

The Ownership of
ENTERPRISE

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An Analytic Framework

A firm's "owners," as the term is conventionally used and as it will be used here, are those persons who share two formal rights: the right to control the firm and the right to appropriate the firm's profits, or residual earnings (that is, the net earnings that remain with the firm after it has made all payments to which it is contractually committed, such as wages, interest payments, and prices for supplies). The reference to "formal" rights in this definition is important. Formal control, for instance, does not necessarily mean effective control. In firms that are incorporated—which comprise most of the institutions of interest to us here, including business corporations, cooperatives, nonprofits, and mutual companies—formal control generally involves only the right to elect the firm's board of directors and to vote directly on a small set of fundamental issues, such as merger or dissolution of the firm. Moreover, in large business corporations the shareholders, who hold formal control, are often too numerous and too dispersed to exercise even these limited voting rights very meaningfully, with the result that corporate managers have substantial autonomy. Hence it has long been common to speak of "the separation of ownership from control," reflecting the substantial autonomy of corporate managers.¹

Nevertheless, I shall principally be concerned with exploring assignment of the *formal* legal or contractual rights to control and residual earnings. As we shall see in the chapters that follow, there are often strong reasons for giving the formal right of control to a particular class of persons even when those persons are not in a position to

exercise that right very effectively. For this reason, among others, the assignment of these formal rights—which is to say, the assignment of ownership—tends to follow strong and clear patterns.

In theory, the rights to control and to residual earnings could be separated and held by different classes of persons. In practice, however, they are generally held jointly. The obvious reason for this is that, if those with control had no claim on the firm's residual earnings, they would have little incentive to use their control to maximize those earnings, or perhaps even to pay out the earnings received. To be sure, this problem would not arise if all important decisions to be made by those with control could be appropriately constrained in advance by contractual arrangements between them and the holders of the rights to residual earnings. But the essence of what we term "control" is precisely the authority to determine those aspects of firm policy that, because of high transactions costs or imperfect foresight, cannot be specified *ex ante* in a contract but rather must be left to the discretion of those to whom the authority is granted.²

Not all firms have owners. In nonprofit firms, in particular, the persons who have control are barred from receiving residual earnings. As we shall see, however, the same factors that determine the most efficient assignment of ownership also determine when it is appropriate for a firm to have no owners at all.

The Structure of Ownership

In the discussion that follows, it will be helpful to have a term to comprise all persons who transact with a firm either as purchasers of the firm's products or as sellers to the firm of supplies, labor, or other factors of production. I shall refer to such persons—whether they are individuals or other firms—as the firm's "patrons."

Nearly all large firms that have owners are owned by persons who are also patrons. This is obvious in the case of consumer and producer cooperatives, which by definition are firms that are owned, respectively, by their customers and by their suppliers. It is also true of the standard business corporation, which is owned by persons who lend capital to the firm. In fact, the conventional investor-owned firm is nothing more than a special type of producer cooperative—a lenders' cooperative, or capital cooperative. Because we so commonly associate ownership with investment of capital, and because the comparison of

investor-owned firms with cooperatives of other types will be at the core of the analysis that follows, it is worthwhile to elaborate briefly on this point.

Consider, first, the basic structure of a typical producer cooperative. For concreteness, we can take as a simple, stylized example a dairy farmers' cheese cooperative, in which a cheese factory is owned by the farmers who supply the factory with raw milk. (The example is not fanciful; farmer-owned cooperatives account for 45 percent of all natural cheese produced in the United States.)³ The firm pays its owners—or "members," as they are usually termed in a cooperative—a predetermined price for their milk. This price is set low enough so that the cooperative is almost certain to have positive net earnings from the manufacture and sale of its cheese. Then, at the end of the year, the firm's net earnings are divided *pro rata* among the members according to the amount of milk they have sold to the cooperative during the year, and distributed as patronage dividends. All voting rights in the firm are also apportioned among its farmer-members, either according to the amount of milk each member sells to the firm or, more simply, on a one-member-one-vote basis. Some or all of the members may have capital invested in the firm. In principle, however, this is unnecessary; the firm might borrow all of the capital it needs. In any case, even where members invest in the firm, those investments generally take the form of debt or preferred stock that carries no voting rights and is limited to a stated maximum rate of dividends. Upon liquidation of the firm, any net asset value—which may derive from retained earnings or from increases in the value of assets held by the firm—is divided *pro rata* among the members, according to some measure of the relative value of their cumulative patronage.

In short, ownership rights are held by virtue of, and proportional to, one's sale of milk to the firm. Not all farmers who sell milk to the firm need be owners, however; the firm may purchase some portion of its milk from nonmembers, who are simply paid a fixed price (which may be different from the price paid members) and do not participate in net earnings or control.

The structure of a consumer cooperative is similar, except that net earnings and votes are apportioned according to the amounts that members purchase from the firm rather than the amounts they sell to it.

Now imagine a hypothetical "capital cooperative" with a form pre-

cisely analogous to that of the dairy cooperative. The members of the capital cooperative each lend the firm a given sum of money, which the firm uses to purchase the equipment and other assets it needs to operate (say, to manufacture widgets—or cheese). The firm pays the members a fixed interest rate on their loans, set low enough so that there is a reasonable likelihood that the firm will have net earnings after paying this interest and all other expenses. The firm's net earnings are then distributed pro rata among its members according to the amount they have lent, with the distributions taking place currently, as dividends, or upon liquidation. Similarly, voting rights are apportioned among members in proportion to the amount they have lent the firm. To supplement the capital that it obtains from its members, the firm may borrow money from lenders who are not members, but who simply receive a fixed rate of interest (which may be different from the fixed rate paid to members) without sharing in profits or control.

This hypothetical capital cooperative is, transparently, a producers' cooperative just as is the dairy cooperative. Yet this capital cooperative in fact has precisely the structure that underlies the typical business corporation. If this is not immediately obvious, it is perhaps just because, in a business corporation, the fixed interest rate paid on loans from the firm's lender-members—whom we conventionally term "shareholders" or "stockholders"—is typically set at zero for the sake of convenience, thus obscuring the fact that the members' contributions of capital are, in effect, loans.

To be sure, there are also various other ways in which capital cooperatives (that is, business corporations) are often structured a bit differently from other types of cooperatives. For example, in a business corporation the loans from members are usually not arranged annually or for other fixed periods, but rather are perpetual; members can withdraw their capital only upon dissolution of the firm, although an individual member may be free to sell his or her interest in the firm to another person before then. In other types of cooperatives, in contrast, members often remain free to vary the volume of their transactions with the firm over time, and even to terminate their patronage altogether. This distinction is not, however, fundamental. Investor-owned business corporations sometimes permit members to redeem their invested capital at specified intervals or even (as in the standard partnership) at will; open-ended mutual funds are a familiar example. Conversely, cooperatives often require that members make a long-term

commitment to remain patrons. For example, electricity generation and transmission cooperatives commonly insist that their members, which are local electricity distribution cooperatives, enter into thirty-five-year requirements contracts.⁴ Agricultural marketing and processing cooperatives, such as the cheese cooperative just described, often require that their members commit themselves to sell to the cooperative a given amount of their production each year for a period of several years.⁵ And mutual life insurance companies, which are essentially consumer cooperatives owned by their policyholders, originally issued only nonredeemable policies that committed policyholders to make premium payments—that is, to continue to purchase a specified amount of insurance from the firm—for the rest of their lives.⁶

The allocation of voting rights is another area where business corporations often differ somewhat from other types of cooperatives. In business corporations, the general rule is one-share-one-vote; that is, votes are apportioned according to the amount of capital contributed to the firm. In many cooperatives, in contrast, the rule is one-member-one-vote, with no adjustment for the volume of patronage of the individual members. Again, however, the difference is neither universal nor fundamental. The charters of many eighteenth- and nineteenth-century American business corporations limited the number of votes an individual shareholder could exercise regardless of the number of shares he owned; only in the twentieth century did the practice of one-share-one-vote become nearly universal.⁷ And, while the statutes governing cooperatives sometimes still impose a rule of one-member-one-vote, this is not universal and many cooperatives allocate votes proportionally to their members' volume of patronage. (We shall consider later why these different voting rules arose and survived.)

