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PROPERTY RIGHTS, SPECIALIZATION AND THE FIRM*

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Specialization in productive team work and in knowledge occurs in all societies. It enables us to attain greater wealth, but we become more dependent on each other. That specialization may be organized by a dictator who assigns tasks and consumption. Or it may be achieved by decentralized control of self-selected specialization with voluntary exchange, if private property rights exist in all scarce resources. Private property rights are assignments to specified individuals of exclusive, exchangeable authority over physical uses of all scarce goods.

Exclusion and exchangeability are key elements of property rights. Salability or exchangeability, of rights enables a person to decide in which rights to which goods to specialize one's holding of wealth. Differences among people in talents and confidence to select, monitor and evaluate more valuable uses and in their risk aversion imply potential gains from specialization. That selectivity in production, and in which resources to own, results from the exercise of the components of private property rights, if the component rights can be partitioned.

For example, I may believe (bet) that an agent can better select uses of some of my resources. He may have better information, analytical power, monitoring ability, energy or desire to work. Though he will heed his benefit rather than <u>only</u>

mine, the resultant value to me may still exceed what I could have achieved. Specialized partitioning of private property rights requires, as does all specialization and agent-principal relations, sufficiently effective systems to ensure the agent performs as anticipated, i.e., without excesssive opportunism.

A. Separation or Specialization of Functions

An ancient normative argument for private property is that use selectors should bear the market value consequences. Otherwise, the nexus between bearing risk (often called "ownership") and use-decision ("control") is weakened. The effectiveness, viability and congeniality of private property as a system of control are reduced.

It has been argued that diffused stock ownership of corporations separates ownership from control and reduces manager's attention to stockholders' interests. Managerial control of the voting rights is said to render stockholders as helpless as citizens in controlling politicians -- except for a few holders of a substantial portion of the corporate stock. So the director-managers use the corporate resources as a government employee could use government resources -- except that a code of "social responsibility" presumed to be applicable to government employees has not yet been adequately applied to the corporate managers. As a substitute, social responsibility and high social ethical inculcation must restrain the managers. That is one of the modern doctrines of corporate governance.

The seed of this interpretation was in Adam Smith. It

blossomed in 1932 in Berle and Means, The Modern Corporation and Private Property, despite several debilitating flaws. Before elaborating, a fundamental fact must be recognized. The "insulated" managers do in fact engage in less than fully conscientious activity in behalf of their employers -- the stockholders. But this is not unique to the modern corporation. It occurs in every human relationship. People do not act entirely in other peoples' interest. Each of us has a modicum of self-interest. The issue is not whether top managers of the modern corporation heed their self-interest. Of course they do. But do they do it more than elsewhere and without punishment, if more than anticipated? Does the modern dispersed ownership corporation increase productivity and protect owners, customers, and employees from each other's self interest more than other forms of organization? Those are the questions to ask in analyzing the effectiveness of the corporate firm and its managers.

Several flaws in the separation doctrine obscure how the evolving corporate structure meets the organizational tasks. The flaws are: (1) a failure to recognize that what is called a firm is a special set of contracts: a contractual coalition including resources specific to the coalition; (2) a failure to see that a capitalistic firm (as distinct from a socialist firm) involves private property ownership in common of the coalition-specific (i.e., what are hereafter called "interspecific") resources; that is, they are not procured on a rental basis; (3) a failure to recognize specialization in components of the

rubric of private property rights; (4) the failure to recognize monitoring by covenants; (5) the failure to recognize monitoring by competition in the managerial and in the capital markets; (6) the erroneous belief that salable private property stockholder rights (common stock) in the large corporations are (or should be) essentially similar to political voting rights; (7) an excessive preoccupation with firms rather than with individuals as competitors, (8) the failure to recognize that competition occurs not only in the variety of goods proferred to customers but also in forms of organizing economic activity. The significance of some of these will be indicated, after some concepts are defined.

An interspecific input is one whose value depends on -- i.e., "is specific to" -- the behavior of some other particular resource or some activity. The investment cost of a interspecific resource that is non-salvageable if the other resource, to which it is specifically dependent, disappears is called the interspecific quasi-rent. For example, if I invest in a machine, A, whose value depends on services rendered by some particular other resource, say B, then the loss of A's investment value if B's services are withdrawn is a non-salvageable quasi-rent value of A and it is specific to B. (Any value in excess of the investment cost is a profit.)

The interspecific quasi-rent is <u>expropriable</u> if its value depends on whether the owner (or administrator) of the "specializing" resource can <u>control</u> its effects on values of the resources specific to it and on the costs of obtaining

indemnity (Klein, Crawford, Alchian, 1978). For example, if a building were constructed on land owned by someone who could do nothing to reduce the services rendered to the building, the building owner would have nothing to fear from opportunistic behavior of the landlord, though the landlord must beware of the building owner's refusal to pay the agreed rent. On the other hand if the land contained a spring and the water was desired by the building owner, the landlord's possible threat to shut off the water would be something the building owner should anticipate, especially if costs of contract enforcement or indemnities are high.

