To avoid this, the firm, as the agent of the buyer of the product, replaces production-by-subcontracting and organizes production over the long term. By doing this, the firm reduces transactions costs and, therefore, is able to sell its product more cheaply than by using the subcontracting process.²²

19. See Coase, *supra* note 7, at 391-92.

20. Faith, Higgins & Tollison, *Managerial Rents and Outside Recruitment in the Coasian Firm*, 74 AM. ECON. REV. 660 (1984).

21. See Coase, *supra* note 7, at 390-91; see also O. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 218-19 (1985). The assignment of a worker to a specific task gives the employer flexibility and the employee more strict performance requirements.

22. See generally Coase, *supra* note 7, at 390-91 (discussing the costs of negotiating separate contracts and a firm's desire to enter into long-term contracts).

Reduced transaction costs is not the firm's only benefit. The firm also tends to foster team production that is more efficient than the subcontracting process, in which associations among complementary inputs are brief.²³ During team production in complex processes, however, individual productivity is hard to measure, and shirking may become a problem that necessitates monitoring of individual productivity. Monitoring, however, is also subject to shirking. One commentator has addressed this issue: "Firms deal with the monitoring problem by establishing a specialized monitoring input that is common to all input contracts and that can renegotiate individual contracts. The incentives of this specialized input are controlled by making it a residual claimant."²⁴

When the production process is less complex, however, subcontracting may be less expensive because the subcontractors may have more incentive not to shirk than do the firm's laborers. Thus, the gains of the firm depend on the complexity of the production process and the costs of transactions. These costs include not only production agreements, but also marketing and distribution agreements.²⁵

The preceding discussion raises an important question: Why would a laborer agree to contract with a firm if it means forfeiting his ability to decide where and when to work? The worker usually finds it more convenient to specialize because the resulting increase in productivity means higher earnings. Other laborers with similar skills, however, may not agree to be part of a subcontracting production process. The subcontracting process may even be quite inefficient. In a review of production by hierarchies, one commentator has noted:

Williamson . . . demonstrates that, in principle, even Adam Smith's pin factory could be operated by a series of independent specialist-entrepreneurs, one for each processing step. But the factory's efficiency would be impaired by the need to maintain substantial inventory buffers between each step to handle absences and negotiation delays and by the relative inflexibility of a division of labour based on property rights in work assignments. To co-ordinate transactions with the pin factory, a hierarchy is more efficient than a market.²⁶

23. See Alchian & Demsetz, *supra* note 7, at 779.

24. *Id.* "Residual claimant" refers to the entrepreneur's right to the profit of the firm. The entrepreneur is the monitor and profit is an incentive to prevent the monitor from shirking. See *id.* at 782.

25. In general, the larger the firm becomes relative to local demand, the more widespread the market must be and the greater is the importance of an efficient marketing and distribution network. Costs of such agreements will be shown to affect the workability of labor-owned output. See *infra* notes 41-42 and accompanying text.

26. Jorgenson, Hafsi & Kiggunou, *Towards a Market Imperfections Theory of*

For the laborer, then, the firm may offer the best opportunity for steady employment and a high wage. The laborer's choice between firm and self-employment, therefore, depends on the probability of increased productivity in the firm and the laborer's taste for independence.

This raises another issue with respect to one's view of the firm: Should the firm be viewed as an exploitative agent seeking its own interests, or as an organizing agent seeking the interests of consumers? One may view the former as dangerous to labor and the latter as beneficial to labor. The "exploiting" firm may be perceived as suppressing wages while the "organizing" firm may be perceived as increasing productivity and the return to labor. One's view of the firm also affects his view of the distribution of output. Thus, while Marxian economics views distribution in terms of class conflict, Marshall contended that profits would be shared²⁷ among all of the factors of production. This implies that, even without the rights to output or to the residual, labor will share both profits and losses with the other resource suppliers in the firm.