In sum, a business corporation is just a particular type of cooperative: a cooperative is a firm in which ownership is assigned to a group of the firm's patrons, and the persons who lend capital to a firm are just one among various classes of patrons with whom the firm deals.

Conversely, supplying capital to the firm is simply one of many transactional relationships to which ownership can be tied, and there is nothing very special about it. Ownership of a firm need not, and frequently does not, attach to investment of capital. Indeed, contrary to some popular perceptions and even to some more sophisticated organizational theory, ownership of the firm need have nothing to do with ownership of capital, whether physical or financial.⁸

To be sure, it might be argued that ownership is necessarily connected to capital in the sense that the owners of a firm, whether they are suppliers or customers or workers or whatever, are the persons who effectively own the firm's capital, such as its plant and equipment. For example, in our cheese cooperative, one might argue that the farmer-members own the firm's capital in the sense that they collectively have title to, and will profit or lose from fluctuations in the value of, the cheese factory's plant and equipment.

But this is not necessarily true. The firm could rent rather than own the land, buildings, and equipment it uses. It could in fact have title to no physical assets whatever yet still be a large and prosperous firm.⁹ It could even have no net financial assets, distributing all profits to members as they are earned and maintaining a line of credit at a bank sufficient to ensure that it can pay bills in periods when expenses temporarily exceed receipts.¹⁰ The members of the cooperative might *choose* to invest some of their personal funds in the firm, or to have the firm retain some of its profits for internal investment. Indeed, as subsequent chapters will discuss at greater length, there are good reasons why the owners of most types of firms, including producer and consumer cooperatives, choose to invest some financial capital in the firm they own. But it is not *necessary* that owners of a firm also be investors in the firm.

Even though the ordinary business corporation is, as I have just argued, essentially a lenders' cooperative, I shall continue to follow the usual convention here and generally use the term "cooperative" to refer only to patron-owned firms *other than* investor-owned firms.

The Structure of Organizational Law

From these observations we can gain a helpful perspective on the general structure of corporation law.

In the United States, basic corporation law is state law rather than federal law. The typical state has three general corporation statutes: a business corporation statute, a cooperative corporation statute, and a nonprofit corporation statute. Most of the organizations we shall be concerned with in this book are formed under one or another of these three types of statutes. (There are, however, a number of exceptions. For example, mutual banks, mutual insurance companies, and housing condominiums are often formed under special corporation statutes

specifically designed for them. And the employee-owned firms that are common in the service professions are often formed as partnerships or professional corporations, which are also governed by separate statutes.)

A cooperative corporation statute typically accommodates all types of producer and consumer cooperatives, from retail grocery cooperatives on the one hand to farm processing and marketing cooperatives, such as our cheese factory, on the other. Once it is understood that investor-owned firms are in essence capital cooperatives, it follows that in principle investor-owned corporations could also be formed under cooperative corporation statutes rather than, as is customary, under the separate business corporation statutes.¹¹ There is no fundamental reason to have business corporation statutes at all; they are just specialized versions of the theoretically more general cooperative corporation statutes. It is appropriate to have separate business corporation statutes simply because it is convenient to have a form that is customized for the most common type of cooperative—the lenders' cooperative—and to signal to patrons more clearly the type of cooperative with which they are dealing.¹² For similar reasons, some agricultural states have separate corporation statutes for another particularly common type of producer cooperative, the agricultural marketing cooperative; some states have special statutes for worker cooperatives; and some states have separate statutes for consumer, as opposed to producer, cooperatives.

The partnership statutes, in contrast, are not as specialized as the corporation statutes. Each state has only one general partnership statute, and under that statute partnership shares can be given in return for any type of patronage—whether it involves the provision of inputs such as labor or capital or the purchase of the firm's products—or to persons who are not patrons at all.

Although cooperatives are sometimes loosely said to be "nonprofit," nonprofit corporations are conceptually quite distinct from cooperatives. The defining characteristic of a nonprofit organization is that the persons who control the organization—including its members, directors, and officers—are forbidden from receiving the organization's net earnings. This does not mean that a nonprofit organization is barred from earning profits; rather, it is the *distribution* of the profits to controlling persons that is forbidden. Thus by definition, a nonprofit organization cannot have owners. A well-drafted nonprofit corporation

statute imposes this “nondistribution constraint” on any organization formed under the statute, and hence prohibits the formation, as a nonprofit corporation, of any form of cooperative and of any other form of owned enterprise.

What Must a Theory of Ownership Explain?

In principle, a firm could be owned by someone who is not a patron. Such a firm’s capital needs would be met entirely by borrowing. Its other factors of production would likewise be purchased on the market, and its products would be sold on the market. The owner would then be a pure entrepreneur, of roughly the character described in Frank Knight’s classic work,¹³ simply controlling the firm and receiving its (positive or negative) residual earnings after all output was sold and inputs were paid for. Such firms are rare, however. Rather, ownership is commonly in the hands of one or another group of the firm’s patrons—that is, in the hands of persons who have some other transactional relationship with the firm, either as suppliers or as customers.¹⁴

It follows that a general theory of enterprise ownership must explain at least two things: First, why is ownership generally given to the firm’s patrons? Second, what factors determine the particular group of patrons—whether lenders of capital, suppliers of labor or other inputs, or purchasers of the firm’s products or services—to whom ownership is given in any particular firm?

The remainder of this chapter sketches such a theory, and the two following chapters flesh out its details. Parts II–IV then offer illustration and further refinement of the theory through detailed application to particular industries and particular organizational types.

The Firm as a Nexus of Contracts

In developing a theory of ownership, it helps to view the firm—as economists increasingly do these days—as a nexus of contracts.¹⁵ More precisely, a firm is in essence the common signatory of a group of contracts. Some of these contracts are with vendors of supplies or services that the firm uses as inputs, some are employment contracts with individuals who provide labor services to the firm, some are loan agreements with bondholders, banks, and other suppliers of capital, and some are contracts of sale entered into with purchasers of the

firm’s products. In small firms organized as sole proprietorships, the individual proprietor signs these contracts. In a corporation or a partnership, the party that signs the contracts is a legal entity. Indeed, one of the most important functions of organizational law is to permit the creation of a juridical person—a single legal entity—that can serve as the signatory to contracts.

A firm’s contracts generally commit it to certain actions, such as making payments to vendors or delivering goods or services to customers. But contracts typically also leave the firm with some discretion. An employment contract, for example, generally gives the firm some freedom to choose the particular tasks to which the employee will be assigned; a loan contract commonly gives the firm some choice concerning the uses of the borrowed funds; and a contract of sale often affords the firm some latitude in the methods to be used to produce the goods or services promised to a given customer. The right to exercise this discretion is a vital component of control over the firm, and is by definition the prerogative of the firm’s owners. The firm may itself also own assets outright, of course, in which case the exercise of discretion over the use of those assets is included among the control rights belonging to the owners of the firm. Again, however, outright ownership of assets is not an essential aspect of what we call a firm.¹⁶

Broadly speaking, each transaction that a firm enters into is embedded in one or the other of two relationships between the firm and the patron who is the other party to the transaction. In the first of these relationships, which I shall call “market contracting,” the patron deals with the firm only through contract and is not an owner. In the second, which I shall simply call “ownership,” the patron is also an owner of the firm.

By terming the first of these two relationships “market contracting” I do not mean to imply that there is necessarily a competitive market for the goods or services in question. The relationship between the firm and its patron may, for example, be one of bilateral monopoly, with only one potential trading partner on each side of the transaction. Rather, I use the expression “market contracting” here simply to emphasize that the patron in question can control the firm’s behavior only by seeking enforcement of his contract with the firm, or by threatening to cease transacting with the firm in favor of whatever other alternatives the market offers him. Where the relationship is one of ownership, in contrast, the patron has the additional option of seeking to

control the firm's behavior directly through the firm's mechanisms for internal governance. Moreover, by using the term "market contracting" I do not mean to suggest that the relationships in question are necessarily short-term, as on a spot market; rather, I shall use the term to encompass also long-term, highly interdependent contracting of the type sometimes referred to as "relational" contracting.¹⁷

Using this terminology, we would then say that, in an investor-owned firm, the transactions between the firm and the patrons who supply the firm with capital occur in the context of ownership, while transactions with workers, other suppliers, and customers all take the form of market contracting. An employee-owned firm, in contrast, obtains labor inputs from workers whose relationship is one of ownership, but obtains its capital and other supplies, and sells its products, through market contracting. And a consumer cooperative, in turn, obtains capital, labor, and all other inputs through market contracting while selling the goods or services it produces in transactions embedded in ownership.