Reciprocally interspecific resources have values that depend on the presence and behavior of each other. (The degree of such dependence is here assumed to be all or nothing, in order to simplify exposition.) It is nonreciprocal if one depends on the presence of the other without reverse dependence.

The difference between a "quasi-rent" and what we will call a "bargain" is important. A "bargain" can result if a buyer can purchase something on better than the next best supplier's terms. This gain or benefit (setting aside the question of why a seller would give such favorable terms) is here called a "bargain". No prior investment is necessary for a "bargain" nor is any quasi-rent involved. Nevertheless, the "bargain" is specific to some supplier, without whom it would not be available. A new grocery store nearer some resident which provides better terms than the next best supplier gives the lucky resident a "bargain". Or an employee may be getting

substantially higher pay than he could get from the next best employer -- and not because of any investment made by the employee in improving his productivity to the employer. Incidentally, this bargain is a "consumer surplus", which occurs even if all suppliers make identical offers with no resultant "bargain" to a buyer. And, of course, it is not a "quasi-rent" since no prior investment was made in any asset that yields that "bargain" for the beneficiary.

For a "quasi-rent", where a prior investment is required, the anticipation that the quasi-rent may be expropriable by the other party to whom it is specific will motivate _pre_-investment protective contractual arrangements to avoid expropriation. But it is also true that for a "bargain" the fortunate recipients will be prepared, once the "bargain" is apparent, to incur costs to ensure continuance of that "bargain", just as anyone would take action to preserve "rights" to a "charitable grant" -- even though the recipient made no prior investments the return on which is the "bargain". The purpose of the present analysis is the behavior and arrangements motivated by the anticipation of creation of expropriable quasi-rents, not the attempt to get a firmer hold on a "bargain".

The preceding paragraphs can be summarized. A resource's value depends on the state of Nature and on the actions of other resources. A resource whose value is alterable or affected by known other resources will have an interest in controlling or restricting the acts of those resources. If arrangements are made between the two resource owners to restrict or control the

actions of the resource that affects that of the other, the two are said to be a coalition. The affected resource is said to be specific to the resource whose acts can affect the value of the affected resource. Of course the acts referred to are legal acts, or acts that are legal absent mutually agreeable arrangements to restrict the acts of the "independent" or affecting resource. If the acts of one party can affect the value of another, but no arrangements are made to influence the acts, the two are not in a coalition. Coalitions, as defined here, can take many forms: marriages, business firms, cooperatives, franchises, to mention only a very few of the many, many forms of arrangements devised to influence actions. Unfortunately excessive attention seems to be devoted to one special form, called the business firm, without a clear conception of what a business firm is.

(1) The Capitalistic Firm:

(1) A Set of Contracts Among Owners of Interspecific Resources

A particular set of contracts involving owners of private property rights in interspecific inputs for teamwork is typically

a firm. Physically the firm is the set of resources subjected to that set of contracts. Teamwork means the jointly used inputs create products which are not uniquely attributable to each input and capable of being summed as the total output of the team, though marginal products of inputs can be defined and estimated (Alchian and Demsetz, 1972).

(2) Common Private Property Ownership Of Interspecific Resources

Interspecificity between resources creates opportunities and incentives for opportunistic behavior and hence induces precautionary action -- one of which, where feasible, is common ownership (Williamson, 1979). The implication is that if of two resources, X is going to become specific to Y, the owner of Y will have to make the initial investment in X that makes it specific to (dependent on) Y. Then Y can not later gain by insisting on a higher payment for continued services.

The owner (with private property) of the commonly owned interspecific resources is here called the "owner of the coalition" -- though in fact no one can literally own a coalition. And owners of resources used with the coalition but which are not specific to the coalition are "adjuncts" to the coalition, even if often called suppliers, employees, and customers.

Generalized resources, non-interspecific in either direction, can just as well be rented or used by spot sale of services, as business men dealing with each other or customers dealing with a firm. As should be evident, the nature of contracts, agreements and arrangements among owners of resources

will depend on the degree of interspecific.

The term "business firm" as usually used probably means a coalition involving _interspecific_ resources, the purpose of which is to increase the _marketable_ value or income of the resources. A family and a social club are coalitions or arrangements that may include formal, informal, tacit , or implicit agreements or contracts or understandings. The business firm is distinguished by its purpose, not by its contractual form or types of resources.