IV. PROPERTY RIGHTS AND PRODUCTION

To properly analyze Fischl's property-rights scheme, the scheme must be distinguished from traditional property rights systems. Under the traditional scheme, property rights to the output of production are usually assigned to the employer. Two points must be noted, however. First, while this scheme²⁸ is the most common system of rights to the product, it is not the universal scheme as Fischl's discussion might suggest.²⁹ Second, Fischl's preferred scheme of assigning rights to the laborer is not precluded under current legal

Organizational Structure in Developing Countries, 23 J. MGMT. STUD. 417, 421 (1986); see T. ASHTON, *AN ECONOMIC HISTORY OF ENGLAND: THE 18TH CENTURY* 103 (1955).

27. This is particularly true in the short run. See A. MARSHALL, *supra* note 7, at 625-28. For a discussion of the sharing of "quasi-rents"—returns to factors temporarily fixed in supply—among laborers and other resource suppliers and owners, see *id.* According to Marshall, laborers with some experience in the firm will earn what he called quasi-rents because their experience makes them a factor which is temporarily fixed in supply. The level of these quasi-rents depends on the level of profits; they may be negative if a loss is incurred. *Id.* To Marshall, then, the division of quasi-rents entails "defacto some sort of profit and loss sharing between almost every business and its employees." *Id.* at 627. See also O. WILLIAMSON, *supra* note 21, at 248-49, 263 (discussing employee bargaining for quasi-rents); Miyazaki, *Internal Bargaining, Labor Contracts, and a Marshallian Theory of the Firm*, 74 AM. ECON. REV. 381, 381-93 (1984) (discussing profit sharing within the firm).

28. See O. WILLIAMSON, *supra* note 21, at 218 (discussing the capitalist mode of production in which a single party owns all inventories including finished goods).

29. See Fischl, *supra* note 1, at 528.

convention.³⁰

A. *Fischl's Value-Added Scheme*

Although Fischl's method of assigning property rights is not clearly laid out in his article, some attention must be given to specifying the assignment scheme implied by his example. The underlying scheme appears to be based on value added by labor in the production process. "Value added" refers to the higher market price that can be had for inputs of raw materials and intermediate product after labor, capital, and land are combined with them in production. Thus, value added results from a change in form and location. Since, in Fischl's example, property rights are transferred after labor is applied, this approach may be referred to as the "value-added-by-labor" scheme.

Ashton³¹ gives examples of industries in 18th century Britain in which traditions were such that the worker received a share of the product of his labor. For example, coal-hewers and coal-meters received a portion of coal by custom, as did ironworkers whose firms used coal. This practice was not limited to the distribution of coal, however. West Indianmen's mates kept the sweepings of sugar and coffee from the hold ships; the gangsmen claimed a right to the molasses sugar on the warehouse floor; and corn ships' laborers claimed title to the grain removed from the ship as samples.³² These customs, however, encouraged workers to handle the product improperly:

In each case the workers saw to it that the crumbs from the master's table were ample. Casks were handled not too gently; sacks were liable to burst open; shipwrights took care that their wives did not go short of firewood. The line of demarcation between the extension of established rights and barefaced robbery . . . [was] difficult to draw.³³

Part of this trend of paying labor a finished product rather than a money wage was attributable to the shortage of coinage in Britain in the 18th century.³⁴ Regardless of the cause of this payment system,

30. *Id.* These are not the only possible schemes. The consumer may hold title to the materials and the product throughout the stages of production. For example, when the consumer commissions a custom house, he often advances money to the builder to buy materials. In this case, it is the consumer (or his lender) who holds title to the materials and output throughout the production process. On the other hand, the owner of the raw materials may hold the rights throughout production. Often, however, the owner of the raw materials also will be the employer.

31. See T. ASHTON, *supra* note 26, at 208.

32. *Id.*

33. *Id.*

34. *Id.* at 207-08. Another reason for paying workers in product was to prevent, or at least deter, the impact on production of chronic alcoholism among workers. *Id.* at 202.

however, the firm's rights often were placed in jeopardy when the laborers' rights, with respect to the product, were vaguely defined.