To be sure, patrons occasionally have some but not all of the prerogatives of ownership, putting their relationship with the firm somewhere ambiguously between ownership and market contracting. The relationship between a firm and its employees under German codetermination, which will be examined in Chapters 5 and 6, is a conspicuous example. In general, however, the simple dichotomy between market contracting and ownership that I have described here will be adequate for our purposes.

An Overview of the Theory

If a firm were entirely owned by persons who were not among the firm's patrons, then all the firm's transactions involving inputs and outputs would take the form of market contracting. Although feasible in principle, in practice this is likely to be quite inefficient. Market contracting can be costly, especially in the presence of one or more of those conditions loosely termed "market failure"—for example, where there is an absence of effective competition, or where one of the parties is at a substantial informational disadvantage. We shall examine the costs of market contracting more closely in Chapter 2. For the present we need simply note that, where these costs are high, they can often be reduced by having the purchaser own the seller or vice versa. When

both the purchaser and the seller are under common ownership, the incentive for one party to exploit the other by taking advantage of market imperfections is reduced or eliminated. Assigning ownership of a firm to one or another class of the firm's patrons can thus often reduce the costs of transacting with those patrons—costs that would otherwise be borne by the firm or its patrons. To assign ownership to someone who is not among the firm's patrons would waste the opportunity to use ownership to reduce these costs.

Pursuing this logic we can then ask, for any given firm: what is the lowest-cost assignment of ownership? By "lowest-cost assignment of ownership" I mean the assignment of ownership that minimizes the total costs of transactions between the firm and all of its patrons. (Alternatively, I mean the assignment of ownership that maximizes the total net benefits—benefits minus costs—of transactions between the firm and its patrons. Since a forgone benefit can be considered a cost, these definitions are equivalent.) The analysis just offered suggests that, all other things equal, costs will be minimized if ownership is assigned to the class of patrons for whom the problems of market contracting—that is, the costs of market imperfections—are most severe. For example, if the firm is a natural monopoly vis-à-vis its customers, but obtains its capital, labor, and other factors of production in reasonably competitive markets, then total costs are likely to be minimized by assigning ownership to the firm's customers. This presumably helps explain why, as discussed in Chapter 9, so many rural electric utilities are organized as consumer cooperatives.

If ownership were always perfectly effective, in the sense that it eliminated all costs of market contracting without imposing any new costs of its own, then there would be no more to a theory of ownership than this. In fact, however, ownership itself involves costs. Some of these costs are what might be called "governance" costs; they include the costs of making collective decisions among the owners, the costs of monitoring managers, and the costs of the poor decisions and excessive managerial discretion that result when collective decision making or managerial monitoring are imperfect. Another cost is the risk bearing associated with receipt of residual earnings. We shall explore these and other costs of ownership in detail in Chapter 3. For the moment we need simply note that, like the costs of market contracting, these costs can vary greatly from one class of patrons to another. Some patrons, for example, are in a much better position than others to govern the

firm effectively. Similarly, some are better able than others to bear the risk associated with the right to residual earnings. Consequently, when deciding which class of patrons is to own the firm, the costs of ownership must be considered in addition to the costs of market contracting. For example, Chapter 9 offers evidence that the costs of consumer ownership in an electric utility are significantly higher in urban areas than in rural areas, and that this is an important reason why utility cooperatives are much less common in urban areas than in rural areas.

The least-cost assignment of ownership is therefore that which minimizes the sum of all of the costs of a firm's transactions. That is, it minimizes the sum of (1) the costs of market contracting for those classes of patrons that are not owners and (2) the costs of ownership for the class of patrons who own the firm.

Although this theory is simple in basic concept, it is important when applying the theory to realize that the costs of market contracting for any given class of patrons may depend on which of the other classes of patrons owns the firm.¹⁸ This will become clearer in Chapter 3.

Survivorship

It is reasonable to expect that, over the long run, cost-minimizing forms of organization will come to dominate most industries. Two mechanisms press in this direction. The first is conscious design and imitation on the part of the entrepreneurs who organize firms: a firm's entrepreneurs, together with those persons who expect to be among the firm's patrons, have an incentive to adopt a cost-saving organizational form and share the resulting savings among themselves. The second is market selection: higher-cost forms of organization tend to be driven out of business by their lower-cost competitors. If we observe that a particular form of ownership is dominant in a given industry, this is a strong indication that the form is less costly than other forms of ownership would be in that industry.

In Parts II–IV we shall use this “survivorship test” as important evidence of the relative cost of different forms of ownership. There are, however, a number of reasons why this test might not be an entirely accurate measure of comparative organizational costs. Most obviously, public subsidies or regulation might give a special advantage to one form over another. Moreover, the diffusion of new forms through conscious imitation does not always happen quickly,¹⁹ and for

various reasons market selection can operate quite slowly as well.²⁰ In interpreting the pattern of ownership that appears in any given industry, we must be attentive to these considerations. In fact, we shall gain important insight into the processes of organizational evolution when we consider the temporal pattern of change in ownership forms in some of the industries examined in later chapters.

What Kinds of Costs?

Some might object that there are other values served by assignment of ownership besides cost minimization and that therefore the cost-minimizing form of ownership might not be the one that is most desirable from a social point of view, or even the one that is chosen by the parties involved. I use the term “cost” here, however, to include all interests and values that might be affected by transactions between a firm and its patrons. For example, among the costs of contracting for labor on the market might be a subjective sense of alienation or disempowerment that could be alleviated if the workers instead owned the firm. In fact, one of the fruits of this inquiry is a better understanding of the range of values, both subjective and objective, that are served by ownership, and of the relative significance of those values to persons who deal with the firm.

Thus I use the expression “cost-minimizing” here to mean “efficient” in the economist's very broad sense of that word—that is, to refer to a situation in which there is no alternative arrangement that could make any class of patrons better off, by their own subjective valuation, without making some other class worse off to a greater degree.²¹

In general, the only persons whose interests are importantly affected by the assignment of ownership in a firm are the firm's patrons. In the long run, moreover, all costs that patrons bear under any particular assignment of ownership—whether those costs are pecuniary or non-pecuniary—should be reflected in the contractual terms under which they will agree to transact with the firm. As a consequence the firms that survive in the market should not be those that simply minimize pecuniary costs, but those that are efficient in the broader sense.

To give the theory sketched here more substance, the next two chapters examine in greater detail the most important costs inherent in market contracting and ownership, respectively.

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The Costs of Contracting

There are several types of market imperfections—most of which are familiar to students of economics—whose costs can potentially be reduced by assigning ownership to the affected patrons. We shall survey here, in very general terms, the most common of these problems in market contracting and discuss briefly their potential effect on the assignment of ownership. Since our principal object at this point is simply to develop an overview and a general catalog of the categories of costs involved, we shall not dwell here on details or refinements of theory or application.¹ Later chapters will offer more extensive illustrations and more elaborate analysis.²

Simple Market Power

Frequently, owing to economies of scale or other factors (such as cartelization or regulation) that limit competition, a firm has market power with respect to one or another group of its patrons. The affected patrons then have an incentive to own the firm and thereby avoid price exploitation. Firms often have a degree of monopoly power in dealing with their customers, and this is a common reason for organizing the firm as a consumer cooperative. Electric utility cooperatives are a conspicuous example. Monopsony—market power vis-à-vis the firm's suppliers rather than its customers—is sometimes also a motivation for patron ownership, as it clearly was in the early development of agricultural marketing and processing cooperatives.

More specifically, by owning a firm that has market power, custom-

ers can avoid two types of costs. The first is paying a monopoly price for the goods or services that the customers purchase from the firm. The second is underconsumption of the firm's goods or services owing to their excessively high price.

