A STRUCTURAL THEORY OF
THE NATURE OF THE FIRM

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A STRUCTURAL THEORY OF THE NATURE OF THE FIRM

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To the memory of my parents and

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PART I. INTRODUCTION AND DERIVATION OF THE BASIC FRAMEWORK

1. INTRODUCTION

Economic theory, it is sometimes surprising to realise, does not have a unified conception of the firm, as such surely the prime economic unit. Moreover, the predominant part of what is known as the "theory of the firm" does not even have *a* conception of the firm, let alone a unified one, nor does it seem to have an interest in the firm as such. Competing theories of the firm often seem to be somewhat more concerned with what the firm is, but any explicit consideration of the latter is lacking just as often: as in the traditional theory there is focus mostly on the goals and purposes pursued. The result is a series of unresolved controversies surrounding the firm. This study will attempt to provide a clarifying and unified framework within which the firm as such can be considered.

1.1 The traditional theory of the firm

As its proponents and opponents have pointed out, the traditional (neo-classical) "theory of the firm", as it is called in the literature, is not concerned with the firm at all. It was constructed "for the purpose of assisting in the theoretical investigation of one of the central problems of economic analysis - the way in which prices and the allocation of resources among different uses are determined" - and difficulties arise when an attempt is made "to adapt it to the analysis of the .. 'flesh-

and-blood' organizations that businessmen call firms".[1] The "firm" is not a firm.

> "In one sense the controversy over the theory of the firm has arisen over a non-existent entity. The crux of micro-economics is the competitive system. Within the competitive model there is a hypothetical construct called a firm. This construct consists of a single decision criterion and an ability to get information from an external world, called the 'market'. ... The market information determines the behaviour of the so-called firm. None of the problems of real firms can find a home within this special construct. ... In fact, all of the empirical content in this neo-classical model lies in the description of the environment within which the firm must operate. Even the sole objective of the firm, profit maximization, is determined by the environment because any other behaviour of the firm will lead to its extinction.[2]

Oscar Morgenstern notes, in one of his Thirteen Critical Points, that this "firm" acts "as an automaton in a fixed and immutable environment. The firm currently presented in textbooks could be abolished and replaced by a computer. It has nothing to decide; there is only information of a specific kind to be gathered and the rest, finding a maximum, is automatically settled."[3] The firm and its product are practically synonymous, and the equilibrium of the firm is the equilibrium output for the product. In addition the traditional theory of the firm is essentially a theory of industry rather than of the firm, for the emphasis is on the interaction between (large numbers of) firms in a perfectly competitive industry/market, with each "firm" viewed as

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1) Penrose, E., *The Theory of the Growth of the Firm,* pp. 11 and 13.
2) Cyert, R.M. & Hedrick, C.L., "Theory of the Firm: Past, Present and Future; An Interpretation", *Journal of Economic Literature,* June 1972, p. 398.
3) Morgenstern, O., "Thirteen Critical Points in Contemporary Economic Theory", *Journal of Economic Literature,* December 1972, p. 1184.

but a "black box.[4]

Fritz Machlup, on the other hand, defends the neo-classical theory of the firm on the basis of its usefulness as a "mental construct" to analyse the direction (only) of price and quantity changes:

> "In the theory of competitive price the 'real existence' of firms is irrelevant; imaginary (postulated) agents pursuing a simple (postulated) goal react to assumed changes in conditions and thereby produce (or allow us to infer) changes in prices, inputs, and outputs.
>
> "The question is not whether the firms of the real world will *really* maximize money profits, or whether they even *strive* to maximize their money profits, but rather whether the *assumption* that this is the objective of the theoretical firms in the artificial world of our construction will lead to conclusions very different from those derived from admittedly more realistic assumptions." [5]

In short: as long as it works this picture of the firm is acceptable, and criticism as to its lack of realism or meaningfulness is misdirected. The "firm" is not *supposed* to be a firm.

