

**Toward Reasonable Capitalism:
The Role of John R. Commons's Price and Business Cycle Theories**

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Abstract: John R. Commons thought that prices should be stable and that the law of supply and demand should be controlled by the power of the state through patent law and by protecting bargaining equality. Commons also thought that prices should be stabilized by macro monetary policy. These means would allow the realization of a “reasonable price.” Commons called the objective and measurable value in money, which is determined by a court ruling, “reasonable value.” Analysis of Commons's price and business cycle theories point toward the realization of both “reasonable price” and “reasonable value” and toward “reasonable capitalism” that can replace banker capitalism.

Keywords: reasonable capitalism, rationing transaction, managerial school, bargaining school

JEL Classification Codes: B25, E32, P16

The purpose of this study is to clarify the role of John R. Commons's price theory and business cycle theory in constructing a reasonable capitalism. In this paper, we first aim to understand Commons's business cycle theory. Next, we analyze Commons's price theory,

as price fluctuation has a significant impact on the business cycle. In particular, we analyze what factors are influencing price fluctuation.

After this analysis, we compare the theories of the managerial school, represented by figures like Walter Rathenau, with those of the bargaining school, represented by figures like Commons. The managerial school's theory leans toward fascism, communism, and banker capitalism. On the other hand, the bargaining school's theory points toward reasonable capitalism. Through understanding the characteristics of and differences between the two schools, we can confirm the elements that are necessary to realize a reasonable capitalism.

Commons's Business Cycle Theory

In Chapter 9, Section 7, in *Institutional Economics* (Commons 1934), Commons analyzed both the "profit-share" and "profit-margin" theories regarding the causes of prosperity and depression.¹ He criticized the profit-share theory because "increasing the share of one class reduces the shares of other classes and does not change the total purchasing power of all classes" (Commons 1934, 589). Therefore, he did not adopt the profit-share theory, which is an underconsumptionist theory but instead adopted the profit-margin theory.

The profit-margin is the difference between the total of all liabilities incurred for all of a firm's purposes and the gross income obtained from all its sales. In short, this margin is

described as net profit (Commons 1934, 527). Furthermore, as pointed out by Kitagawa (2017), Commons examined the “expected profit-margin” or “expected profit rate.”² He stated that “The business owner is looking forward, and what he might call his wage or salary, if he gets it, is merged into the expected margin of profit remaining after he pays all his debts” (Commons 1934, 605). As Shibata (2017) argues, if the market interest rate falls below the expected profit-margin (expected profit rate), debt-dependent investment will expand, and if the market interest rate exceeds the expected profit-margin (expected profit rate), debt-dependent investment is suppressed. With this understanding, we turn to Commons’s explanation of the business cycle with profit-margin theory with reference to his work “World Depressions,” written in 1931.

Commons outlined the rising phases of the U.S. economy from 1924 to 1927 in “World Depressions” as follows.³ First, in the United States during this period, because of the policy of the Federal Reserve system, credit was extended to support England’s gold standard restoration. The rate of interest in the United States was induced to a lower level than the interest rate in England through this policy, which meant that the companies’ expected profits expanded because of the compression of interest payment costs. As a result, investment expanded in the United States, which resulted in overproduction, and soaring stock prices. This led to an increase in demand for production of goods and an

accompanying increase in the prices of production, resulting in rising prices of products. In profit-margin theory, the rise in prices led to an increase in the profit-margin as nominal amount of debt did not change. This resulted in an upward spiral that led to an increased rise in expected profit. Eventually, if marginal business expansion could not be realized and expected profits were not achieved, expectations were finally revised. This was the trajectory of development until the fall of 1929.

Afterward, during the downturn from the fall of 1929 onward, some companies went into bankruptcy due to the excessive debt they incurred through their failure to achieve their expected profits. Expected profits decreased, which led to a reduction in production, and a decline in stock prices. This led to a decline in the demand for productive of goods and the accompanying decline in production prices, eventually resulting in a decline in prices of products. In profit-margin theory, the decline in prices led to a decline in the profit-margin because the nominal amount of debt did not change. This resulted in the downward spiral that led to a further decline in expected profits. When further price declines arose due to the sale of assets for interest payments, debt deflation eventually occurred. This was how Commons's profit-margin theory analyzed the Great Depression.

What is important here is the relationship between price fluctuation and profit margins. Commons explained that a general fall in prices reduced the margin for profit 33% through

a fall of 1% in sales prices (Commons 1934, 577–579). Thus, as the example above suggests, slight changes in price have a major impact on the profit margins of firms. Therefore, in order to understand Commons’s business cycle theory in more detail, it is necessary to analyze the influence of prices on the economy.