The first type of cost is likely to be by far the largest from the customers' point of view. But it is only a private cost to the customers—a matter of distribution between them and the owners of the firm—and not a social cost. If a monopolistic investor-owned firm is converted to customer ownership, any savings to its current customers from a reduction in the price they pay will be offset by an equal loss to the former owners. This type of cost consequently does not provide an incentive for customers to purchase a firm from existing investor-owners, since those owners will only be willing to sell the firm for a price that includes the present value of the future monopoly profits they will lose by virtue of the sale. This private cost can, however, provide a strong incentive for customers to establish a *new* firm on their own, or to use the threat of doing so to acquire the existing monopolist's plant at a reasonable price.

The second type of cost—the distortion in consumption resulting from a price above cost—is a true social cost. The prospect of its elimination may therefore provide an incentive even for an existing monopolist to sell his firm to his customers so he can share with them the resulting efficiency gains.

Ex Post Market Power (“Lock-In”)

Problems of monopolistic exploitation can also arise after a person begins patronizing a firm even if, when the patronage began, the firm had a substantial number of competitors.³ These problems arise where two circumstances are present. First, upon entering into the transactional relationship the patron must make substantial transaction-specific investments—that is, investments whose value cannot be fully recouped if the transactional relationship with the firm is broken. Second, the transactions are likely to extend over such a long period of time, and are sufficiently complex and unpredictable, that important aspects of future transactions cannot be reduced to contract in advance but rather must be dealt with over time according to experience. In such circumstances, the patron becomes locked in to a greater or lesser degree once she begins patronizing the firm: she loses the protective option of costless exit if the firm seeks to exploit her.

Labor contracting provides an example. At the time an individual first enters the labor force there are likely to be many firms with which she could obtain employment. As a consequence, she will be in a position to make those firms compete with one another for her services. After she has taken a job with a particular firm and worked with that firm for a number of years, however, her skills are likely to become specialized to that firm to some degree, and her flexibility for retraining may also diminish. She thus may be substantially more productive at her present firm than she would be elsewhere. Moreover, she may have made important personal investments in the community where her employer is located—investments that cannot be recouped if she leaves that community. Her spouse may be employed there, her children may be accustomed to the local school system, and her entire family may have developed strong personal ties with other members of the community. In short, with time it may become increasingly costly, both professionally and personally, for her to change employers. When this happens, her present employer is in a position to act opportunistically toward her in setting wages or other terms of employment, compensating her only well enough to prevent her from leaving and thereby, in effect, appropriating the value of the job-specific investments, both professional and personal, that she has made.

An individual who perceives the possibility of such an outcome when first seeking employment is likely to insist on higher initial wages to compensate her for the risk of subsequent exploitation, and she may refuse employment altogether with a firm that, though otherwise an attractive employer, cannot effectively bind itself not to act exploitatively in the future. Likewise, after accepting employment with a firm, she will have suboptimal incentives to make firm-specific investments, such as acquiring knowledge or skills that are valuable only to that firm or buying an expensive or idiosyncratic house that is just right for her family but might be difficult to resell if she should leave the firm and seek employment elsewhere.

This problem of “lock-in” can be mitigated by assigning ownership of the firm to the patrons who are potentially affected by it. This point is now familiar from studies of vertical integration, where lock-in has come to be recognized as an important incentive for merging two individual firms when one of the firms is an important customer or supplier of the other.⁴ But the lock-in problem can also help explain why ownership of a firm is extended, not just to another individual enterprise with which the firm deals, but to a whole class of the firm’s

patrons—which is the situation of most interest to us here.⁵ In particular, lock-in apparently provides an incentive not only for worker ownership but also for various forms of consumer ownership: a conspicuous example is the common practice, discussed in Chapter 8, of making franchisees the collective owners of their franchisor.

The Risks of Long-Term Contracting

There are various common situations in which a firm and its patrons have strong incentives to enter into a long-term contract. One of these is to avoid the possibility that transaction-specific investments will expose one or both parties to opportunistic behavior by the other. Another is to allocate specific risks between the parties. And yet another is to mitigate the problems of adverse selection that are endemic to insurance and related industries.⁶

Even where long-term contracts are relatively successful in dealing with these types of problems, the contracts themselves can generate substantial risk for a firm and its patrons. As conditions change during the term of the contract, the price(s) specified in the contract can produce a substantial windfall gain for one party and a corresponding loss for the other. A long-term contract can therefore become a pure gamble between the parties, inefficiently creating large risks for both where there is little or no underlying social risk (that is, where the parties taken together face no risk, but rather are engaged in a zero-sum transaction). For example, the vagaries of inflation have this effect on all long-term contracts whose price terms are written in nominal dollars—as contracts effectively had to be written before the development of reliable price indices, and as many contracts are still written. Making the patrons the owners of the firm eliminates much of this risk: what the patrons lose as patrons they gain as owners, and vice versa. As we shall see in Chapter 14, this has historically been, and may continue to be, an important reason for the success of mutual life insurance companies.

Asymmetric Information

Contracting can also be costly when the firm has better information than its patrons concerning matters that bear importantly on transactions between them or, conversely, when the patrons have better information than does the firm.

For example, a firm often knows more than its customers about the quality of the goods or services that it sells. This is especially common when the contracted-for goods or services are complex or difficult to inspect. The firm then has an incentive to deliver a lower-quality performance than it promises. Customers, in turn, have an incentive to distrust the firm, and may offer to pay only the value of the worst possible performance or decline to purchase at all.⁷ The result is an inefficient transaction: although the customers are getting just what they are paying for, and the firm is getting paid no more than is necessary to cover the cost of the quality of performance it is providing, both the customer and the firm would prefer a higher-quality performance and a higher price. Firms can sometimes manage this problem by investing in a reputation for quality, but that strategy generally takes time and can often provide at best a partial palliative.

In these circumstances, customer ownership has the virtue that it reduces the firm's incentive to exploit its informational advantage. A simple example is provided by agricultural fertilizers and livestock feed. When commercial fertilizers and feed were first introduced on the market at the beginning of the twentieth century, farmers had difficulty determining their contents. As a consequence, the quality of the products offered on the market was low. The response of many farmers, as discussed in Chapter 9, was to form supply cooperatives to manufacture and distribute the feed and fertilizer they needed. Even more conspicuous examples can be found in the service industries, including savings banking and life insurance.

It is not just in dealing with customers, however, that the firm may have an informational advantage. The same problem can arise between the firm and its suppliers or employees. An investor-owned firm may skimp on efforts to assure its workers continuity of employment or to maintain a safe workplace, and the firm's workers, in anticipation of this, may invest less in firm-specific skills or insist upon higher wages than they would otherwise. Worker ownership may promise more efficient labor relationships in this respect.

The problem can also run the other way, with the patrons possessing information about their own level of performance that is unavailable to the firm. Managers of an apartment building may not be able to police the degree of care taken by tenants in maintaining their units, and insurance companies may not be able to monitor the

safety precautions taken by their insureds. (Indeed, the insurance business is the original source of the term "moral hazard" that is now commonly employed to refer to the incentive to skimp on effort that asymmetric information creates.) Similarly, workers are likely to know more than their employer concerning the amount of effort they are devoting to their job. Patrons in these situations have an incentive to behave opportunistically, and firms can be expected to adjust their prices or wages to compensate. By reducing this incentive for opportunism, patron ownership has the potential to improve the terms on which patrons can deal with the firm. Where the class of patrons is numerous, however, the incentive for individual patrons to exploit their informational advantage at the expense of others may remain strong even with patron ownership—an issue we shall examine more carefully when considering mutual companies and worker-owned firms.

Strategic Bargaining

Asymmetric information can also result in costly strategic bargaining. A firm's management commonly has information about the firm's plans and prospects that is not available to its patrons, and a firm's patrons often have information about their own preferences and opportunities that is unavailable to management. If the patrons in question do not own the firm, they may have little incentive to reveal their private information to the firm, because that would give the firm an advantage it would otherwise lack in bargaining with them. Likewise, the firm's management will often have no incentive to share its private information with the patrons. Moreover, even where the firm would gain from disclosing information to its patrons, or vice versa, credible disclosure may be impossible.