Of which of the resources jointly used in the coalition will the owner be the director, the monitor, the contract reviser, and the risk taker of the coalition? It will be the owner of the resources specific to the coalition, or some agent of that owner, who is usually called the "owner of the coalition". That owner is the person most interested in creating and maintaining an effective coalition. In a corporation, it is the stockholders. They own the "firm's capital," _i.e._, the resources with values most susceptible to the coalition's success. To say a set of resources is specific _to a coalition_ is to say it is vulnerable to loss from an ineffective coalition. The owner of those interspecific resources is the only one who will lose in an _in_effective coalition since resources not specific (to this coalition) can transfer to other equally high value uses. Owners of resources with no value specific to other assets in the coalition will have slight interest in the coalition, because they can walk away at virtually no loss.

Labor Inputs. It is tempting to use the term "employee" (or

renter) to denote any resource with an equal value (i.e., salvageable) outside the coalition. However, three classes of labor resources should be noted according to whether they are (a) interspecific with nonhuman resources, or (b) to other people, or (c) are completely generalized. The contractual arrangements will differ.

(i) People will seek to own the nonhuman resources to which they are going to be specific. If that ownership is not economically feasible, the owners of the nonhuman resources will have to pay for the investment that make the people specific to these resources. For example, a mine in a remote area will create, own, and offer houses at a rental to employees, in order to reduce the dependence of an employee's wealth on the mine. Threats to lower wages would be effective if the employees owned houses and land near the isolated mine. The mine owner is in part investing in the resource (house) that would otherwise make the employee's wealth more specific to this mine.

Tenure, seniority, or job rights are examples of arrangements that can help reduce that threat. Action by a cohort of interspecific laborers, possibly taking the form of a union, can protect that labor specific to non-human resources in a firm. Expropriable quasi-rents may be in pension and health benefit rights or may be in initially acquired skills specific to the non-human resources in the firm. In reverse, a <u>monopoly</u> union could expropriate quasi-rent of non-human resources specific to a <u>monopoly</u> union. For example, monopoly unions could expropriate the quasi-rent of agricultural capital by effectively

threatening to strike at harvest time. Or monopoly unions can raise wages to extract the quasi-rent of non-human resources specific to the services of a monopoly union by closure of access to substitutes. This two-edged function of unions: (a) "agency" to protect its expropriable quasi-rents and (b) its "monopoly strike-power" to make associated resources be specific to it in order to expropriate that quasi-rent, creates dispute about the "legitimate" roles of the union.

(ii) An interesting problem arises when people are interspecific as a team and therefore are more productive than if separated. They will suffer a loss because of high costs of adjusting to new possibly equally productive coalitions. How are interspecific human talents contractually organized, when not all members can be owned by some person? Some success in answering that has been achieved for law firms and social country clubs (Liebowitz and Tollison, 1980; Klein, Crawford and Alchian, 1979) and conglomerates (Williamson, 1981). A team of interspecific people cannot be owned as private property, as slaves, and can not guarantee performance as they could for machines. Instead partnerships are created. Teams of comedians, lawyers or doctors whose services are highly dependent on the performance of a colleague will form partnerships or mutually owned organizations. Alternatively some forms of contracts such as first negotiation/first refusal, tenure, or group action among a group of resources specific to some "employer" or owner of interspecific resources can prevent opportunistic exploitation of some of the members of the group.

(iii) Generalized labor will be "casual", "transient" or independent contractors. Like customers, no one has significant effect on the salvageable value of any of the coalitions asets, even though the set of customers as a whole would seriously affect the coalition value if they all refused to deal with the coalition.

(b) The Long Term Contract

Since what is called a firm is characterized by special kinds of contracts among the owners of jointly used, interspecific resources, the proposition of Williamson that long term contracts are a necessary attribute of any coalition that will be called a firm is prescient.

What distinguishes a long term from a spot contract? In spot contracts responses to future developments are not restrained by contractual provisions. The spot contract has no future restraints. A series of spot transactions is not a long

term contract. A long term contract affects the costs or rights of some of the parties to adapt to future events.

A long term contract is formed to induce an investment by one party, the value of which will depend on the actions of the other party. Inducing a "specific to party A" investment by party B will require or <u>imply</u> an explicit or implied long term contract restraining A's future actions. We would therefore expect to observe long term contract restraints on party A in order to induce some dependent, interspecific investment by party B. If one party makes an investment based on expectations of continued business with another party, the contractual arrangement would be considered to be long term by the investing party -- even if the explicit formal contract were "spot", with no <u>formal</u> long term contract. Behavior in conformity with implicit long term "contracts" restraining one of the parties would preserve reputability for not exploiting the "trust" of others. If a copper refiner supplies a fabricator who has made investments the values of which depend on the behavior of the refiner, it is likely that, explicit contract or not, the refiner will be expected to and will supply the fabricator with copper as if there were a formal long term contract. (We leave aside the question of why explicit long term contracts are not made.)