In spite of this a very definite underlying concept of the firm as real firm is embedded in traditional economic theory and thinking: "It is assumed implicitly or, on occasion explicitly, that the firm is run by an individual owner who is a profit maximizer".[6] "It may be recognized that firms are often large organizations, but the view is maintained that even large firms are, in a sense, merely 'inflated' entrepreneurs.

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4) Cf. Sawyer, M.C., *Theories of the Firm,* pp. 9/10.
5) Machlup, F., "Theories of the Firm: Marginalist, Behavioral, Managerial", *American Economic Review,* March 1967, pp. 15 and 14.
6) Shubik, M., "A Curmudgeon1 s Guide to Microeconomics", *Journal of Economic Literature,* June 1970, p. 411.

This enables the retention of the assumption that the firm has a single objective, that the objective is profits, and that the entrepreneur is able to enforce his decisions on his workforce."[7] It may be that the neo-classical "firm" is not supposed to be a firm, but this closely resembling very real view of the firm as a real firm is the "enterprise" Adam Smith had in mind, and also the picture of the firm that has formed the basis of most economists' and businessmen's thinking for the last two centuries - a picture built around the concepts of private property, private enterprise, entrepreneurship, individual initiative, the profit motive, perfect competition, the Invisible Hand, etc.

1.2 Alternative views: the "managerial revolution"

Developments in actual firms and markets since the time of Adam Smith, notably the increased size of firms, the small number of firms in many industries, plus the creation of the joint-stock company, seem to have made the above-mentioned concepts and views inapplicable: "the gradual development of the modern corporation has made the entrepreneur of classical economic theory a somewhat unreal figure in a large part of the typical modern industrial economy".[8]

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7) Sawyer, M.C., *op. cit.*, p. 9.
8) Vickrey, W.S. *Microstatics*, p. 142.

Prompted by this several alternative theories of the firm have been developed.[9] These theories have a number of general features. Firstly, they are theories of imperfect competition (monopoly, oligopoly) in that they incorporate the existence of barriers against new firms entering the industry, which potentially allows firms to earn so-called super-normal (or "abnormal") profits. This frees the firm from the necessity to maximise profits in order to survive. Secondly, they allow for firms wishing to pursue goals other than profit-maximisation. This is based largely upon observance of the so-called "managerial revolution", notably brought to attention by Berle & Means[10] who argued that the dispersion of shareholders cause corporate firms not to be controlled by their owners, but by non-owner managers who have an interest in pursuing objectives other than profit-maximisation. Such pursuits are generally seen as being subject to certain minimum earnings-constraints set by shareholders. Thirdly, these theories treat the firm as an organisation and the goals of the firm are derived from the interaction of groups within the organisation with different interests, especially managers and shareholders. Problems of decision-making and -implementing are considered in some.

William Baumol, attempting to show "that the goals of the firm cannot be determined by a priori considerations,[11] argues that for reasons of

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9)For surveys see Sawyer, M.C., *op. cit.,* or
Marris, R. & Mueller, D.C., "The Corporation, Competition and the Invisible Hand", *Journal of Economic Literature,* March 1980.
Also, McEachern, W., *Managerial Control and Performance,* chapter 1;2.

10)Berle, A.A. & Means, G.C., *The Modern Corporation and Private Property.*

11)Baumol, W.J., *Business Behaviour, Value and Growth,* {2nd ed.), p. vii.

self-interest (salary, promotion, status) and other considerations managers seek to maximise sales revenue subject to a minimum acceptable profit-level. The latter is seen as being determined by the need to ensure finance for future expansion of sales: profits make retention possible and/or satisfies the capital market. (Profits above the minimum level could be "traded in" for increased sales, using it for e.g. sales promotion and advertising.)

Oliver Williamson[12)] in a sense generalizes this view: he sees the manager as maximising a utility function, subject to a minimum profit constraint which ensures the interference-free operation of the firm by management. Arguments in the utility function are security, power, prestige, salary, professional excellence, etc. From these he derives three classes of expenses favoured by managers: expenditures on staff, emoluments ("discretionary perquisites") and funds for discretionary investment (actual profits minus minimum required profits) as operational elements. (The constraint is thus redundant for in its mathematical formulation it is of the same form as the last element in the utility function.)