In the presence of private information of this sort, substantial time and effort can be lost in contractual negotiations. The parties have an incentive to delay reaching an agreement in order to test the other side's true willingness to compromise and to signal their own resolve. The strikes and lockouts that often accompany labor contracting provide a familiar illustration.⁸ Patron ownership can reduce or eliminate this strategic behavior, because it removes the incentive for either the firm's management or its patrons to hide information from each other or to take advantage of information that the other lacks.

Communication of Patron Preferences

When patrons cannot credibly communicate their preferences to management, inefficiencies may arise beyond the costs of strategic bargaining. In particular, management may have difficulty finding the least-cost combination of contractual terms that will satisfy the firm's patrons.

Consider a firm's efforts to choose an appropriate mix of wages, fringe benefits, and workplace amenities to offer its employees. What are the workers' preferences concerning tradeoffs between financial compensation and working conditions? What balance do they prefer between current and deferred compensation, or between job security and higher wages? What is their preferred tradeoff among job safety, workplace aesthetics, speed of production, and variety of work? If management lacks this information, it may fail to find the package that offers the greatest satisfaction to the employees per dollar spent by the firm. Yet if the workers do not own the firm, they have an incentive to misrepresent their preferences on such matters for the sake of enhancing their overall bargaining position. And management, knowing that the workers have an incentive to dissemble, has reason to disbelieve the workers, whether they are in fact speaking honestly or not. Consequently, workers may fail to communicate their true preferences even though both the firm and the workers would be better off if those preferences could be credibly communicated.

Patron ownership, by removing the conflict of interest between patrons and owners, reduces these obstacles to communication.

Compromising among Diverse Patron Preferences

Often a firm must deal on the same terms with all patrons in a given class even though individuals within that class have differing preferences. The firm may be constrained to offer the same working conditions to all of its employees or the same quality of goods or services to all of its customers. In these circumstances, market contracting can lead the firm to choose an inefficient compromise among its patrons' differing preferences. This problem occurs because a firm contracting in a market has an incentive to accommodate the preferences of the marginal patron. Yet efficiency generally calls for choosing conditions that suit the preferences of the average patron,

and these preferences may be quite different from those of the marginal patron.⁹

Consider a firm's choice of the appropriate level of safety for its workers. The firm has an incentive to adjust safety to respond to the tradeoff between higher wages and enhanced workplace safety that satisfies the marginal workers—that is, those workers who are indifferent between remaining with the firm at the current wage and working conditions or seeking employment elsewhere. But the preferences of the marginal worker may not be those of the average worker. For instance, the marginal worker may be a young person who will happily take large risks in return for higher wages, while the average worker is an older person with family commitments who is much more risk averse. As a result, the level of workplace safety chosen by the firm may not be that which most efficiently meets the needs of the firm's workers as a whole.

Where the patrons in question own the firm, they are likely to make decisions collectively by voting in some fashion. And voting—particularly the conventional majority rule—tends to favor the preferences of the median member of the group rather than those of the marginal member. Although the preferences of the median patron may not be those of the average patron, they will often be closer to the average than are the preferences of the patron who is marginal in the market. Patron ownership can thus offer advantages in selecting an appropriate compromise when patron preferences diverge.

Alienation

Advocates of “noncapitalist” forms of ownership—such as worker-owned firms, consumer cooperatives, and nonprofits—frequently express, explicitly or implicitly, ideological opposition to capitalist (investor-owned) enterprise. The rhetoric is often vague, simply decrying the “alienation” or “exploitation” said to characterize capitalist firms. At bottom, this opposition to investor-owned enterprise frequently seems to be rooted in concerns about market failures of the types just surveyed—for example, concerns that investor-owned firms, in dealing with their customers or workers, will take advantage of market power, lock-in, or informational asymmetries. But sometimes opposition to capitalism also seems rooted in concerns about what we might term the “transactional atmosphere” of market exchange. A

clear analysis of the problem is difficult to find. But perhaps part of what is involved is an objection to the subjective experience of market contracting itself.

Market contracting is, in an important sense, an adversarial process: purchasers try to obtain the best goods or services at the lowest price possible; sellers try to provide the lowest-cost goods or services at the highest price possible. Some individuals enjoy this contest, and most participants in market economies are acculturated to engaging in it with a fair degree of indifference, at least in conventional commercial contexts. Yet some individuals evidently find it unpleasant to obtain or provide goods or services through such adversarial relationships.

One source of this unpleasantness is presumably the vigilance required to protect oneself from exploitation when transacting on the market. This vigilance could appropriately be included among the costs of market failure described earlier, since without market failure vigilance would often be unnecessary. In addition, however, some individuals may have preferences concerning the types of relationships they have with other people, preferences that go beyond the quality or price of the goods and services ultimately received through those relationships or the vigilance those relationships require. They may dislike the experience of having an adversarial relationship when they would instinctively prefer to have relationships that are more cooperative, trusting, or altruistic. For such individuals, there may be considerable value in eliminating the most tangible adversarial link in the chain of commerce by owning the firm they patronize (say, by purchasing through a consumer cooperative or selling through a producer cooperative) or by patronizing a nonprofit firm.

In assessing the relative efficiency of alternative economic arrangements, received economic theory generally ignores such preferences concerning transactional processes, as opposed to preferences concerning transactional outcomes such as price and quality of performance. It does not necessarily follow, of course, that these preferences are unimportant. And, where they *are* important, market contracting brings the cost of running counter to them.

An alternative interpretation of alienation is that individuals gain important satisfaction from having a feeling of control over an enterprise they patronize, or from participating with other patrons in its governance—a satisfaction that may be lost when they deal with the

firm only through market relationships. More will be said about this in the next chapter.

Who Bears the Costs?

When contracting with a given class of patrons is costly, the patrons involved will sometimes bear those costs. For example, customers are likely to bear most of the costs of a firm's monopoly in its product market. But in many cases some other class of patrons will end up bearing the costs of contracting. If a given firm hires labor in a competitive market, then the firm's workers generally will not bear any special costs that are involved in contracting with the firm. Rather, those costs are likely to be borne by the firm's owners, customers, or suppliers of other factors of production, depending on the nature of the other markets in which the firm contracts. Regardless of who bears the costs, however, there is an incentive to reduce those costs wherever possible by reorganizing the firm with a more efficient form of ownership.

Who Owns Whom?

We have been speaking of reducing the costs of market contracting by having the patrons own the firm. In principle, those costs could also be reduced by having the firm own its patrons. Where there is only one patron involved, there is often no important distinction between these two forms of vertical integration. But where—as in the cases of principal interest here—multiple patrons are involved, there commonly is a difference. Ownership of a single firm by multiple patrons does not create the same incentives as does ownership of the patrons by the firm.

If the problem is that patrons, having information inaccessible to the firm's management, can behave opportunistically toward the firm, then this problem is not completely solved by having the patrons own the firm. There remains an incentive for each patron to act opportunistically even as an owner, since he will bear only a small fraction of the cost of his behavior, while the rest falls on the other patron-owners. Consequently, where it is the patrons rather than the firm that have the informational advantage, it is potentially more efficient for the firm to own the patrons than for the patrons to own the firm.

In some situations, however, it is infeasible for the firm to own its patrons. In particular, when the patrons are individuals such as workers or consumers, legal prohibitions on personal servitude, as well as a variety of practical contracting problems, obviously bar this arrangement. If the firm and its patrons are to be connected by ownership, the patrons must own the firm.

For related reasons, ownership of the patrons by the firm can sometimes be impractical even where the patrons are not individuals but instead are other firms. Consider the common case—discussed at length in Chapter 8—of a wholesaler owned as a cooperative by the retail stores to which it sells. The problems of market failure to which this ownership arrangement responds (typically market power on the part of the wholesaler) might alternatively be solved by having the wholesaler own the retail stores. And, of course, fully integrated chain store operations of the latter type are common. But that arrangement can create diseconomies of scale, including loss of the strong incentives for efficient operation that exist when the individual retail stores are owned separately by their local managers. Having the stores collectively own their supplier, rather than vice versa, can be the superior arrangement. In short, the costs of ownership are often asymmetric between a firm and its patrons—a point that emerges even more clearly in the next chapter.