In contrast, Alchian-Demsetz (1972) asserted "...neither the employee nor the employer is bound by any contractual obligations to continue their relationship. Long term contracts between employer and employee are not the essence of the organization we call a firm." In the light of Williamson's

(1975) analysis that assertion is incorrect. Williamson's discussion of the long-term contract in the context of "idiosyncracies, small numbers, and opportunism" is surely his way of calling attention to non-salvageable investments with quasi-rent expropriation by opportunistic action of the other parties. A long lasting relationship without non-salvageable investments specific to the other parties is not a representation of the contracts in a "firm". Typically, some parties must make some non-salvageable, specialized investment (e.g., location of residence, firm specific learning by the employee or some employer investment in employer-specific knowledge and techniques).

The range of promises and restraints is matched by the range of non-salvageable specific investments thereby induced. A buyer may merely "suggest" he will be buying in the future, and thereby induce a seller's current investment in buyer specific service-facilities in anticipation of that buyer's future business. Another buyer may make committments to induce more extensive (non-salvageable) specific investments by the other party. Indefinite promises, expectations, and committments will create a variety of relationships among the "contracting" parties. Long term contracts, price stability, reciprocity, loyal customer reputation, franchises, price limitations, advertising, exclusive dealing, job security, tenure, first refusal rights, union representation and seniority are some examples. Even if customers to a firm have made no implicit promises of future business, the firm may act responsibly and reliably to customers

because the firm made non-salvageable, specialized investments of value to customers, the value of which can be maintained only if the firm performs as it promises the public (Klein and Leffler, 1981).

Earlier references to "teamwork" as a crucial factor in the firm rested on the inability to objectively detect separable products of each member. The aggregate output of the group could not be measured as the sum of outputs of individual members. This led to the monitoring task, i.e., detecting in some way the marginal product of each member. But what is crucial? Is it the absence of separable, measurable, additive outputs or the difficulty of measurement of the output effects of each input's behavior? Team production makes measurability of marginal products difficult, but not impossible. And even without team production, the contribution of one person in an exchange may not be economically measurable in all pertinent characteristics. If one party can gain by shirking in its performance, this <u>means</u> the other party is "specific" to the shirker by the circumstances. This mode of expression emphasizes the specificity of one resource to another, but it obscures the significance of measurement of performance. On the other hand, if measurement of performance is emphasized, then the significance of expropriability of interspecific resource quasi-rents is obscured. Even if measurement were no problem at all, opportunistic behavior can occur blatantly because contracts are not costless to enforce, though I presume that without substantial expropriable quasi-rents of specific resources,

blatant defiant cheating is not a serious problem.

One might therefore define the firm in terms of two features: the measurable detectability of input performance in team production and the opportunity for expropriation of quasi-rents of interspecific resources: A firm is a coalition of interspecific resources, only some of which are owned in common, and some generalized inputs who are paid, because of teamwork, according to some criteria other than directly measured marginal productivity, and the coalition is intended to increase the wealth of the owners of the inputs by producing salable products.

Whether or not that definition is accepted, the important question is what kind of contractual relations are institutionalized or used in what circumstances. With that point of view, it is hard to see what would be lost if the term "firm" were abandoned, except a source of confusion.

The coalition typically called the "business firm" in almost all standard economic literature has never been defined or analytically distinguished from other coalitions of contractual relations. Little harm was done when analyzing a group's output and pricing activities, as if there were no internal, separate entities (individuals) acting cooperatively in some respects though not in others. The group might be acting as "one" in buying inputs and pricing, but not in selling activity and division of rewards. Or the members may act as "one" in selling the product but separately in buying inputs. To treat all "firms" as internally similar, black boxes monolithically

competing against other black boxes is adequate for some phenomena, but very misleading for understanding some other phenomena.

For example, in antitrust litigation the test of whether a group is single entity (one firm) has been widely used -- and has been useful for some questions. But to phrase the test that way is to ignore the variety of contractual structures that have evolved to increase economic productivity and viability with consequent gains to consumers and producers. The "family", the principal agent relation, social clubs, holding companies, professional sports leagues, cooperatives, groups of franchisees, not-for-profit foundations, NCAA, U.S. Golf Association, to name a few are contractual coalitions. They may or may not be called "single entities" or "firms". It makes no difference. To attempt to ascertain effects by asking whether the arrangement is "one" firm is to blind oneself to the fact that the conception of a firm used in cartel theory <u>assumed</u> the members have <u>no</u> other motive than to restrict offerings to consumers in order to raise prices and make larger profits. The conjoining of that assumption with the simple minded assumption of "separate" entities made it sensible to ask if they were separate entities (assuming the assumptions were valid). But that assumed all economic activity could be efficiently organized in the same way, viz., the standard, classical, organization called a "firm", which is in reality only one special kind of organization (Jensen and Meckling, 1976, p. 311).