Although workers on occasion have been paid in product, the feasibility of the "value-added-by-labor" approach is by no means universally acceptable. If applied thoroughly to all production processes, this scheme becomes strange because it apparently would allow the person who mows the lawn to take home a portion of the mown sod. With no restrictions on the scheme's application, the list of similar anomalies would be endless. Furthermore, one needs to specify the scheme *before* any firm will supply materials, land, machinery, and organizational skill that labor requires for production.³⁵

Labor-owned product could be practical under certain conditions, yet before the laborer will prefer the right to the product over the wage, at least three conditions must exist. First, the production process must not be lengthy or complex. Second, the cost of marketing and distribution must be low. And third, the potential gains from owning the product must be greater than the gains from the wage.

B. *Do-It-Yourself Production and Labor-Owned Output*

The conditions described above are precisely the conditions associated with do-it-yourself purchases. First, the process is relatively "simple" because of the proximity to the end of the production line. The buyer adds his labor to some unfinished product that he intends to keep. This makes the process simple and such products usually require little additional contracting. Second, the cost of marketing and distribution is low because no marketing or distribution will be needed. Third, the gains from owning the product are greater than the gains from receiving the wage because the laborer intends to keep the product. Keeping the product instead of the wage eliminates a transaction because the wage, if it were paid, would have to be paid back, in essence, for the product.

Do-it-yourself purchases are seen in many places in our economy. We wash cars at someone else's car wash, buy "kits" and finish them ourselves, and assemble our own picture frames in someone

35. The precise arrangement between the worker and her boss is not clear in Fischl's widget example. Does the worker have an *ex post* option to exercise, or an irrevocable *ex ante* decision already made as to whether she keeps the product or takes a wage? The timing of the decision is crucial as to whether a firm will agree to operate within this structure of property rights; an *ex post* option will be unacceptable to the firm. The role of contracts, whether explicit or implicit, is to reduce the uncertainty in the operation of a firm. Moreover, property rights include the dual rights of exclusive use and voluntary assignment of ownership. See DeAlessi, *Property Rights, Transactions Costs, and X-Inefficiency*, 73 AM. ECON. REV. 64, 66 (1983).

else's frame shop. We add labor to the parts made by a toy manufacturer who finds it preferable to ship a toy unassembled, and we finish furniture that has been assembled and assemble pre-finished furniture. We now pump our own gas and prepare our own salads at the salad bar.

In each of these agreements, the laborer has the title to the finished product, and the owner of the firm appears satisfied with this arrangement. Ironically, "organized labor" may not be so content with the arrangement because it is disenfranchised by the do-it-yourself arrangement. Furthermore, do-it-yourself production is not efficient for many products. As Adam Smith stated: "It is the maxim of every prudent master . . . never to attempt to make at home what it will cost him more to make than to buy."³⁶ The inefficiency of do-it-yourself production is also reflected in the auto shop's facetious sign listing the hourly labor rate as "\$20 an hour if we do the work . . . \$30 an hour if you help."

Regardless of potential inefficiencies, do-it-yourself projects are examples in which the value-added approach to property rights does work. It remains to be shown that this approach has much wider applicability than in the do-it-yourself context, for in some production processes, the approach cannot reasonably be applied.

C. *The Test of the Market*

Despite its feasibility under certain conditions, a value-added assignment scheme is not widely used because the test of the market deems it to be inefficient. This test states: If a value-added scheme of assigning rights is not illegal,³⁷ and if it is more efficient than the alternative of paying labor a wage, then the market will be dominated by the value-added scheme. Workers everywhere will take their product instead of a wage. Since it is apparently not illegal to arrange production in this way, and since this scheme is not observed in most firms, the value-added approach is impliedly inefficient.³⁸

Stated differently, if Fischl truly believes that efficiency is not a legitimate basis for the employer to maintain title to the product and to pay labor a wage, he should organize his own widget firm under a value-added-by-labor assignment scheme. The firm will not only

36. A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 424 (1776).

37. Fischl seems to imply that it is illegal though he never explicitly demonstrates this.

38. For an application of this argument in the context of production by small firms as contrasted with large firms, see E. BROWNING & J. BROWNING, MICROECONOMIC THEORY AND APPLICATIONS 274 (1986). For an application of the argument to labor-managed firms, see O. WILLIAMSON, *supra* note 21, at 266.

fulfill his democratic and egalitarian aspirations, but also will do as well as, and perhaps better than, many other firms. In the event it does better, workers will flock to his company. This will allow him to reap his own surplus for allowing them to benefit by this arrangement. If entry into Fischl's value-added-by-labor-scheme is easy, the market eventually will be dominated by this kind of firm. The employer's surplus, however, will be shortlived under easy entry conditions.