Commons’s Price Theory

Commons wrote that “In a money economy, as in Menger’s commodity economy, Demand and Supply cannot be measured directly, but the effects of their variations are measured.

This measurement of effects is price, so that price is the measure of the variable relations of scarcity, and is the pecuniary equivalent of his marginal utility” (Commons 1934, 381).

This assertion does not refute the law of supply and demand but suggests that relative scarcity appears as price. However, this outcome depends on the bargaining transactions of sellers and buyers in a market.

According to Commons, bargaining transactions in a market require two sellers, and two buyers. For example, when there are only two people in the market, one of whom is a seller, and one of who is a buyer, the transaction appears to be like a robbery. If the seller has strong bargaining power, the price will rise. On the other hand, if the buyer has strong bargaining power, the price will fall. If there are four people, that is, two sellers and two buyers, there emerge a set of “actual” transactions and another set of “potential”

transactions as alternatives (Commons [1924] 1995, 65–67). Therefore, proper bargaining transactions need to have a minimum of four persons. Furthermore, he believed that a fifth person, such as, historically, a judge, priest, chieftain, or arbitrator who has legal powers, was needed. These bargaining transactions decide prices on the basis of relative scarcity.

How does the efficiency of managerial transactions affect scarcity? Commons wrote “This is what we mean by capitalism, the double process of creating use-value for others and restricting its supply so as to create scarcity-value. Hence, capitalism, unlike the Marxian Communism, requires two units of measurement, the man-hour and the dollar” (Commons 1934, 284). He insisted that we could perceive scarcity through price and abundance producing use-value, which is, in fact, efficiency measured in man-hours. These affect relative scarcity, which is the law of supply and demand realized through managerial transactions.

Abundance is achieved through managerial transactions based on the principle of efficiency. We can perceive it as a quantitative relationship. If abundance increases, relative scarcity will decrease. If abundance decreases, relative scarcity will increase. These changes will affect prices. However, this is not all. Proprietary scarcity will increase if a supplier “withholds” supply from the market. Figure 1 confirms the suggested trend, that is, price being decided by relative scarcity (the law of supply and demand) by way of bargaining

transactions. However, abundance resulting from efficiency by way of managerial transactions affects relative and proprietary scarcity.

Finally, this study considers what factors impact prices during a period of stabilization. Rationing transactions are important at this stage in order to distribute the burdens and benefits of wealth creation. Rationing transactions work by connecting the concept of “futuraity” to expected events. The board of directors in a company estimates the level of “the margin for profit,” which is the firm’s expected profit. These estimates affect production planning and pricing, namely, managerial transactions and bargaining transactions.

<insert Figure 1>

As shown in Figure 1, the connection between rationing micro-level transactions and bargaining and managerial transactions can affect prices. Furthermore, Figure 1 also shows that efficiency can be protected by rationing macro-level transactions, such as through patent laws, leading to the “stabilization” of bargaining transactions, hence maintaining the price level and protecting the interests of inventors. Concerning macro-level stabilization, Commons believed that worldwide stabilization of the average purchasing power of money,

that is, of the movement of prices, is needed (Commons 1934, 804). This leads to proper control of general prices to protect intangible property, such as patents and brands, through macro-scale monetary policy.⁴

The Managerial School and the Bargaining School

Commons introduced two schools, the “Managerial School” and “Bargaining School,” as new forms of economic thought after World War I in *Institutional Economics*, Chapter 11, “Communism, Fascism, Capitalism” (Commons 1934, 891). In post-World War I capitalism, it had become clear that there was universal overproduction and unemployment, along with an accompanying universal decline in prices.

Comparing the two schools, first with regard to the stabilization of the economy, the managerial school, exemplified by Benito Mussolini and the communists, was characterized by the prevention of overproduction and unemployment through rationing (production levels) by an Economic Planning Council. In contrast, the bargaining school, represented by John R. Commons himself and John M. Keynes⁵, was characterized by trying to prevent overproduction and unemployment by stabilizing the general level of prices through concerted international monetary policy such as through the Bank for International Settlements. Next, regarding the important concept of transactions, the managerial school emphasized managerial transactions and rationing transactions. This was

because it depended on the principles of superiority and inferiority within an organization and affected output and efficiency. On the other hand, the bargaining school attached great importance to bargaining transactions. This was because these transactions affected pricing and were necessary to ensure the equality of bargaining power. Commons regarded this difference as the “ultimate difference” between the two schools (Commons 1934, 891). Finally, what both sides agreed upon was that the managerial school was rationing productivity and expected the political movements of communism and fascism to implement this program. On the other hand, the bargaining school emphasized the equality of bargaining power and expected to create a reasonable form of capitalism based on this. These differences are summarized in Table 1.