In their so-called behavioral theory of the firm Cyert & March[13)] attempt to incorporate the notion of "satisficing" into the internal decision- making process. They consider the possibility of conflicting (groups of)

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12)Williamson, O.E. "Managerial Discretion and Business Behaviour", *American Economic Review,* December 1963, and especially his book *The Economic of Discretionary Behaviour: Managerial Objectives in a Theory of the Firm.*
13)Cyert, R.M. & March, J.G., *A Behavioral Theory of the Firm.*

managers with conflicting goals: production, inventory, sales, market share, and profits. Any policy which is "satisfactory" with respect to all the goals, but not necessarily maximising in any sense, is chosen. This choice can be seen as the outcome of a struggle in the board where each of these managers is present or represented.

Another class of theories also embodying the "managerial revolution" is so-called managerial growth theories, with Robin Marris as main exponent.[14)] These theories are related to the (static) theories of Baumol and Williamson noted above, only here the rate of change in the size of the firm replaces other proxies for utility objectives such as absolute size or expense: the growth rate is thus the proxy for income, power, prestige, etc. Another term in the utility function is job security, for which stock-market value is taken as proxy, because of the threat of a take-over posed by low stock-market valuation of the firm. (The threat of take-over is here regarded as the main constraint on managerial behaviour. Stock-market value is seen as being dependent on the firm's profitability and especially its dividend policy.[15)]) The

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14) Cf. Marris, R., *The Economic Theory of Managerial Capitalism;* Williamson, J., "Profit, Growth and Sales maximization", *Economica,* February 1966; Marris, R. & Wood,_ W. (eds.), *The Corporate Economy.*

15) Cf. Marris, R., "An Introduction to Theories of Corporate Growth" in Marris & Wood, *op. cit.,* p. 1.
Sawyer, M.C., *op. cit.,* chapter 7.5 provides a good summary. A related view is expressed by Galbraith, J.K. in *The New Industrial State,* with the added dimension that the "technostructure" seeks to control supply and demand, and thus prices, to make itself secure. Cf. Sawyer, M.C., *op. cit.,* p. 139.

managerial utility function thus contains two elements: the growth rate of the firm (assets, sales, etc.) and some measure of stock-market value like the market price of equity shares. This formulation allows for great flexibility and variability in the objectives pursued by firms, and even includes the neo-classical theory - the profit-maximising element is represented by stock-market value, the link to shareholder welfare:

> "(T)he firm is said to be 'classical' if the weight given to the growth rate in the utility function is negligible and the firm's prime objective is to maximize through stock-market value stockholder welfare ... the sole criterion for choice of growth rate is that of stock-market value. When the utility function displays a positive preference for growth, the firm is said to be 'managerial'. Unlike the 'classical' label, managerialism is a matter of degree, depending on how much utility weight is given to growth per se, relative to the competing claims of stock-market valuation."[16)]

Often the utility function is in lexicographic form, in which case a minimum stock-market value is the first priority, and the second priority is growth.) The relevant consideration thus becomes whether the share-price is (or should be) the dominant goal or whether it is (or should be) only an indication of a basic constraint.[17)]

Quite another alternative line of approach is offered by the so-called internal organisation approach, which is discussed in chapters 4 and 5. Suffice to mention here Ronald Coase's transactions-internalisation

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16) Marris, R. & Mueller, D.C., *op. cit.*, p. 41; also see Marris, R., "An Introduction..." in Marris & Wood, *op. cit.*, p. 16.

17) Cf. Solow, R., "Some Implications of Alternative Criteria for the Firm" in Marris & Wood, *op. cit.* p. 318 for a "classical" model formulated in terms of share-price.

explanation of the nature and emergence of the firm; Alchian & Demsetz' emphasis on the contractual nature of firm relationships and the advantages of team work as reason for the existence of firms; Jensen & Meckling's principal-agent approach to the firm, based on inter-individual contractual relationships within an artificial legal construct; and Oliver Williamson's markets-versus-hierarchies view of the firm as organisation. All these will be considered in chapters 4 and 5.)