On the other hand, if labor-owned output is less efficient than the usual method of assigning title to the product, then Fischl's firm will be run out of business, and others will avoid this value-added-by-labor approach. Laws and social conventions will tend to develop and institutionalize the efficient approach. Laborers also will prefer the wages approach over accepting rights to the product because the efficiency of this approach enables both the firm and the laborer to do better.

D. *Employer-Owned Product and Efficiency in Production*

Organizing firms with labor-owned product appears to fail the test of the market because of the complexity of modern production and the costs of marketing and distributing products. Furthermore, the intangibility or indivisibility of certain products and the high cost of other tangible products make labor-owned products impractical or nearly impossible.

Consider, for a moment, a complex production process that has multiple stages, in which value is added by successive workers at each stage. As noted earlier, transaction costs can be reduced by the firm that enters into long-term contracts with labor and with suppliers of other inputs and materials. Assigning product rights to the laborers at each stage of the production process, however, would involve many more contracts than accepting the employer's rights to the product. The firm formed with labor-owned output could not compete because the burden of the extra transactions would be reflected in higher production costs.³⁹ For this value-added approach to succeed, labor would have to agree to accept a lower share of the total product because extra legal costs associated with each transaction would reduce the net output.⁴⁰ While the scheme may be technically workable in firms in which a tangible product is produced, it would be too costly for such firms to compete successfully with firms using the traditional employer-owned approach. The only possible advantage

39. For a discussion of the difficulties with continuous contracting, see O. WILLIAMSON, *supra* note 21, at 220.

40. If Professor Fischl does not agree that more contracts cost more, we would like to hire him as our lawyer in negotiating future contracts because the price sounds right!

of this value-added scheme is that the firm's monitoring costs would be reduced because the workers would have no incentive to shirk.

For firms that produce no tangible product—as in service industries—the issue is feasibility rather than cost. A value-added scheme simply will not work in most industries in which the product is intangible. Fischl's own professions, teaching and law, come to mind. What would he hope to take home at the end of his day if not a wage or a claim to a later wage payment? The professional athlete is another example. What would the individual basketball player take home at the end of the game and sell for a profit?

Distribution and marketing of the product would cause laborers in many industries to reject labor-owned output. The reason is that both distribution and marketing are subject to economies of large scale—that is, per-unit costs of product marketing and distribution fall as the amount of product involved rises.⁴¹ The employer-owned product, therefore, can be distributed at a lower cost than the labor-owned product when there are many laborers and one owner.⁴² Consider the case in which the product is made in one country and sold in another—as with automobiles, electronic equipment, and agricultural machinery and commodities. Few laborers want to bear the cost of marketing and distributing these products when the home market is closed to them. The laborer would rather take the wage and leave the profit and the reward for distribution to the firm and its agents abroad.

Another difficulty with labor-owned product will occur if the worker is producing an expensive product like a car. The worker may have to borrow money to pay for the "fair market value" of a car at the end of the week. If the worker chooses to build up credits toward one car every four months, he may decide that the time between payments is too long. Alternatively, if several workers own a car jointly, it may be difficult to agree upon the conditions of and the distribution of the revenues of a subsequent sale. Money, therefore, is more con-

41. For the widget example to be practical, the difference between the firm's costs and the laborer's costs of marketing and distributing the product must be negligible—that is, that economies of scale do not exist in marketing and distribution. This is generally not true, though, when production is large scale and when distribution must be accomplished over a large area. Therefore, in large-scale production, the firm may make a profit on the the product, while the laborer would incur a loss selling the product herself.

42. The owner will not always choose to distribute the product. The firm may instead contract with one or more firms to act as distributors. The point is that, with labor-owned output, each laborer would be selling a smaller quantity with higher transactions and marketing costs per unit. For a historical recount of the the theory and practice of vertical integration of production and distribution, see O. WILLIAMSON, *supra* note 21, at 103.

venient than the rights to the car and more desirable than the uncertainty involved with product sales in the future.