3

The Costs of Ownership

We have observed that ownership has two essential attributes: exercise of control and receipt of residual earnings. There are costs inherent in each of these attributes. Those costs fall conveniently into three broad categories: the costs of controlling managers, the costs of collective decision making, and the costs of risk bearing. The first two categories are associated with the exercise of control. The third is associated with the receipt of residual earnings. All of these costs can vary substantially in magnitude from one class of patrons to another.

We shall survey these three types of costs here in general terms. As with the costs of market contracting surveyed in the preceding chapter, subsequent chapters will offer deeper analysis and more copious and detailed illustrations.

Costs of Controlling Managers

In large firms, and especially in firms with a populous class of owners, the owners must generally delegate substantial authority to hired managers.¹ Thus, in widely held business corporations, as in large cooperatives, most decision-making authority is delegated to the firm's board of directors, who in turn delegate most operational decisions to the firm's senior officers. This delegation brings with it the costs commonly labeled "agency costs." For our purposes, these costs can conveniently be broken down into two types: the costs of monitoring the managers and the costs of the managerial opportunism that results from the failure to monitor managers with perfect effectiveness.²

Monitoring

If the patron-owners of a firm are to control its management effectively, they must incur the costs of (1) informing themselves about the operations of the firm, (2) communicating among themselves for the purpose of exchanging information and making decisions, and (3) bringing their decisions to bear on the firm's management. I shall refer to these costs collectively as "monitoring costs." These costs can vary substantially among different classes of patrons. Since patrons are likely to accumulate information about the firm simply as a by-product of transacting with it, the cost of monitoring for a given class of patrons will generally be inversely proportional to the importance, frequency, and duration of the patron's transactions with the firm.³ The costs of monitoring will also depend on the ease of organizing the patrons for collective action, which may depend in turn on factors such as the patrons' physical proximity to one another and to the firm.

For example, tenants in an apartment building generally have relatively low monitoring costs. They deal repeatedly with the building's management, often for a number of years, in transactions that involve a significant fraction of their budget. They therefore have both the opportunity and the incentive to learn a great deal about how well the building is managed. Close proximity also permits easy organization for collective action. These are important factors in the viability of tenant ownership of apartment buildings through cooperatives and condominiums, as will be discussed further in Chapter 12.

Finally, the number of patrons among whom ownership is shared affects monitoring costs. If all patrons are to participate effectively in decision making, then a large class of owners requires substantial duplication of effort in becoming informed. Moreover, the monitoring efforts of any individual owner have the properties of a public good for the owners as a group: the benefits of that monitoring are enjoyed by all other owners as well, regardless of whether they have undertaken any monitoring of their own. Consequently, as the number of owners grows, each individual owner's share of the potential gains from effective monitoring decreases, thus reducing the individual's incentive to monitor.

It follows that, where the class of owners is large, it may be prohibitively costly to induce the owners to undertake anything beyond the most cursory monitoring. In itself, this argues for the smallest group of

owners possible—preferably a single owner. The fact that, despite this, a large firm often has a very large class of owners therefore suggests that either or both of two things must be true. First, the costs of market contracting would be much higher under any alternative assignment of ownership. Second, the costs of managerial opportunism are modest even though the firm's owners cannot actively supervise the managers. We shall first explore the latter possibility. Then, at the end of the chapter, we shall return to the former.

Managerial Opportunism

To the extent that the owners of a firm fail to exercise effective control over its managers, the managers have an opportunity to mangle or engage in self-dealing transactions. Clearly this can sometimes be costly.⁴ Yet the conduct of a firm's managers is conditioned by a variety of constraints and incentives beyond direct sanctions or rewards from the firm's owners. There are important limits to the costs of managerial opportunism even in firms whose nominal owners are in a poor position to do any active monitoring of the firm's management at all.

Consider first self-dealing. The transactions necessary for managers to divert to themselves a significant fraction of the residual earnings in a large firm are often difficult to conceal. Moreover, these transactions are in most cases explicitly proscribed by contract or by law, thus exposing the managers to a variety of moral, contractual, tort, and criminal sanctions that can be brought to bear without collective action on the part of the firm's owners. In particular, self-dealing managers expose themselves to shaming by fellow workers, friends, or family, to derivative suits initiated by individual shareholders or enterprising lawyers, and to civil or criminal prosecution by the state (including, conspicuously, the tax authorities).

To be sure, although legal, contractual, and moral constraints may generally suffice to keep managers from putting their hand in the till, they will not necessarily ensure that managers work hard and make effective decisions. Again, however, pride and moral suasion provide important motivation, particularly for the types of individuals who work their way to the top of a managerial hierarchy. The need for the firm to prosper if managers are to keep their jobs or, even better, to enhance them, also provides an important work incentive.⁵ Moreover,

it may be a mistake to exaggerate the degree of effort or ingenuity that is required of the senior managers in a typical business enterprise, and thus the potential gains from better monitoring of those managers by a firm's owners. In many firms, imitation of standard managerial practices may suffice for relatively successful performance.

In sum, the inability of a firm's nominal owners to exercise much direct control may result in only a modest amount of organizational slack, at least when compared with any realistic alternative.⁶ Indeed, in the chapters that follow we shall encounter large groups of firms (including mutual life insurance companies and nonprofit hospitals) that have been successful over long periods of time in competitive environments without any effective exercise of control by owners whatever—often without even having any owners.

There is, however, one costly managerial perquisite—excessive retention of earnings—that is not easy to detect or proscribe, that is likely to bring approval rather than censure from friends and colleagues both inside and outside the firm, and that is generally encouraged rather than checked by managers' desires to retain or build their empire. Retentions benefit managers by creating a buffer against adversity and by increasing the size of the firm that the managers control. But retentions are costly to the firm's owners if the rate of return on the retentions is less than the return available on investments outside the firm or if, regardless of the rate of return the retentions bring, the funds retained can never be recovered by the current owners (as happens in some mutuals and cooperatives). This problem is most easily discerned in nonprofit⁷ and mutual firms, but it is arguably the principal source of inefficiency in investor-owned firms as well.⁸ And because excessive retention of earnings tends to enhance rather than decrease the survival value of a firm, those firms that are particularly subject to this tendency—as firms with diffuse ownership are—may actually be favored rather than pressured by the invisible hand of market selection.

Whatever the nature of the managerial opportunism involved, where the losses it brings are smaller than the costs of the monitoring that would be required to prevent it, it is of course efficient for the firm's owners to tolerate the opportunism. Agency costs, therefore, are the sum of the costs incurred in monitoring and the costs of managerial opportunism that result from the failure or inability to monitor with complete effectiveness.

Collective Decision Making

When many persons share ownership of a firm, there are likely to be differences of opinion concerning the firm's policies and programs. Sometimes those differences will merely reflect different judgments about the most effective means for achieving a shared goal. More serious differences arise, however, when the outcome of the decision will affect different owners differently. Broadly speaking, this could happen for either of two reasons.

First, the individuals involved may differ in the way in which they transact with the firm as patrons—that is, in the nature of the goods or services they sell to, or purchase from, the firm. To take a simple example, a decision to repair the elevators in a four-story cooperative apartment building will benefit the first-floor residents much less than those on the fourth floor. The residents, depending on where they live in the building, may therefore disagree on the desirability of paying costly overtime to get the repairs done quickly. Similarly, if a worker-owned firm must shut down one of its two plants, the workers at the two plants are likely to have very different preferences about which plant should be chosen.

Second, the owners may have differences in preferences that arise from their personal circumstances rather than from any differences in their transactions with the firm. A decision by a cooperative apartment building to accelerate repayment of the principal on the building's mortgage may affect members differently depending on their personal liquidity and tax status even if they occupy identical apartments and have identical leases. Or a decision by a worker-owned firm to shift to riskier lines of business, and thereby increase the chance that the firm will fail, is likely to be less attractive to older workers than it is to younger workers who, though doing the same job, are more easily retrainable and have fewer ties to the local community.