The analytically useful procedure is not to ask, "Is it

action among competing firms or that of one entity. What counts are the goals and consequences of the contractual conditions imposed on the joint activities. Whether the contractual relations be declared to be among separate "firms", as is usually done for purchases by Ford from U.S. Steel, or a relationship within one firm, as when Ford automotive assembly buys from another Ford division, reveals naught about reasons or effects for the different arrangements.

In sum, concentration on "the" firm as a well-defined basic module of analysis without recognition of the diverse internal actions controlled in different ways in different circumstances has led not only to poor antitrust decisions but to a confusion about the "control" and "ownership" of the coalition -- the topic of this paper. It would not be an unmitigated loss if the "firm" could be dropped from the economists' vocabulary, to be replaced by "coalition".

(c) No Pure Rental Coalition

Common private property ownership of interspecialized assets is a characteristic of a capitalist coalition -- typically dubbed a firm. That "capitalist" firm would not exist, if all resources were non-specialized and separately owned. The cooperating team members would be monitored by a pure residual claimant. [Jensen and Meckling, 1979.]

(3) Specialization as Division of Labor in Management: Directing, Monitoring, Team Revising and Risk Bearing.

Confusion among "separation" and "specialization" of control (use decisions) and "ownership" (bearing risk of market value)

probably reflects insufficient understanding of the generality of the principle of specialization in exercise of the partitionable components of private property rights. For example, that misunderstanding is manifest in assertions that middlemen increase costs to consumers by separating consumers from producers. In fact, middlemen, by specializing in communication, transport, product knowledge, etc., more effectively (*i.e.*,at lower cost) correlate the interests and actions of consumers and producers. A consumer who grew and ground wheat into flour could bake his bread in whatever form he was able. But when he permits specialists to intervene and perform these separate tasks, so that consumption is separated from production, the available variety of bread is greater and cheaper. Though some people believe producers decide what bread consumers eat, consumers determine which bread the baker can profitably continue to produce.

This specialization also occcurs for the elements of private property rights and thereby strengthens the power of private property rights. These component rights can sometimes be exercised separately by specialists more effectively than if all were held by one person who miraculously had all the specialized knowledge and talents of the several specialists. (Manne, 1964, 1965, 1967).

Four of the separable tasks in exercising property rights are: (a) selecting uses of the resources; (b) monitoring (evaluating) the performance of inputs; (c) revising contract terms or replacing inputs; and (d) bearing the value changes of

resources. The first three can be delegated to fiduciary agents acting as specialists, but the fourth cannot.

Someone tells inputs what acts are expected to maximize the value of the group's products. Someone revises membership and rewards to conform to observed performance and outside competition. Only if competition from new potential members reveals shirkers costlessly can internal monitoring be ignored. Typically, competitive monitoring is more effective when combined with some internal monitoring.

Whatever may be meant by ownership of private property, it certainly includes bearing risk of the marketable value, *i e.*, having the rights to the marketable value. That can't be delegated while still retaining ownership. The other attributes, such as selecting uses and directing and revising activities can be delegated. Owners can, however, *reduce* or control some sources of risk. One way, as has been explained, is to have interspecialized resources jointly owned; owners of resources specialized to a coalition can be the "managers" of the coalition or they can specialize by delegation in exercising the other component rights in private property rights.

(4) Contractual Covenants to Monitor and Control Specializing Agents

For evidence of the extensive use of accounting and financial covenant to police the agency relationship between stockholders and operator-managers, it is sufficient merely to make reference to R. Watts (1977), and C. Smith (1981).

(5) Management, Managerial Competition and the Stock Market

Define management as any choices of uses that affect the values of the specialized resources in the coalition. Of course, anyone can have a big effect by simply burning or bombing the resources. But let the range of selectable uses be specified for each person for each resources. Given the range of authorized optional actions, there will be some probability distribution of value effects, called the "conditional" (or "constrained") value distribution, conditional on the range of selectable uses and the amount of monitoring of that person's behavior. Any person whose constrained, conditional distribution of effects on values of resources in the coalition is wider is more of a manager -- no matter what particular tasks he performs.

I do not define a manager by the types of actions, but instead by the anticipated, conditional, probability distribution of effects on the values of specialized resources. Managerial actions are not confined only to personnel supervision or investment decisions or output decisions.