If the value-added approach to property rights in production seems to be the "natural" way to apportion rights, then it must be imposed where it is not efficient. Furthermore, based on the foregoing analysis, it probably would have to be imposed against the will of the laborer who would prefer the wage over rights to the product. This final point will be dramatized more fully by revisiting Fischl's example of the widget factory worker.

V. ANOTHER LOOK AT FISCHL'S HYPOTHETICAL WORKER

Fischl indicated that he uses hypothetical examples and questions in his law school classes.⁴³ This Section will test his premise further by redefining his widget example, and then asking more questions of the class. First, assume that the laborer makes transmission gears for domestic automobiles each day. Will the worker still prefer to pay the "fair market value" for other inputs into the day's output of gears and take them home with her to sell them at a profit? Will she spend the next day, or week, looking for a buyer? Will she spend time contracting with the laborer who assembles the transmission, who then will have to bargain with the laborer who installs transmissions, who then will have to bargain . . . ? Will the boss continue to invest in a firm where half the day is spent working and the other half making and remaking contracts? Will any long-term contracts that develop between workers put the firm in essentially the same position as the traditional assignment of rights, but with far greater transactions costs?

Second, assume that the laborer works in Korea, assembling a circuit board to be installed in a VCR headed for the U.S. market. Will this laborer prefer the circuit boards or the wages? Will she choose to, or be able to, sell them abroad and still work in the plant? Does including some of the details of modern production and distribution change our view of the feasibility of a value-added-by-labor approach to product property rights?

Finally, assume that the laborer is a labor law professor. Will the professor be able to take her product home with her at the end of the day to sell it, even if she wanted to? Would it not be easier just to settle for cash? Will the professor view her employer, the law school, as a helpful agent, rather than an exploiting entrepreneur if she takes home only her wages each month?

43. Fischl, *supra* note 1, at 527.

It should be clear why this example has been redefined. The widget factory laborer who takes the product home probably will decide to return them to her boss the next day and take her wages. In general, labor does not want property rights to the product.⁴⁴ The transactions costs of marketing and delivering the widgets would be too great to forego a reasonable wage for the laborer's production time. The sales revenue may even be insufficient to cover the wages of the laborer, let alone ensure a profit. The time involved in finding a buyer, and the risk of finding no buyer at all, make the guaranteed wages more desirable to the laborer than the product. Thus, the worker will prefer to stick to production and leave the marketing and distribution to the employer. One night of worry about the transactions costs and the uncertainties of marketing the product will convince the worker that her decision to take a property right in the product was, indeed, a bad one.

VI. THE OWNER AS THE RESIDUAL CLAIMANT

When one examines the widget factory worker example closely, it is apparent that Fischl actually is concerned about the firm as a residual claimant.⁴⁵ According to his example, the worker plans to sell the widgets at a profit. Alternatively, the law supposedly reflects the employer's right to a profit. This emphasis on profit is no doubt related to a tendency to see the firm as an exploiter who regularly earns an excessive profit, rather than to see the firm as an agent who provides multiple services for the consumer. Often the firm is both the owner of the finished product and the residual claimant; yet, the distinction between residual claimant and owner of the product is important because the property rights to the product do not ensure a profit, let alone an above normal profit.⁴⁶ Many times the firm takes a loss while still paying the worker a wage. This loss occurs in spite of the employer's right to the product.⁴⁷

44. Worker-owned output does not seem to be an important issue to labor because labor unions do not make this an issue during collective bargaining. The fact that it is not a legal convention today does not prevent it from becoming an issue in contract negotiations in the future, if labor actually thinks that it would be beneficial to workers. Once again, though, the idea seems to fail the test of the market. See *supra* text accompanying note 38.

45. See *supra* note 24.

46. Fischl's example, on the other hand, appears to suggest that all value in the product is profit or, at least, that all product will earn a profit. In fact, the widget factory laborer who takes the widgets home must first recover wages and the costs of marketing and distributing the product herself. The residual will then be profit.