1.3 Conflicting views and controversies: can they be resolved?

The development of these "alternative" theories have given rise to a sometimes violent controversy between proponents of the two broad approaches. Marris & Muller, for instance, have depicted those propounding the profit-maximising, purely competitive model even in the so-called corporate economy as suffering from "paradigmatic myopia", meant as a form of shortsightedness caused by excessive loyalty to a false but perfect example, thus ignoring non-conforming propositions and realities.[18)] on the other side Milton Friedman has described views incorporating corporate goals "other than to make as much money for their stockholders as possible" as "fundamentally subversive".[19)]

Both positive and normative considerations feature prominently in this debate. The central bone of contention is the so-called separation

18)Marris, R. & Mueller, D.C., *op. cit.*, pp. 36/7.
19)Friedman, M., *Capitalism and Freedom,* p. 133.

of ownership and control - the "managerial revolution" - and its relation to the goals the firm does, may or should pursue. The first disagreement is whether such a separation has occurred or does occur at all. Friedman, for instance, more or less denies its occurrence:

> "A major complaint made frequently against modern business is that it involves the separation of ownership and control - that the corporation has become a social institution that is a law unto itself, with irresponsible executives who do not serve the interests of their stockholders. This charge is not true."[20]

This is, secondly, representative of those arguing that the directors of the company will attempt to maximise shareholder welfare, a view which arises from the notion that shareholding is a form of collective ownership, merely an extension of a single-ownership or partnership. That is, profit-maximisation is regarded as an integral feature of the firm, an objective common to all firms.

On the other hand the fact "that directors, rather than shareholders' committees, determine executive salaries and other remuneration, and the general imperfections of the stock market, have led some to argue that the stockholder welfare maximization hypothesis is absurd."[21] More generally it is argtled that "the actual goals that are pursued by firms cannot be determined on a priori grounds but will depend on the role structure and power structure within the firm".[22]

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20) Friedman, M., *op. cit.,* p. 135.
21) Marris, R. & Wood, A., *op. cit.,* p. xxi.
22) Leibenstein, H., *Economic Theory and Organizational Analysis,* p. 282; see also pp. 274-276.

From the former view of ownership of the firm, thirdly, also flows the view that directors and managers *should* try to maximise shareholder welfare, whether such a separation of ownership and control has occurred or not. The principle of ownership, says this view, has a clear normative implication. Fourthly, if the modern corporation has indeed caused a separation of ownership and control, is it an undesirable aberration that should be reversed?[23]'or, fifthly, is the modern corporation a new societal institution, quite different from earlier firms and to be looked at with different criteria? (Note that applicability of the "managerial" theories is restricted to corporations, especially large corporations with dispersed shareholders.)

It should be noted that the theories above are theories of the behaviour of the firm, seeking in particular to derive the latter from the objectives pursued by the firm (which explains the dominant role goals and purposes have played in their approach to the firm). (The internal organisation approach takes a somewhat different tack. See chapter 4 and section 5.2.) It is evident, however, that all the above-mentioned considerations, and especially judgemental and normative aspects, are intimately related to (one's view of) certain prominent aspects of the firm and its surroundings - the capacities of shareholdership, ownership, directorship, managership, workership, suppliership, customership; the relations of power, control and

23) Cf. Galbraith, J.K., *op. cit.,* p. 52.

authority. What do these capacities entail, and how do they fit into the whole firm-picture? What are the relationships between these capacities, or what should they be? What is the role of power, control and authority? And how do goals and purposes fit in? Do they really determine the nature of the firm? Are they intrinsic or are they imposed by the external environment? What is the relationship between the firm and its (market-)environment? And not least, what is the firm? What is the modern corporation? These questions are, ultimately, what the controversies are about, and my thesis is that they can only be resolved by addressing these questions directly, by asking the hard questions. It is a curious habit of theorists do hardly ever do that, to study the firm without going to the core. Here the black box-approach of the traditional theory is a prime example. And there seems to be no attempt to develop a coherent and consistent framework within which all these questions can be examined (although there is some of this in some of the "alternative" theories).