The common belief that in widely dispersed stock corporations managers are hardly subject to discipline of owners' control does not recognize the effects of competition among incumbent managers, and between them and outside challengers, and that in the capital markets (Fama, 1980). Management is not a monolith. It consists of self-interested persons seeking to displace others. The corporate survival test is increasing the aggregate value of the interspecific resources owned by the stockholders. Competition from potential managers restrains an incumbent's deviation from that objective. Personal competition

among people within the firm can be stronger, because the personal qualities of each member may be more cheaply and reliably discerned within, than across, firms.

A manager's salary is derived from what he is expected to do for and to his principal's wealth. To deter defective (i.e., worse than anticipated) behavior, the manager's prospective punishment need not match the loss he might impose on other coventurers. The prospective punishment need only match what the malfeasor expected to get. Unanticipated managerial malfeasance can be dissuaded if managers anticipate that their future salaries will be adjusted downward, where revealed performance is an indicator of future performance. Performance that is seen to be less than anticipated will lower the forecast, and be capitalized into a lower present value of the future stream of wages. (Fama, 1980; Jensen and Meckling, 1976.)

A revelation of information about one's present and past performance is the price of the common stock of the firm. The common stock price reflects the value of the interspecialized resources, precisely the resources whose values he is primarily influencing. The stock market thus serves as a signal not merely for "capital" investment but also for effects of, and rewards for, managerial performance. That signal can be more effective, the more widely the stock is dispersed. Without a stock market, information about performance of managers would be more difficult to obtain. Thus the stock market is a part of the managerial market.

The extent of diffusion of stock ownership may be correlated

with the size of the firm, measured, say, by the number of people in the firm. Because larger firms usually have more levels of administration, their adaptability to new idiosyncratic circumstances may be reduced by their more formal, restrictive standard operating procedures. To adapt while taking into account the effects on the entire firm may be more difficult in larger firms. Information coordination and calculation (bounded rationality and impacted information; Williamson, 1975) is a more extensive problem in a larger firm. Therefore _effectiveness_ (but not extent) of task-specialization may spuriously appear to be negatively correlated with stock diffusion when in fact, effectiveness may be related to the size of the firm and its greater administrative problems.

(6) _Effects of Types of Property Rights_

Competition among managers discloses managers who are paid more than their effect on values of the specialized resources. But "value" to whom? What, and to whom, can challengers offer to displace overpaid managers? The response to the prospective values of specialized resources depends on whether the rights to those resources are cooperative, socialist, or private property rights. (Crain and Tollison, 1978, Alchian 1965; Furobotn and Pejovich 1970).

In a socialist firm, the values of the specialized resources are not capitalized into anyone's present salable wealth. In the cooperative or participatory democracy firm the rights to specialized resources are claimed on some non-salable basis by the _generalized_ resource members. For example, since no one has

salable rights to the specialized resources in socialist firms or cooperatives, members are interested in a shorter horizon -- with less capitalization of future events. This affects the responses to offers, and the investments and actions that are acceptable to the members.

Anonymous salability, not limited liability, is the significant factor in the capitalist, private property corporation. Limited liability was contracted for without the corporate form. (Meiners, Mofsky, and Tollison, 1979.) Salability of rights enables continuity of a corporate venture beyond the departure of any one member. A well functioning team is not capriciously terminated. And also the longer life enables more complete capitalization of anticipated future results into current corporate stock values.

The historic English foreign trading corporation initially was a cartel device during the Mercantilist period (Ekelund and Tollison, 1980). Because salability of shares permitted continued existence despite membership changes, successful foreign trade cartels survived. The modern corporation, using the same organizational features, is, <u>in contrast</u>, because of the absence of political restrictions on newcomers, forced by competition to a different survival result -- lower costs and improved products. The difference between the modern and the old mercantilist corporation flows from the absence of political restrictions on competitors -- not from changes in the corporate form or managerial and stockholder incentives.

The significance of salability of use control rights is

noticeable by comparing a large government agency like the Post Office or any state owned enterprise -- or non-profit firm -- to General Motors, with private property ownership. The rights of thousands of stockholders of a large corporation differ from that of the thousands of citizens of a city government. The process for selecting agents -- voting -- appears the same if one looks only at the act of voting and the delegation of decisions. But I cannot sell my share of rights to the Tennessee Valley Authority, the Federal Reserve System, the Post Office or the city golf course. With private property, I could decide whether or not to own rights to them.

It might be countered that a stockholder of General Motors cannot sell his interest in only the Cadillac Division; he shares in rights to all the specialized assets in the whole corporation, just as if he had a share in all government property. In a city, I cannot divest myself of ownership rights to the city golf course, nor could I divest myself as a General Motors stockholder from the Cadillac Division. So, what is the difference? You can't *sell* of your interest in a city.