<insert Table 1>

Although the outline above highlights the attributes of both, Commons himself supported the theses of the bargaining school after pointing out the danger of the managerial school. Therefore, we will deeply analyze the managerial school that Commons criticized. He stated in *Institutional Economics*, Chapter 11, “In view of this universal overproduction the managerial school of economists is passing through three stages of their

philosophy. The first is the Scientific Management stage for individual establishments. The second is the regularization stage for an entire industry. The third is a National Planning Council for all industries of an entire nation” (Commons 1934, 893). The first stage of scientific management here refers to Frederick Taylor's scientific management method. The purpose of Taylorism was to increase output per man-hour by eliminating waste in the factory through managerial transactions and by using labor and machinery more efficiently.

On the other hand, the second and third stages are based on the theories of the German industrialist Walter Rathenau.⁶ In the second stage of regularization, the waste of excessive production in the market, not waste in the factory, was eliminated by rationing, and managerial transactions. The goal was to increase dollar revenue by limiting the amount of output supplied to the market. Commons made no direct mention of the third stage, but it was probably based upon the arguments developed by Rathenau.

Rathenau explained the need for the introduction of technological innovation and the rationalization of management as a whole rather than leaving the process to individual managers. The introduction of professional associations (*Berufsverbände*) horizontally combined the management of the same industries within a country, whereas the commercial associations (*Gewerbsverbände*) vertically combined industries in the processing stage. He placed special emphasis on the former. A government had the great feature that it had the

right to supervise and intervene in the professional associations. The significance of this was its ability to intervene in production through economic policy to reorganize the country's productivity structure.

Toward Reasonable Capitalism

Banker capitalism, the representative of the managerial school in the United States, moved away from syndicate capitalism, which increased and limited output. Banks provided corporations with funds to integrate their operations and conduct mergers. Why was this banker capitalism not positive? Large companies, mainly holding companies, created a difference in bargaining power in the market with strong binding power and control over output and prices. Furthermore, it created substantial marketing and overhead costs, which were associated with skilled mechanics and managers. Therefore, companies might continue to produce if they could meet their overhead costs even if overproduction existed. These were Commons's criticisms of banker capitalism.

If banker capitalism is unable to cope with universal overproduction and unemployment, then we need to examine whether the other managerial school theories are effective in solving those problems. In other words, the question is why fascism and communism are not effective. As mentioned in the previous section, the managerial school should be able to achieve efficient production management through national production

policies. Furthermore, Italian corporatism appeared to have a mechanism that reflected the interests of various stakeholders. Commons discerned that the problem was that the representatives were forcibly elected by administrative orders.

On the other hand, he noted that the United States Congress and state legislatures had a useful administrative committee system that freed them from the fine administrative work required by complex conflicts of interest. This administrative committee is a system that equalizes bargaining power, reflecting the interests of various economic organizations. Specifically, Commons emphasized the significance of voluntary associations such as labor unions, farmers' unions, business cooperatives, and political parties in this kind of committee.

The realization of fair competition through the institutional adjustment of interests in this committee would create "reasonable value," meaning the price level resulting from equality of bargaining power, equality of opportunity, and fair competition. The capitalism based on price stability created in this way is the "reasonable capitalism" that Commons aimed for.

In this way, the committee system creates laws that reflect various interests, and the Supreme Court finally decides whether the law is constitutional or not. This is judicial sovereignty, which protects the things that are not protected by the managerial school's

methods. First of all, it protects the producer, for example, protecting the producer's price from being made unreasonably cheap by failures in patent law. Second is consumer protection, such as restricting sales prices from becoming unreasonably high through antitrust laws. These methods of price stabilization will create reasonable value and realize the redistribution of income by the state.

However, Commons thought that this was not enough. He said that "the bargaining school is not as convincing because the price mechanism of the world is invisible, and there is no great international bank with years of success to be pointed to as an exhibit" (Commons 1934, 891). He appealed for international cooperation in financial policy at the world level, as we analyzed in the previous section.

Thus, economic control, in particular economic intervention through rationing transactions, is necessary but in a method that does not restrict political freedoms like the managerial school's fascism, communism, and banker capitalism. The bargaining school method of rationing transactions is to make institutional adjustments that equalize bargaining power.

<insert Table 2>

Conclusions

From the analysis above, we learn that international cooperation in the monetary field and the respect for voluntary private association—specifically, the development of committee system to represent competing interests—is necessary in order to realize a reasonable capitalism. Through these two facets, prices are stabilized and intangible property is protected. If these two things are not achieved, the power of non-state economic governments will be strengthened, and because of their price control, the protection of intangible property will not occur, and income inequality will widen. This is true for both 20th-century American holding companies and today's giant international corporations. We can recognize these problems of modern capitalism and potential solutions through Commons's price theory and business cycle theory.