More importantly, these theories are narrow and superficial in the sense that they cannot provide answers which can clarify these issues among the overwhelming array of different forms, shapes and sizes that firms come in and have come in historically - single-ownership, partnership, expanded partnership, small private corporation, large private corporation, government corporations, socialist firms, Yugoslav-style worker-controlled firms, etc. Most of these theories only apply to a more or less restricted economic, legal or historical environment. They

accordingly fail to penetrate to a deeper or more general level, fail to provide a grasp of what is the *underlying nature* of these institutions, capacities and relationships. For all these variable forms of the firm are all typically *firms,* which implies that they have to share certain common *typical* features which are thus *constantly* present, which underlies the spectrum of different forms. By penetrating to these underlying features, we will show, one can acquire a grasp of the typical nature of the firm and the typical nature of the relevant capacities and relationships. This, we will show, can provide new and resolving insights into the controversies noted above.

1.4 Purpose and methodology of the study

Our purpose in this study is then to develop a general, coherent and consistent conceptual framework for addressing all the issues noted above, and we will show that our framework provides a method of analysis which provides superior insights into the issues and controversies. Specifically, we will consider the following broad questions:

1. What is the typical nature of the firm as societal institution?
2. What is the typical nature of the relevant capacities -ownership, shareholdership, directorship, managership, etc. - and the relationships between them?
3. What is the role of goals and purposes with respect to the first two contexts? Notably, does it determine the typical nature of the firm? Is it as important as the theories of the firm seem to indicate?

In examining these we will also consider the other approaches and comment critically. In addition we will utilise our answers to gain new insights into and explanations of the historical developments in the firm, notably those in ownership- and control-relations observed by Berle & Means.

Historical developments in the firm have a more fundamental role in this study, however - a role which in a sense makes it a second topic of this study, but mainly one which will be utilised constructively in the derivation of the basic framework. We do this by considering the factual historical development of the firm, drawing upon the period between the late eighteenth century and the early twentieth century. During this approximately 150 years the business enterprise in the United States developed from the simple family farm, artisan shop and general merchant of the colonial era to the complex modern integrated mass producer/distributor. (This history is briefly summarised in chapter 2.) The period thus covers a significant portion of the spectrum of stages and forms in the historical development of the firm, including those observed by Berle & Means as displaying the separation of ownership and control.

The constructiveness of studying these developmental changes lies in the simple principle that any such "change" necessarily implies a concurrent "constant" presence of an aspect *within which* the change occurred.

Change can only occur in something constantly present, otherwise it is not change but something totally different and essentially non-comparable. Comparison presupposes an underlying constant feature. Accordingly, that feature within which changes occur during the development of the firm must be present in the firm at all times, and that will be the clue to what is the true underlying nature of the firm[24)] our methodological point of departure is thus that during the process of development the characteristic features of the firm will emerge and be displayed as the constant features within which the observed developmental changes occur.

It will be argued that these features are displayed in a special coherence which forms a *structure of characteristic features* which captures the broad typicalness of the firm as societal institution (chapter 3). This structure provide the beginnings of a powerful basic framework for analysing existing firms, the historical development of the firm and also the current development of a business enterprise. From this basic structure, we will then show, one can derive the insights and distinctions necessary to resolve the other questions - it is a unified approach, based on this structure of features, whence "a structural theory of the nature of the firm". It also provides a clarifying and critical perspective of the traditional and "alternative" approaches.

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24) Some features may be difficult to detect in early stages, being present only in seminal form; in such cases its clear emergence later may indicate where to detect it in earlier stages.

It must be noted that the basic framework, developed in chapter 3 (especially 3.3 and 3.4), is not a "model" that can be tested statistically. It is a characterising or "definitional" framework in the sense of being the answer to "what is the firm?", and as such precedes and underlies all hypothesis-testing related to the firm. For example, statistical tests of the behaviour or motivation of people in the firm presupposes a conception of what the firm is. One cannot test such a conception statistically because one has to use it to gather data for such a test. One can only rely on everyday (non-scientific) experience to determine which "things" are commonly and intuitively perceived to be "firms", and then proceed systematically to determine what it is that they all have in common, making them all "firms". In our case we also rely on the historical experience and the historical perception of firms.