Except that it would be possible in a world of many small, open, independent governments, *if* land owning were a necessary condition for membership in any city, *and if* all consequences of the use of government property were fully thrust on the exchangeable value of the land, *and if* land were salable as private property, *and if* all the land in a given city were homogenous or easily categorized into classes of land, parallel to types of corporate securities. In that case, private property

rights in land would be equivalent to holding corporate stock rights. But I know of no such world (not even in the town of Buenaventura, California, whose city manager concluded the role of city government was to increase the value of the land -- a not unreasonable conclusion for an "open, small city," and possibly even for large cities like New York and Cleveland, which seem bent on the opposite goal.) Perhaps _one person, one vote_ should be replaced by _one acre, one vote_.

Salable rights in government property in a democracy is an inconsistency of concepts. It is not realized in any real government, even though I'd sell _my_ "ownership" rights to Yosemite National Park or TVA for a nickel. It is salability that makes private property rights different in their effect from government property rights. Salability is not eliminated by diffused stock ownership; instead, it is enhanced by the corporate structure.

If there were no salable right to vote for a manager or an agent to the Board of Directors, every stockholder would remain merely a residual claimant with little power over corporate resources. However, so long as some corporate shares have that voting right, and those rights (shares) can be bought, then stock markets can discipline managers to conform more to the interests of the stockholders. An ill-managed corporation can have its management displaced by the purchase of shares, which are then voted to alter the management. The gains are achieved, not by having bought shares at a value below their resulting later value reflecting installation of improved management or gains of

synergistic mergers. Indeed, the prices of the acquired firm's stock do not rise after the takeover. They typically fall below the tender price. Instead the gains of such acts to the acquiring firms are realized by the rise in its stock prices. The large variety of ways capital markets permit displacement of poorer management is corroborated by studies of stock market tenders, takeovers, mergers and "raids" (Manne, 1964; Bradley, 1980; Fama, 1979; Dodd and Ruback, 1977).[1]

(6) The Role of the Board of Directors Where there are many stockholders, not all can be the CEO nor be on the Board of Directors. Directors are agents believed more capable of detecting, assessing and responding to information about managerial effects on the value of the specific resources. Directors do not direct managers; they do not select uses; they detect and evaluate managers' performance and may replace them.

Common stock, preferred stock, debentures, notes, bonds, warrants and options are claims to portions of the value of interspecialized resources. Their owners demand representation (as principals or by agents) on the Board. And if any persons or "employees" have human capital specific and specialized to the firm, they too demand some control and monitoring *via* representation on the Board of Directors or some other form of protection (e.g., long-term contracts of employment or stock ownership) from expropriation of their specialized investment's quasi-rent (Goldberg, 1976). Stockholders desire responsiveness to challengers seeking to replace less effective managers and even less perceptive, fellow stockholders. Even if chief

executive offers are said to control the Board of Directors, responses by the Board will occur. This should be apparent when one recognizes that the Directors are agents of stockholders (owners of the specialized resources.)

Successful, proven managers of other firms will be better directors in assessing or predicting managerial performance. Like any other agent, directors should be made to anticipate post-performance rewards or punishments equal at least to any gains they might seek by excessively deviant behavior. The more reliable or able a Director is expected to be, the less the need to be able to impose a heavy punishment. If the directors are earning high salaries in other primary jobs and fail to work as good agents, their loss of reputability will affect their salaries in their primary jobs. This will tend to induce behavior responsive to stockholders' interests. They will tend to be people of extremely high reliability, reputability, and proven diligence with low probability of irresponsible actions.

Of course, everyone in the coalition would like to be on the Board of Directors, if they could, with impunity, divert the specialized asset value to their own welfare. For example, the current campaign for "worker participation" or "industrial democracy" or codetermination on boards of directors appears to be an attempt to obtain control of the wealth of stockholders specialized assets in the coalition -- a wealth confiscation scheme. But no firm with that arrangement could profitably obtain new funds for specialized assets. Furthermore, _future_ employees with codetermination rights would have to pay incumbent

employers for that right to control the specialized assets of stockholders. Control of specialized resources by generalized resource owners is not an economically viable contractual arrangement for creating a voluntary coalition with specialized assets.[2]

(7) Individuals in Competition

An important implication of interpreting the firm as a set of contracts is that the "firm" loses some significance as the basic unit of analysis of competition. Attention is focused more on competition among individuals and particular resources. Thinking of firms as the fundamental actors conceals the _intra_-firm competition. New entrants into old firms can offer more desirable options to consumers. Top managers of firms act as surrogate markets. Managers screen proposals for offerings by the firm. This prescreening may more cheaply estimate consumer response than by actual experiment. If a new entrant nevertheless organizes his own firm and is successful, that is evidence of a mistaken judgment by managers of existing firms, just as its failure would be evidence of good judgment by incumbent managers of existing firms.

