The Social Cost of Labor

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Social Costs and the Economics of Cost-Shifting

For a profit-maximizing firm pursuing a reduction in its costs, it is equally "efficient" to: (1) Develop a process that will economize on the quality or quantity of inputs necessary to produce a given level of output; (2) Purchase the same quality and quantity of inputs at a reduced price; or (3) Adopt a new process that shifts a portion of the firm's production costs to some other person, entity, or the environment.

When economists speak of "technical change" the first of these approaches is almost always implied. The second is, to a degree, covered when the analysis of "factor markets" is covered. The third option, cost-shifting, is almost always downplayed or neglected.[1] Despite its neglect by professional economists, cost-conscious firms have been most attentive to the possibilities of cost-shifting. It follows that economists' tendency to neglect this variety of cost savings is unwarranted.

As an example, consider a situation in which some unique characteristic of a workplace necessitates the wearing of a specialized garment. Examples may include a protective suit in the case of a hazardous workplace, or an idiosyncratic costume that "fits" with the theme of a restaurant or place of entertainment. Now, further suppose that this industry's conventional practice is that changing into and out of these specialized garments takes place on company time. Clearly, if the firm can modify this convention to one in which employees change on their own time, then a savings on labor cost can accrue to the firm. Naturally, employees and employers will disagree on the merits and desirability of such a modification of the workrules. Moreover there is no obvious "resolution" to this quandary, other than what follows from the bargaining process.[2] Unless the labor market approximates the specific and largely implausible qualities of "perfect competition," the outcome will be subject to the vicissitudes of relative bargaining power (Prasch 1995).

The problem, as K. William Kapp, James Swaney, and Martin Evers have argued, is that cost-shifting is, and must be, *endogenous* to a competitive, for-profit, market system (Kapp 1971; Swaney and Evers 1989; Swaney 1987). Entrepreneurial firms that are successful in shifting the costs and risks associated with production to consumers, labor, the environment, or the government (through special tax considerations, wage subsidies, etc.), will gain a competitive advantage over their competitors (Prasch 1997, 2002, 2004b). Success in shifting costs and risks to third parties will pressure a firm's competitors to imitate its "innovations," or face the competitive struggle at a marked disadvantage. Absent effective regulation, what results is a competitive process of "destructive competition" (Culbertson 1985).

With labor, the locus of the problem is that to a private firm the cost of hiring labor is a per-unit accounting cost. Today's economists, taking as they almost always do the perspective of the business firm, categorize labor as a "variable cost." Yet from the perspective of society, labor is an overhead cost. This divergence between the firm's and society's perspectives on the cost of labor was once widely understood and discussed in the economics literature. Institutionalists invoked this distinction when they referred to the "Social Cost" of Labor, or the "Social Overhead Cost" of Labor (Kapp 1971; Clark 1923). Consider, for example, the following comment by Richard Lester:

> In a market economy only money costs count; human costs, such as unemployment through displacement by labor-saving machinery, or deformed bodies and stunted minds resulting from child labor, work injuries, and occupational diseases, do not affect economic action and policies unless they somehow enter money costs (Lester 1947, 42).

Social Costs, and the economics of cost-shifting, have been lost to economics (environmental pollution represents a unique exception). The reason is that it is *presumed*, although rarely argued, that market societies are characterized by perfect information with a full set of "spot" and "futures" markets. These are -- again it is presumed -- embedded in a complete definition of property rights.[3] Additionally it is assumed that there is costless contracting between all market participants. Under these conditions, cost-shifting without compensation can not readily occur. Confusing this idealized model with things as they are, today's economists have simply dropped the concept of labor's social cost (feminist economists are an important exception to this generalization).

A second reason for professional neglect of social costs is that economists have been, despite their stated denials, rather optimistic about the moral sentiments of the owners of firms. This implicit belief in the high moral standards of business owners is, to be sure, a deviation from their often-professed adherence to the proposition that business owners single-mindedly pursue their own self-interest.[4] Happily these economists have, if only accidentally, stumbled across a more accurate understanding of humanity. Studies by experimental economists, social psychologists, and others have consistently affirmed that our motives are generally a blend of multiple agendas. That said, competitive pressures can, and periodically do, overwhelm people's moral inhibitions. It follows that moral constraints cannot be exclusively relied upon to end the shifting of costs and risks.