47. Even without property rights, labor may share in the profits and losses of the firm. See *supra* note 27. Literature on property rights focuses not on labor's right to the product but on labor's property rights to the job itself. Rights to the job allow labor to capture more of the

It is now increasingly common to organize firms with the laborers as owners—that is, as residual claimants.⁴⁸ Nevertheless, the firm, not individual laborers, usually has the property rights to the finished product: The firm retains control of the product until it is converted into money to be paid out as resource costs and as a residual to laborers as owners.⁴⁹ The Weirton Steel company of West Virginia is one example of a labor-owned firm. In 1983, the company was on the brink of dissolution when Weirton's 9,500 employees voted for 100 percent employee ownership of the firm.⁵⁰ Currently, Weirton Steel is the nation's ninth largest integrated steel producer, and in November of 1984, it earned higher operating profits per ton than any of the six largest steel companies.⁵¹ But, even with labor as owners, the system is more efficient when the firm retains rights to the product until final sale.⁵² Furthermore, organizing production in a labor-owned firm does not always ensure that there will be a residual after the product is sold.⁵³ Therefore, it may not be in the best interest of the laborer to retain the rights to the product or be the residual claimant.

VII. CONCLUSIONS: REALISM, IDEALISM, AND MODERN ECONOMIES

In much of his article, Professor Fischl argues against an ideal conception of law. Ironically, however, Fischl implicitly—perhaps

quasi-rent attributable to "firm-specific human capital." See O. WILLIAMSON, *supra* note 21, at 263.

48. For a theoretical discussion of collective ownership by workers, see O. WILLIAMSON, *supra* note 21, at 217.

49. There is an exception. It is the "communal-emh" (every man for himself) form of collective ownership. *Id.* Under this organization, work stations are shared by workers who move between stations at prescribed intervals. *Id.* No worker specializes, and every worker has a claim to his own output. For this reason, the system is not considered efficient and is not widely used today.

50. See *The Workers Are Set to Buy Weirton*, BUS. WK., Sept. 5, 1983, at 35. In negotiations for ownership rights, Weirton employees relinquished annual wage increases, vacation pay, and other benefits in order to participate in an Employee Stock Ownership Program. *Id.* Thus, even labor recognized that rights to the residual come only at some expense. In exchange, this innovative program gave Weirton employees the rights to receive one third of the profits when the company reached 100 million dollars in equity, and fifty percent of the profit when corporate equity reached 250 million. As shareholders, workers also had full voting rights and more input into the production process. *Making Money—And History—At Weirton*, BUS. WK., Nov. 12, 1984, at 140.

51. *Id.* at 136.

52. For example, Weirton steel workers who own the firm do not take rods of steel home each night.

53. People's Express Airlines is a case in point. As a means of providing worker incentives, labor owned 25 percent of the firm, until it went into receivership and was acquired by a more dominant airline. See *Nice Going, Frank, but Will It Fly?*, BUS. WK., Sept. 29, 1986, at 34-35.

even unconsciously— substitutes for it an ideal conception of the economy in which production is simple and uncertainty about sales and marketing does not exist. His suggestion of assigning product property rights to labor can work only in a frictionless world in which transactions and accounting costs are zero, and in which marketing and distribution of the product do not exhibit increasing returns to large scale. This economy, depicted by Fischl, is indeed idealistic and bears no resemblance to a modern economy with complex and large scale production and distribution. Production in the real world is often done in many stages. Sometimes products are assembled in several different countries by many different workers. Economies of scale in marketing and distribution do exist. And as any lawyer familiar with contracts law knows, transactions costs are not zero.

What is clear in this Essay is that realism often is the basis for legal convention. The discussion even lends support to Marx's idea that the mode of production gives rise to the legal and social conventions regarding property.⁵⁴ These concessions to economic realism in the law and to a Marxian view of the materialistic basis of certain legal conventions, however, should not be taken as a radical stance.⁵⁵ In fact, it is quite clear that realism in the law, or law that conforms itself to the necessities of modern forms of production, does not always disadvantage the worker.⁵⁶ Rather, in the world of free con-

54. Marx stated:

[N]either legal relations nor political forms could be comprehended . . . by themselves or on the basis of . . . development of the human mind, but . . . on the contrary they originate in the material conditions of life The totality of . . . [the] relations of production constitutes the economic structure of society, the real foundation, on which arises a legal and political superstructure

See K. MARX, *Preface to A Contribution to the Critique of Political Economy*, in K. MARX: EARLY WRITINGS 425 (1975). See also T. ASHTON, *supra* note 26, at 217 (noting that worker's drinking habits "had conformed to the requirements of industry").