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2. SURVEY OF THE HISTORY OF THE FIRM

During the late eighteenth century and the early twentieth century several phases in the historical development of the business firm can be distinguished. We will summarise them very briefly, only to give an idea of the spectrum we intend to consider.[24)]

The colonial era: up to ±1790

In commerce (distribution, marketing) the era is dominated by the general merchant, who is exporter, importer, wholesaler, retailer, shipowner, banker, insurer all in one - essentially thus an undifferentiated business. There is a very close relationship between the business and the family: it is mostly in the form of a single- ownership or partnership, with the family remaining the basic unit.

In production the dominant unit is the family farm, complemented by artisans in small towns. In both cases single-ownership is the rule, with the family also being the basic unit - in both nearly all the families lived on the same premises on which they raised crops or practiced their craft.

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24) Chandler, A.D., *The Visible Hand,* provides a very comprehensive and detailed history of the business enterprise in the United States, and is our main source of historical data.

Up to 1840

Between 1790 and 1840 commerce underwent a process of differentiation and specialisation which produced exporters, importers, wholesalers, retailers, banks, insurance companies, common carriers, etc. These firms were mostly partnerships, and still family affairs. Also, owners managed and managers owned these enterprises. However, there were more and more incorporated stock companies, first having appeared earlier in the financial and transport services (banks, canals and turnpikes) where the need to pool capital was felt first. In these service enterprises salaried managers rather than the owners came to administer the firm.

In manufacturing the period after 1790 saw the expansion and specialisation of simple manufacturing by entrepreneurs: craftsmen using more apprentices, increasing use of the putting-out system, the use of simple machinery, the appearance of small mills, etc. By 1840 production of most products was still carried out in a large number of small business units. These were mostly partnerships and still family affairs, with the owner still managing - i.e. the traditional form of the enterprise. The factory-form of manufacturing was a rarity before 1840, appearing significantly only in textiles. High capital requirements caused these factories to be incorporated enterprises. Nevertheless the shares were closely held by a few associates and their families, and the firms were still managed like partnerships.

After 1840 and up to ±1880

The decades after 1840 saw breakthroughs in technological limits, as such causing the blossoming of the business enterprise compared to earlier forms - the transport and communication infrastructure (telegraph, railroad) and the new energy sources (especially coal).

In distribution the high speed and volume of business made possible by the new infrastructure gave rise to the modern mass marketer who operated more or less directly between producer and final customer: first the modern commodity dealer (for crops) and the full-line, full- service wholesaler (for manufactured/consumer goods), and later the mass retailer (department store, mail-order house, chain store). These were incorporated enterprises, but the entrepreneurs and their families remained the major stockholders since large cash flow eliminated the need to go to the capital market to raise capital. And although they had managerial oganisations, the owner/entrepreneur(-family) continued to manage at the top.

In manufacturing, coal as new energy source led to the widespread replacement of the small business unit by the factory. Moreover, the railroad and telegraph, permitting the high volume and speed of the new production technology, encouraged the integration of several production process units into one establishment. Increased demand created potential markets. This was the birth of the mass producer, the era of mechanisation, automation, continuous-process machines,

synchronised high-speed production, energy-intensive and capital-intensive production. It was also manager-intensive, caused by the organisational imperatives of an integrated high-velocity process. In many cases the overall capital requirement was still relatively low, however, and the entrepreneurial family continued to have a role as major stockholders as well as top executives.

After 1880 and up to ±1917

The mass production enterprise's high capital- and manager-intensity and high volume output created pressures to integrate, within one enterprise, the processes of both mass production and mass distribution. This would increase utilisation of machine, worker and manager, increase productivity through better coordination of the flow of goods, and ensure smooth distribution in adequate volume. This growth process produced the modern multi-unit, multi-functional industrial enterprise in either of two ways:

i) Internal expansion, i.e. integration achieved by the firm building its own market (and purchasing) network;

ii) Expansion by merger between several smaller production units, followed by forward (and backward) integration.