In order for a firm's owners to make decisions when their interests differ, they must employ some form of collective choice mechanism. The nearly universal approach is to adopt a voting scheme, with votes apportioned either by volume of patronage or on the basis of one-member-one-vote. When the interests of the individual owners are diverse, such mechanisms for collective choice engender costs. These costs, which for future reference we can label the "costs of collective decision making," are logically distinct from agency costs. They can be

large even in firms, such as modest-sized partnerships, in which there are no hired managers and hence no significant agency costs. Conversely, the costs of collective decision making can be negligible in large corporations in which ownership is widely shared and hence agency costs are large, as long as the owners have highly homogeneous interests.

To make this distinction clear, we can define "agency costs" as the costs of monitoring and managerial opportunism that the firm would incur even if the interests of all owners were identical. The "costs of collective decision making" are then the additional costs that result from heterogeneity of interests among the owners. Unlike agency costs, the costs of collective decision making have been largely neglected in the literature on corporate control and the economics of organizational form.⁹ Nevertheless these costs play a crucial role in determining the efficiency of alternative assignments of ownership.

The collective choice mechanisms employed within firms are essentially political mechanisms. Their costs are therefore characteristically the costs of political mechanisms in general. In recent decades, the "public choice" literature has begun to provide a more systematic understanding of these costs, which might be termed the costs of "political failure," analogous to the costs of "market failure" that affect market mechanisms. Although that literature still leaves us with a very partial understanding of these costs, some general characterizations are possible.

The costs associated with collective choice mechanisms are of two broad types. First, there are the costs resulting from inefficient decisions—that is, from decisions whose outcomes fail to maximize the aggregate welfare, or surplus, of the owners themselves as a group. Second, there are the costs of the decision-making process itself.

Costly Decisions

Inefficient decisions can arise in several ways. To begin with, as already noted, majority voting tends to select the outcome preferred by the median member of the group, while efficiency generally calls for the outcome preferred by the average member. Where the median and the average member have substantially different preferences, voting can produce seriously inefficient decisions.¹⁰ Consider again the hypothetical four-story cooperative apartment building with a broken

elevator. If the residents of the first two floors, who do not use the elevator, outnumber the residents of the top two floors who do, then the residents as a whole might vote not to pay overtime to hasten the repairs, even though the money thus saved is substantially less than the costs, both pecuniary and nonpecuniary, that the delay imposes on the residents of the upper floors.

Alternatively, control over the political process can fall into the hands of an unrepresentative minority who, intentionally or unintentionally, use that control to make decisions that inefficiently exploit the majority in favor of the minority. This is particularly likely to happen when, as is often the case, some patrons are better situated to participate effectively in collective decision making than others—perhaps because they have few other demands on their time, or have special managerial expertise, or have special access to information. For example, governance of a cooperative apartment building might be dominated by those residents of the building who are retired, even if they are in the minority, because they have more time to attend meetings. As a consequence, improvements that primarily benefit the retirees, such as elevator repairs, might be emphasized at the expense of those that do not, such as repairs to the children's playground, even if the reverse priorities would be more beneficial to the building's occupants as a whole.

Whether it is the majority that inefficiently exploits the minority or vice versa, the dominant group need not be particularly venal for the resulting costs to be substantial. It is sufficient that, as is natural, the decision makers' own interests simply have more salience for them than do the interests of others.

Costly Process

The costs of the collective choice process, in turn, may also have several sources. Even if individual owners always seek to exercise their right of control without opportunism and to reach the decisions that will be most efficient for the owners as a whole, they may need to invest considerable time and effort in obtaining knowledge about the firm and about other owners' preferences, and in attending the meetings and other activities necessary to reach and implement effective collective decisions. We also know from public choice theory that the possibility of a voting cycle¹¹ among alternatives increases as preferences

among the electorate become more heterogeneous.¹² Such cycling may be costly if there are transaction costs involved in repeatedly altering the firm's policies. More important, the instability that underlies cycling can give extraordinary power to those in control of the voting agenda to obtain the outcomes they desire, no matter how inefficient those outcomes may be.¹³ Finally, if owners seek to behave strategically, then further costs may result from efforts to hide or discover information or to make or break coalitions.

Methods exist for limiting these process costs. Delegation of authority to committees, for example, can reduce the costs of participation, inhibit cycling, and facilitate vote trading that will mitigate the median voter problem. But delegation can also produce seriously inefficient outcomes by empowering committee members to impose their own idiosyncratic preferences on the group as a whole.¹⁴

Resolving Conflicts

Even if the owners of a firm are heterogeneous in their interests, the costs of collective decision making may nevertheless be low if there is some simple and salient criterion for balancing those interests. Consider the division of the firm's net earnings among its owners. This is potentially controversial where the character or volume of the transactions between individual owners and the firm varies substantially. Important examples, which we shall examine closely in Chapter 6, involve employee-owned firms in which the employees differ in the types of work they do. The costs of reaching agreement on an allocation of earnings, and the possibility that the resulting allocation will create inefficient incentives, may be manageable if it is easy to account separately for the net benefits bestowed on the firm by transactions with individual owners and to apportion the firm's earnings according to that accounting. Alternatively, if the value of each individual owner's transactions with the firm is difficult to measure, a rule of equal division may serve as a focal point¹⁵ on which agreement can easily be reached, thus minimizing the process costs of decision making though perhaps creating some inefficient incentives. Law firms often follow one or the other of these approaches: some use explicit multifactor productivity formulas to determine partners' shares; others follow a simple rule of equal division of earnings among all partners of a given age. Where such clear and conventional decision-making criteria are

absent, however, workable agreement among the owners can take a long time to reach, and may in fact never be reached.¹⁶

Participation

In some cases, the process of collective decision making arguably yields benefits for the patrons involved and not just costs. In fact, advocates of worker ownership often suggest that participation in control of the firm through democratic processes is of value in itself, quite apart from the practical import of the substantive decisions that result,¹⁷ and a similar argument is sometimes made on behalf of consumer cooperatives and other forms of noncapitalist enterprise.¹⁸ Although the reasons for valuing participation in this way are seldom spelled out explicitly, at least three can be identified.

First, individuals might simply enjoy the experience of participating in collective decision making—attending meetings, debating alternatives, assuming offices—as a social activity that is satisfying in itself. That is, political activity may in effect be a consumption good. Second, as is sometimes argued in the context of worker ownership, individuals may gain psychological satisfaction from the feeling of being in control, and this feeling may be enhanced for a firm's patrons by permitting them to participate directly in the decision making of the firm.¹⁹ Third, as has also been argued on behalf of worker ownership in particular, participation in collective decision making within the firm may be useful training for participation in the democratic political processes of the larger society, and might be valued for this reason not only by the individuals involved but also by the rest of society.²⁰

But note that these benefits, real though they may be, still involve tradeoffs. To grant the franchise and the associated benefits of participation to one group of patrons typically requires denying them to all other groups of patrons. Advocates of alternative forms of ownership sometimes overlook this point. For example, it has been argued, on behalf of worker ownership, that it is inconsistent to have democracy at the level of the state and not at the level of the firm.²¹ Yet in fact there is democracy in the typical investor-owned firm; it is just that the investors of capital do the voting rather than the workers. Converting to worker ownership means not only enfranchising the workers but also disenfranchising the firm's investors while continuing to deny the franchise to the firm's consumers. Consequently, the question gener-

ally is not whether there is voting in a firm, but rather who votes. If the benefits of participation as a good in itself are greater for one group of the firm's patrons than for another, then this becomes a further consideration in assigning ownership.

The value to individuals of participation as a good in itself is an empirical question that is illuminated by the analysis of existing ownership patterns in subsequent chapters. Interestingly, the evidence suggests strongly that for all classes of patrons—including, in particular, employees—the benefits of participation are generally insufficient to outweigh the costs of collective decision making.

Why Not Make Everybody an Owner?

In theory it would be possible to have all classes of patrons share in collective decision making, and thus not completely disenfranchise anyone. This is essentially the position taken by those who feel that every group affected by a business firm's decisions—its "stakeholders," such as workers, customers, suppliers, members of the local community, and environmental groups—should have representation on the firm's board of directors.²² Moreover, one might think that this would also have the important advantage of reducing the costs of market contracting for all of the firm's patrons and not just for a single group of them.