Acknowledgments

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Footnotes

1 See Shibata (2017) and Kitagawa (2017) for a detailed explanation of profit-share theory and profit-margin theory.

2 Kitagawa (2017) analyzes the difference between financial statement analysis and *Institutional Economics* regarding this point. According to him, *Institutional Economics* shows the present decision about the future, while financial statement analysis is a posteriori analysis.

3 See Terakawa (2017) for details.

4 See Koh (2013) and Takahashi (2008) about Commons's monetary policy. Commons had focused on the role of money in his early work and thought about proper control. See Commons (1893a) (1893b).

5 Commons listed John M. Keynes, *A Treatise on Money* (1930), as well as Irving Fisher, *The Purchasing Power of Money* (1911) and Ralph B. Hawtrey, *Currency and Credit* (1919) etc. as references for the bargaining school (Commons, 1934, 906).

6 Commons listed Walter Rathenau, *In Days to Come* (tr. 1921) etc. as references for the managerial school (Commons, 1934, 905). See Ota (1975).

Table 1. Two Schools after World War I

Managerial School		Bargaining School
Rationing by National Economic Planning Council ⇒ prevent overproduction and unemployment	Economic Stabilization	Stabilizing the general level of prices by a concerted international monetary policy ⇒ prevent overproduction and unemployment
Managerial and Rationing transactions ⇒ affect Output and Efficiency	Important Transactions	Bargaining transactions ⇒ affect Prices
Rationing of Producing Power ⇒ toward Communism and Fascism	Expected Contents	Equality of Bargaining Power ⇒ toward Reasonable capitalism
W. Rathenau, B. Mussolini	Persons Concerned	J. R. Commons, J. M. Keynes

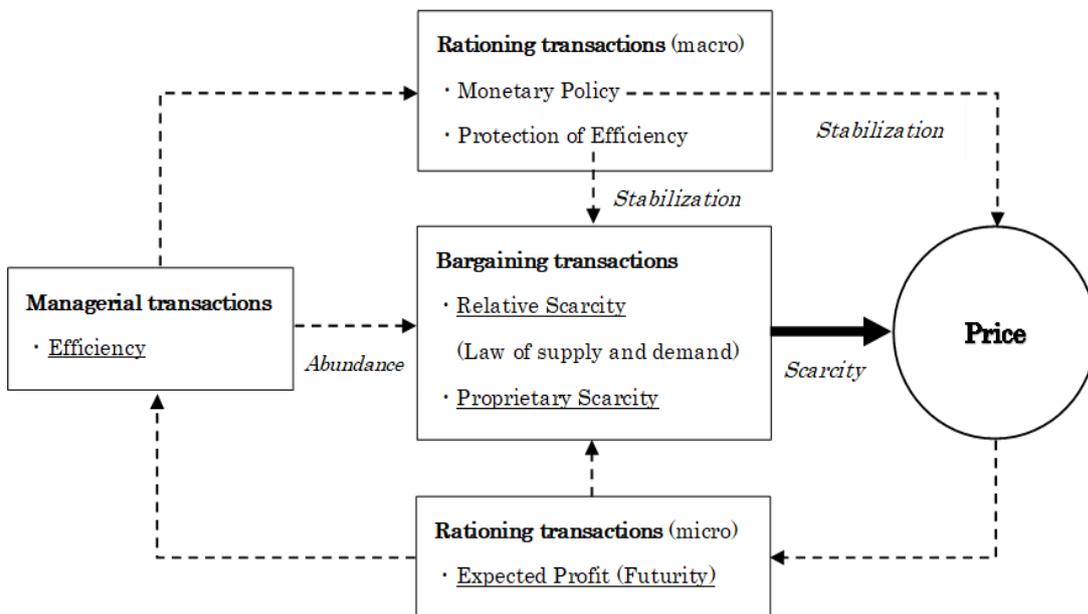
Source: Compiled by the author based on Commons 1934, Chapter 11.

Table 2. Managerial School’s Economic Systems and Reasonable Capitalism

Managerial School’s Economic Systems (Fascism, Communism, and Banker Capitalism)		Reasonable Capitalism
Inequality	Bargaining Power	Equality
Forced Elected Representative	Representative of the Interests	Representative of Voluntary Association
Production control by Vertical Relationship	Role of Rationing Transactions	Securing Bargaining Power and Protecting Intangible Property
Necessary to Secure Profit and National Income	Price Stabilization	Necessary for Income Distribution and Creation of Reasonable Value

Source: Compiled by the author based on Commons 1934, Chapter 11.

Figure 1. Relations of Price and Its Factors in Commons’s Institutional Economics



Source: Compiled by the author