In the first case the integration generated high cash flows, enough to finance working capital and expansion. The firm had no need to go to the capital market and the entrepreneurs and their families continued to be major stockholders. Thus, even though a hierarchy of salaried managers was created, the entrepreneurs continued to control the enterprises at the top.

In the second case the initial merger diluted ownership considerably. Essential rebuilding and consolidation forced the firm to go to the capital market, causing further spread of share ownership. Salaried managers moved into the top executive level for the first time. The entrepreneur, his family or other shareholders no longer administered the enterprise. The managerial hierarchy had become essential for the successful operation of the firm.

After World War I the modern industrial enterprise continued to spread, especially in high-volume capital- and energy-intensive industries. Growth of firms continued via both expansion and merger, with the latter more and more involving the merging of already integrated enterprises. New forms like the diversified firm and the conglomerate appeared. In these ownership has generally become very diluted, with minimal entrepreneurial or family holding and influence, and the complete ascendancy of the managerial hierarchy.

The distinction of these successive developmental phases does of course not imply that all modern firms are like those in the last paragraph. It is more a case of observing a ever-widening spectrum of forms, with new forms having been added over time, so that one finds, in the twentieth century, the whole spectrum: from simple traditional-form firms to complex modern corporate firms.

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3. DERIVATION OF THE BASIC FRAMEWORK: CAPITAL AND MANAGING

In this chapter we lay the foundation of this study. We now consider the firm's historical development to determine which features are prominently displayed, how and in which role they are displayed, and how these change during the development process. From this, we will show, one can derive systematic conclusions regarding the nature of the firm, and these will become our basic framework.

During its historical development in the period under view the firm developed from the simple one-man business to the complex and sophisticated integrated multi-unit modern corporation. We will show that this progression can be characterised as an *unfolding* or *opening-up* process, going from a rather "closed" form of the enterprise to a more or less "opened" form.

Consideration of this process will be most constructive if we can identify certain features typically displayed by the firm during its development, and ascertain how they changed during the latter process. Searching for prominent typical features two oft-encountered aspects of the firm immediately spring to mind, i.e. *"ownership"* and *"management"*. In some form or another these two seem to dominate both the history of the firm and many of the current controversies surrounding the firm, as outlined in the Introduction. The prominence of these two factors is too persistent to be ignored. The question is: why these two? Are they more typical or more important than other features of the firm? Or is it

something behind them? Or, is it their role, the way they feature in the historical development process?

3.1 Ownership and capital

The something behind ownership is capital. In the capitalist system the concept of ownership has, from the beginning, been commonly associated with capital, or more precisely with the supply of financial capital to the firm. The shareholders who, by pooling their capital resources, provide the corporate firm with its capital stock are called the "owners" of the firm. In the traditional enterprise, the single- ownership and the partnership, the businessman himself is the (co-)"owner", having provided the initial capital himself.

We can explain the prominence of capital (and its supplier) by considering the role of capital during the historical development or "unfolding" of the firm. Simultaneously we will consider the changes that occurred within the capital-feature itself.

3.1.1 Capital in the historical development of the firm

In the initial form, that of single-ownership farms, artisan- and general merchant shops, all the financial capital of the firm is supplied by the single owner who is also the manager. The implication of this is that the initial scale of the single-ownership is constrained by the owner's personal capital resources. Expansion and development,

similarly, is constrained by the firm's internal sources of capital (i.e. earnings in excess of operating costs, tax, depreciation and living costs for the entrepreneur and his family), perhaps supplemented by borrowing.25) This constraint is partially lifted when the firm develops into its second form, the partnership, where the personal capital resources of two or three businessmen becomes available to the firm, thus providing for an enlarged scale of activities. Expanding the capital stock, a necessary condition for the expansion of business activities, is still limited to internal sources of financial capital, unless new partners are added to the partnership, of course. Nevertheless the higher level of capital formation allow the general expansion of the scale of the firm between 1790 and 1840 - the enlargement of the shop, the employment of more craftsmen, the increased use of machinery or other capital goods, etc. to expand output (such as to meet the growing demand of the time).