But because the participants are likely to have radically diverging interests, making everybody an owner threatens to increase the costs of collective decision making enormously. Indeed, one of the strongest indications of the high costs of collective decision making is the nearly complete absence of large firms in which ownership is shared among two or more different types of patrons, such as customers and suppliers or investors and workers.

Risk Bearing

The preceding discussion has focused on the costs associated with the first element of ownership: the exercise of control. But there are also costs associated with the second element of ownership: the right to residual earnings. Most conspicuous among these is the cost of bearing important risks associated with the enterprise, since those risks are often reflected in the firm's residual earnings.²³ One class of a firm's patrons may be in a much better position than others to bear those

risks—for example, through diversification. Assigning ownership to that class of patrons can then bring important economies.

This is a familiar explanation for the prevalence of investor-owned firms. It is not true, however, that lenders of capital are the only low-cost risk bearers. For example, customers can also be in a good position to bear the risks of enterprise, particularly where the goods or services involved are a small fraction of the customers' budget or where the customers are themselves firms that can pass the risk on to their own owners or customers. Moreover, the existing literature often imputes to a firm's noninvestor patrons, and to employees in particular, a greater degree of risk aversion than they actually seem to exhibit. Indeed, the evidence offered here suggests that the importance of risk bearing as an explanation of ownership is commonly overstated.

Entrepreneurship

So far we have been focusing on the costs of ownership for an established firm. But there are also costs associated with organizing a firm in the first place or with changing a firm's form of ownership. We can think of these costs as the costs of entrepreneurship.

If, initially, the prospective owners of a new firm had to assemble and organize themselves on their own before establishing the firm, then it would generally be impossible for any numerous and widely dispersed class of patrons to assume ownership. But in fact the organization of a firm is generally brokered. An entrepreneur first establishes the firm by herself and then sells it to the patrons who will ultimately own it. In the process, the entrepreneur organizes the patrons into a group.

For example, widely held business corporations are typically organized first as closely held firms. Subsequently, shares are sold off to members of the investing public in a stock offering brokered by an investment banking firm. Similarly, new condominium and cooperative housing is usually built by a single developer who initially owns the entire building and then sells the separate units to individuals who ultimately become, collectively, the owners of the building. And the numerous worker-owned plywood manufacturing cooperatives in the Pacific Northwest, discussed in Chapters 5 and 6, were in many cases established by individual promoters who would form a company and then find workers to buy it.

Established firms, moreover, can often change their form of own-

ership relatively easily. For instance, over the past century a number of investor-owned insurance companies have converted into mutual (policyholder-owned) companies and vice versa. Since the 1970s, large numbers of apartment buildings have converted from investor ownership (that is, rental) into cooperatives or condominiums. And more recently a number of investor-owned industrial firms have been sold to their workers. Because such transactions can be brokered, the costs of the transactions are often modest relative to the value of the firm. As a consequence, the costs of changing forms of ownership need not have an important bearing on the forms that ultimately survive. Two factors can, however, make the costs of changing a serious impediment.

First, important economies derive both from the presence of established brokers who specialize in ownership transactions and from the existence of standardized procedures for handling those transactions. Where such institutions have not yet developed, the costs of adopting or converting to a particular form of ownership may be high.

Second, when a firm's owners do not effectively control the incumbent managers, the managers may seek to preserve their autonomy or their jobs, by substantially raising the costs of changing the firm's form of ownership. The managers are particularly likely to be successful in this regard where, as in many cooperative and mutual firms, shares in ownership are not freely marketable.

Both of these factors produce inertia in the selection of organizational forms. This inertia is more pronounced for some forms of ownership than others. As we shall see, there are industries in which anachronistic forms of ownership have remained firmly embedded long after they have lost their original efficiency advantage over other forms.

Applying the Calculus

Although the particular categories of costs described here do not exhaust all the efficiency considerations relevant to ownership, they usefully organize those that appear most important. Ignored here are some other considerations, such as the "horizon problem," the problem of "perverse supply response," and the tendency of cooperatives to "degenerate" into investor-owned firms, that have sometimes been emphasized in the literature but that do not seem to play a fundamental role in determining patterns of ownership. These latter considerations

will be discussed later in the context of particular industries that illustrate the issues involved.²⁴

The chapters that follow show how tradeoffs among the various costs described here determine the structure of ownership in particular industries. In anticipation of those analyses, some general comments about these tradeoffs are in order.

As noted in Chapter 1, the efficient assignment of ownership minimizes the sum, over all the patrons of the firm, of the costs of market contracting and the costs of ownership. If the class of patrons for whom the costs of market contracting are highest is also the class for whom the costs of ownership are lowest, then those patrons are unambiguously the most efficient owners. This is often the case for small businesses.

Farms in the staple grain crops, such as wheat and corn, are obvious examples. It is not costly to borrow most of a farm's capital on the market, because the land, equipment, and crops can be pledged as security. Nor is it costly to sell the farm's products on the market, since they are simple, standardized, and easily evaluated by their purchasers (and since, to the extent that the purchasers have market power, this can be dealt with by farm-owned marketing cooperatives). Most farm inputs are also sufficiently simple and standardized to permit their purchase on the market with little cost, and farm-owned supply cooperatives provide a good solution where this is not the case. In contrast, hiring all of the labor for the farm on the market would generally lead to serious inefficiency owing to the difficulty of monitoring farm work—essentially a problem of asymmetric information—and this problem cannot be solved by having the farm own its workers. These costs of labor contracting can, however, largely be avoided by giving ownership of the farm to the family that provides most of the farm's labor. As for the costs of ownership, two of the three principal categories of those costs—the costs of monitoring managers and the costs of collective decision making—are obviously low for family farms. The chief cost of family ownership is risk bearing, and this can be mitigated by passing risk on to the market (via futures contracts), to insurers (via crop insurance), to the government (via price supports), and to creditors (via default).

Yet frequently—and especially in large-scale enterprise where the relevant classes of patrons are sizable—the efficient assignment of ownership is not so obvious. One reason is that, when the costs of market

contracting are high for a given class of patrons, the costs of ownership are often high too, and for much the same reason: because it is costly for the patrons in question to become informed about how well the firm is serving them. Life insurance policyholders in the early nineteenth century provide an example we shall return to. Contracts alone were insufficient to assure the policyholders that their insurance company would ultimately pay off on their policy, yet the policyholders were too numerous and dispersed to exercise meaningful control over their insurance company if they owned it collectively.

Such patrons are often efficient owners, despite their high costs of ownership. Even if they cannot monitor the firm's management effectively, and thus cannot exercise much control over the firm beyond that available simply through market transactions with the firm, it does not follow that there is no substantial gain from having those patrons own the firm. To use Albert Hirschman's felicitous terminology,²⁵ it can be efficient to assign ownership to a given class of patrons even if, for those patrons, voice adds little to exit in controlling the firm. An important reason for this is that, by virtue of their ownership, the patrons are assured that there is no other group of owners to whom management is responsive. It is one thing to transact with a firm whose managers are nominally your agents but are not much subject to your control; it is another to transact with a firm whose managers are actively serving owners who have an interest clearly adverse to yours.²⁶

In short, the costs of contracting for a class of patrons may be substantially reduced by making those patrons the owners even if they will only be very passive owners. Thus life insurance companies in the early nineteenth century were typically owned by their policyholders. Large U.S. industrial corporations in the twentieth century are arguably another example, as will shortly be discussed.

In the extreme, when both the costs of market contracting and the costs of ownership are exceptionally high for a given class of patrons, the efficient solution is sometimes to assign ownership to none of the firm's patrons but instead to form an unowned, or nonprofit, firm. Making owners of anyone other than those high-cost patrons would inefficiently threaten those patrons' interests. Yet making those patrons owners would result in no meaningful reduction in the agency costs of delegated management, while leading to useless administrative burdens (such as keeping track of and communicating with the nominal owners) and running the risk that the members of some subgroup

will succeed in using their authority as owners to disadvantage fellow patron-owners who are less well positioned.

In any event, as we shall see in Chapters 13–15, the distinction between nonprofit firms and firms owned by patrons who are very poor monitors is often negligible. Indeed, the tenuous character of that distinction is an important theme even in the following chapter on investor ownership.