Another institution that undermines the ethical foundations of modern commerce is the corporate form of business organization. In addition to their legal and corporeal differences from actual persons, corporations are different in that they, by law, custom, practice, and imposed workplace norms and incentives, rarely exhibit the multiple agendas that are normally evident in a mature and properly socialized adult. This, of course, is a competitive advantage to the corporation as it single-mindedly pursues its "bottom line." A self-interested proprietor, with a normally functioning conscience and social status in her community, might balk at the shifting of certain costs or risks onto her neighbors. This conclusion is, perhaps, less of a surprise when we consider that even as the dispersed ownership of a corporation diffuses financial risk, it also diffuses moral accountability (Bakan 2004; Eeghen 1997).

Social Costs and Economic Theory

Things wear out. Knowing this, responsible firms and homeowners plan for the expenses associated with maintenance and depreciation. Over the past forty years Americans have come to believe that they can no longer assume that the environment will regenerate itself under any and all conditions. This realization has created and sustained political pressures for improved stewardship of the nation's environment.

Likewise, a nation's labor force and citizenry must be maintained. To society, this is an overhead cost. Moreover, this maintenance inevitably comes at someone's expense -- typically from the resources of the individual laborer with periodic assistance from family or friends. Classical economists clearly understood that labor, considered as a resource, had to be maintained. This idea was reflected, however imperfectly, in their notion of a "subsistence wage." The Institutionalist school retained and built upon this idea. They believed that labor had a distinct social cost, one that could, they argued, be estimated with a reasonable degree of accuracy.

The Neoclassical school, with its unique emphasis on methodological individualism, dropped such concerns. The Neoclassical theory thereby bypasses the Classical and Institutionalist idea of society and the economy as "ongoing concerns" that had to be reproduced from period-to-period. Starting from a static theory of "choice," Neoclassical economists depicted labor as arriving in the market in each and every bargaining period with whatever economic capacities it happened to possess. In parallel to its static image of the consumer, with his or her fully formed and articulated "preferences," the Neoclassical school took the skills, attributes, and abilities of labor as an unproblematic "endowment."

Of course, the Neoclassical rejoinder to the existence of unmet needs on the part of the workforce is that firms could be made to account for them through the wage-demands made by workers who, as rational beings, will account for the full costs of their own maintenance when they make their wage bargains. Underlying this assertion is the belief that (1) labor is a commodity not inherently different from any other commodity, and (2) that the market structure termed "perfect competition" is applicable. The first of these assumptions has been addressed elsewhere (Prasch 2004a). As to the second, the notion of perfect competition, by design, explicitly devalues issues related to relative or asymmetric bargaining power. Yet it is evident that the labor market, and in particular the market for unskilled labor, is anything but a perfectly competitive market. Transportation costs, differential information, the relative neediness of employees, the level of unemployment, etc., each and severally act to undermine the bargaining power of labor (Lester 1947, Ch. 15; Prasch 1995).

Society and the Economy as Ongoing Concerns

As mentioned, the idea of a social cost of labor embodied the dual idea that the economy, and the society within which it was embedded, were ongoing concerns that are costly to maintain. This idea suggests two inferences. First, that a failure to sustain labor, while possibly to the immediate advantage of individual firms, could be a more expensive choice when viewed from a societal perspective (Clark 1923). The second is a more controversial idea from the perspective of Nineteenth century liberalism. This is the idea of *sustainability*, which implies that there is at least one value that exists independently of, and perhaps in opposition to, market prices. Should market prices fail to support sustainability, a case *could* be made that the government has grounds to intervene in the market. Specifically it could either: (1) modify market prices to more accurately reflect the needs of society, or (2) provide for unmet social needs out of direct expenditures. Social overhead costs, to reiterate, imply that there are social values distinct from, and potentially in conflict with, market values. Such a perspective is clearly in conflict with the Neoclassical vision that considers all values, other than market prices, to be inessential to economic analysis. This eradication of non-market concerns from the realm of professional concern or consideration is presented, not as a gap or oversight, but as a sign of the maturity and scientific status of economic reasoning (Prasch 2003).