Take a different example of the principle. Having only one newspaper in a town does not deny competition to serve readers. Among that paper's present and potential staff is a competitive struggle seeking to better satisfy readers' tastes for news and entertainment. It is the same in other industries. Does it make any difference that people competed within an existing firm rather than via many, new, small companies? Is there reason to

believe entrants would have been more productive or tested more accurately or more cheaply under one procedure than the other? I know of no reason to affirm or deny that the menu of viable products from a few firms is better or worse than from many new smaller rising and falling firms.

"Entry of new firms" can be achieved by people moving from one firm to another. With different membership, a firm changes; more accurately if inputs that are specialized to the firm change, the firm is changed. It is a new firm, even if its name is the same. Someone can enter another firm bringing resources and ideas either as an employee who rents services to the group or as someone who becomes a joint owner of the specialized inputs, replacing some other owner. Different stockholders can change the course of the company. Competition among people to own those specialized resources (i.e., become part of the firm) changes the firm. The new replaces the old, and market survival determines which is the more profitable. This competitive process seems to be ignored in much popular talk about mergers and takeover bids, which differ from ordinary purchases of stock in a corporation in that the amount bought is substantially larger. The larger amount increases the probability that the new stockholders will modify the existing coalition's composition and activities. That is, "control" is affected. Why should that be objectionable? Movement of people "into and out" of the firm (as stockholders or as employees) is a competitive process of seeking more profitable composition, activity or internal organization of coalitions of resources. A takeover is a method of outbidding

existing stockholders for the control of an organization -- the determination of its membership, activity and organizational form.

Even if the number and name of 10 firms in an "industry" didn't change, that would tell nothing about the intensity or effectiveness of competition -- for it tells nothing about the changing content and actions of any of the firms. There is little reason to contend that 10 firms, limited by some law as the admissible number, would not yield the same competitive results as without such a limitation -- so long as people are allowed to approach any of the organizations (coalitions) and suggest admission in the expectation that it and the existing members will achieve better results. As a not entirely misleading analogy, one can imagine 10 cities in a country with people moving from city to city and altering the actions within a city, without new cities being created or old ones disappearing. Every entry or departure changes the city, just as it is a change in the firm. It is not silly to consider the entry of a new stockholder to be the creation of a new firm. The usual convention of thinking creation of a new firm with the adoption of a new name by a new coalition is simply looking at form, not substance. The usefulness of this approach of concentrating on people is indicated by the results of mergers and takeover bids, summarized earlier.

(8) Organizational Competition

A pertinent feature of competition is not only accuracy of testing and evaluation of entry of new people, techniques,

resources and products but also of forms of organizations and contracts. For example, the extent of commonly owned assets (integration) of the corporate rather than partnership firms, of franchises rather than employee operated branches, or of mutual membership rather than stock corporation types of firms -- all these are types of questions that are slighted by excessive attention to "numbers" of firms rather than to competition among and within types of contractual arrangements for furthering economic objectives. Which forms of contractual coalitions, and in which circumstances, enhance investment by avoiding agent-principal conflicts or specific asset quasi-rent expropriability? Which enhance correlation of reward with productivity? Which permit more effective displacement of inappropriate by more appropriate persons? Which induce better current responses to anticipated future consequences of proposed actions? Searching for the better forms of contractual coalitions and organizations is a significant feature of the competitive process, not just searching for price or most valuable goods to produce.

FOOTNOTES

[1]The Williams Act requires public disclosure of the tender's intentions. If the tenderer has knowledge of ways to improve the performance of the targeted firm, and if that must be disclosed before the shares can be acquired, then as a consequence of the Williams Act disclosure requirement, stock prices of the targeted firms would rise more upon disclosure of the tender intentions than if the disclosure were not required. More precisely, more of the total rise would occur before the tender completion and less afterwards. Also the tenderer firm would experience a smaller rise, if any, in its own stock price after the Williams Act than before. This would imply the Williams Act reduced the rewards and incentives for managerial competition and enhanced the tenure of less able incumbent managers. It gave more of the potential improvement to the incumbent stockholders. The targeting management gets less of the gain they create in the acquired firm. These implications were corroborated by the Jerrold data.

[2]An example of the dangers of theorizing about the role of the Board of Directors without a clear theory of the nature of the capitalist firm is in Eisenberg (1975, fn. 2, p. 399), though he gives one of the best discussions of the role of the boards of directors. "The role of the board is to hold the executives accountable for adequate results whether financial, social or both, while the role of executives is to determine how to achieve such results." (Emphasis supplied.) However, in the

capitalistic corporation the critical test is solely the effect on the market values of the interspecific resources (owned by stockholders) in the coalition, or to whatever criteria the _owners of those_ resources indicate should be used.

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