55. We would not go as far as Marx does in applying this materialistic approach to all legal and political structures. This is a thorny issue, however, and it is important to distinguish between materialistic influences on statutes themselves, as opposed to influences on legal conventions or on the application of the statutes. Nonetheless, some scope exists for an economic critique in many areas of the law. For example, one of the latest issues in the critique of statutes is the inclusion of special tax provisions for certain individuals in the Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2085 (codified as amended in scattered sections of 26 U.S.C.). See *The Great Tax Giveaway*, *The Philadelphia Inquirer*, Apr. 10-15, 1988, § 1A, at 1 (criticizing individual tax breaks provided in section 1277(c)(2)(D) of the Tax Reform Act of 1986, 1986 U.S.C. CODE CONG. & ADMIN. NEWS (100 Stat.) 2601, and other sections of the Act.).

56. On a related point, one commentator stated: "That the development of industry . . . stimulated, and aided the achievement of, personal ambition is shown by the number of men who began life as wage-earners and ended it as employers. . . . [In] the main, it would appear, the social changes of the century derived from economic processes." See T. ASHTON, *supra* note 26, at 216.

tracts, these legal conventions appear to have the vote of laborers who agree to take the wage and leave the product with the firm.

The communal-emh⁵⁷ mode of production, for example, is simply no longer feasible in competition with other organizational forms in which workers have no right to the product. The issues raised by labor in collective bargaining recognize this reality; recent discussions of laborers' property rights focus not on rights to the product, but on rights to jobs themselves. As Woodbury notes, the issue of power and property rights is important to laborers; but what concerns laborers is "the right to dispose freely of their property, which is the ability to be productive."⁵⁸ This does not mean the right to carry the product home at the end of the day.

The theory of the firm illustrates that employer property rights are taken for granted in our economic organizations because we recognize that many firms could not work any other way. In cases in which labor-owned product could work, the market often specifies these alternative arrangements, as in the do-it-yourself products. Where labor-owned product cannot work, we tacitly agree not to challenge the present system because we commonly recognize its efficiency. The key point is that these property rights are not unexamined features of our legal system.

It is a crucial part of a complete legal education to challenge the young law student with these issues, however. Professor Fischl should be commended for raising these issues in his labor-law courses, since examining social, legal, and economic conventions, rather than taking them for granted, is the essence of a large portion of the education process. His hypothetical example skillfully exposes the reader's propensity to take the property-rights convention for granted. Most would immediately agree with the student who says that the employer will have the employee arrested for taking home the product. Nowhere, however, does the example state who owns the output. The employer and employee could have had an agreement that the employee would take the product and give the employer compensation. When we assume the worker's guilt, our preconceptions are at work, and it is important to investigate why we hold them. The point of this Essay is that these preconceptions are grounded in economic efficiency, rather than in economic power: Efficiency, not the law, assures that producer-owned output is the convention. The crucial question to ask is not: "Why do laws allow only for employer-owned

57. See *supra* note 49.

58. Woodbury, *Power in the Labor Market: Institutionalist Approaches to Labor Problems*, 21 J. ECON. ISSUES 1781, 1781-1805 (1987).

output?" Rather it is: "Why, in a world in which other property-rights schemes are perfectly legal, do most employers and laborers agree to employer-owned output?"

It appears, then, that a basic understanding of economics is also crucial to a complete legal education, especially regarding the relation of labor contracts to the economic theory of the firm. Moreover, in the area of property rights and labor law, the criterion of efficiency cannot so easily be dismissed as merely a pretext for promoting the "particular political program . . . [of] the conservatism of so-called laissez faire."⁵⁹ Efficiency, independent of ideology, is an important explanation of social convention in the area of labor law and property rights. Thus, the appeal to ideology probably depends more on efficiency than the appeal to efficiency depends on ideology.

59. See Fischl, *supra* note 1, at 523 n.63.