In opposition to the Institutionalists, Neoclassicals have argued that freely-formed market prices were essential to the organization and structure of the market. From this perspective, market prices are the best period-by-period "signal" of the state of supply relative to demand in each and every market. Such valuable information, reflecting as it does the most important attributes of an unfathomly complex system, can not be recreated or deduced by any outside observer, no matter how well informed (Hayek 1945).

This vision of the information content of free-market prices sets aside the fact of their often-extreme contingency. This contingency follows from past or present decisions with regard to property law, contract law, current and future expectations, distribution of income, norms, habits, whimsy, fashion, etc. By contrast, a social value such as sustainability can, to the extent that social overhead costs are well-described and articulated, convey a concrete meaning that transcends such epiphenomena. This matters because people, people with lives and needs, must meet their needs in each and every "short run." The social overhead costs of labor must be met if the economy and society is to be sustained:

> There are costs of institutional relief to be borne if maintenance is not met, and much larger losses in productive efficiency. Without attempting to define just where this line comes, we can be quite sure that the laborer does not avoid the cost of maintenance by sleeping on a park bench and living on fifteen cents a day; he deteriorates and both he and the community bear the cost of the deterioration (Clark 1923, 362).

Sentiments such as John Maurice Clark's were the foundation of the Progressive Era's critique of "sweatshop" labor (Power 1999; Prasch 1998). By hiring employees at less than their replacement cost, a parasitic firm was thought to be the beneficiary of a direct or indirect subsidy from the larger society. Shifting some of the costs of maintaining its labor force onto the larger society, a firm can incur a tangible advantage over its rivals. For a firm's employees to survive with wages below subsistence, they would have to draw upon previous savings, or receive some variety of transfer from family members, private charity, or the state. Should the social overhead costs necessary for a "decent" standard of living not be met from any source, society would still have to pay through the degeneration of its labor force and citizenry.

Conclusions

Regrettably, none of the negative consequences outlined above are a direct concern to a cost-cutting firm. One reason is that its employees are only a small portion of the labor pool of a given city or region. This characterization is particularly true for those firms that hire unskilled labor. In addition, the firm's rate of discount can generally be assumed to be higher than that for society as a whole, implying that they are less interested in the long-run degradation of the workforce.

Beyond these considerations, a larger conceptual problem is that for several decades economic theorizing has been caught up in what we might usefully label a "shopkeeper" perspective. It is this perspective, enshrined in the textbooks, that takes labor to be a "variable cost." For the business firm, and only the business firm, is this true. For society, the health and welfare of its citizenry are clearly "social overhead costs." From this latter, social, perspective it is almost self-evident that the purpose of the economy is to support a vibrant society (Polanyi 1944). This position can be usefully contrasted with the politics of Neoliberalism, which insists that it is society's role to support the economy.

The idea of labor's social overhead cost, if revived, presents us with an underlying logic of labor market regulations. Laws concerning wages, hours, health, or safety may still, of course, be criticized for being misspecified or ineffective. However, acknowledging the existence of a social cost of labor means that they can not be considered, *ipso facto*, to be "distortions." On the contrary, they represent a civilized society's response to the inevitable limitations of relying solely on market prices to ensure the sustainability of the economy, society, and polity. The political philosopher Harold Laski nicely summarized the issue, "Factory Acts, Trade Boards, and the like were all the logical outcome of *laissez-faire*; it is because without them the community would have found a civic life impossible to the vast majority of its citizens" (Laski 1931, 487).

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Notes

1. James Swaney and Martin Evers have suggested that it would be useful to distinguish "between mere *technical* advance, where costs are shifted, resulting in total social opportunity costs that are no lower (and may be higher), and true *technological* advance, where costs are reduced for society as well as for the micro-unit" (Swaney and Evers 1989, 29n.6).

2. An exception occurs in the event that the minimum wage law is binding. In such a case the state may intervene to ensure that "off the books" labor-time is not used to reduce the effective wage below the legislated minimum.

3. What, exactly, a "complete set" of property rights and markets might mean in a world characterized by entrepreneurship and technological change has never been given a satisfactory explanation.

4. Some economists reconcile these notions by proposing the existence of "reputation effects" or "enlightened self-interest," but I nevertheless stand by the statement in the text. Oliver Williamson is perhaps exceptional in his clear depiction of predatory behavior ("opportunism") as being a core characteristic of self-interest (Williamson 1985, Chs. 1-3).

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