On the capital supply-level the joint-stock corporation is the third form of the enterprise to develop, and equity issue is the third way of capital formation to be displayed. Although the corporation is very different from the earlier forms on legal and managerial levels, in terms of financial capital-suppliers the corporation is the logical extension of the partnership. It is equivalent to a substantially

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25)Cf. Marris, R., *Economic Theory of Managerial Capitalism,* pp. 4, 7-9.

expanded partnership, with a large number of "partners/owners" pooling their capital resources. As such the corporate form can be seen as a natural outgrowth of the need for higher levels of capital formation as required by large-scale, high-volume undertakings. The early banks, turnpike and canal companies were the first to feel the need for pooling large amounts of capital. The first factories (the textile mills) were incorporated "to provide the unprecedented amount of working capital needed to pay regular wages and to buy cotton in volume" (p. 59).[26] Even stronger were the capital needs of the railroads, far more than could be supplied by a single entrepreneur, family or small group of associates in a partnership. Similarly in later phases of the enterprise the mass marketer, mass producer and integrated mass producer/distributor generally reverted to the corporated form of capital formation to secure the capital stock necessary for their large-scale undertakings.

The railroads also serve as early illustration of the flexibility of the corporate form - they were among the first to develop and utilise the additional ability of the corporation to obtain external financing from the selling of securities. Bond issues became a primary instrument of additional capital formation to expand the railroads: "Railroad builders inevitably underestimated the cost of construction, causing first mortgage bonds to be followed by second and third mortgage bonds" (p.92). This provides a financing flexibility to the corporation which is unmatched by the other two legal forms of the firm. In the

26) Page references in brackets refer to Chandler, A.D., *op. cit.*

corporate form the function of capital formation can be "opened" to any desired extent by using financing methods of any desired level of sophistication. Witness here the different options with respect to financial structure available to the modern corporation. This flexibility explains the persistence, despite the variable shapes and sizes that firms display, of the corporate form of capital formation.[27]

Two observations are in order. Firstly, we can describe the changes in the way capital was formed as an unfolding process which opened up the function of capital formation in the firm - from its early closedness, narrowness and constrainedness to its opened and sophisticated state in later stages in the historical development of the firm. Secondly, we can summarise the role of (financial) capital in and its effect on the business enterprise, as displayed during the historical development of the firm, as follows. Generally the establishment, expansion and development of the firm could occur only insofar as capital formation had occurred in sufficient quantities.

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27) A side-effect of the flood of railroad securities in the 1850's was its impetus on the state of the U.S. capital market. Indeed, it dramatically increased its volume, helped the centralisation of the market in New York and was a direct cause of its early sophistication (pp.90-93). The importance of this for the later development of firms cannot be stressed enough, as a well-organised capital market provides access to exactly the kind of capital resources essential to the activities of the corporate firm. In analysing the development of the firm in a country it will be important to assess the extent to which the level of development of the capital market may have been a constraint on the development and growth of firms. In the U.S. there was, apparently, no such constraint. (See section 9.5 for further discussion of the role of the capital market.)

Conversely the need for more capital, for one, induced the successive creation, historically, of the three basic legal forms of capital formation or "ownership", as well as the development of more sophisticated methods of financing. As such this unfolding was necessary for the accompanying development and unfolding of the firm itself, at the same time having a significant influence on the positive form displayed by the firm.

3.1.2 The role of capital in the firm

Against this background we can now derive an explicit statement of the apparent role of financial capital in the firm. *It is a central thesis of this study that capital has what we will call a foundational role with respect* to *the existence of the firm.* This is suggested by our observations above, and also follows more generally from the observation that an initial and indeed essential step in the establishment of any new firm is the organisation and formation of capital (by pooling personal capital and/or issuing shares). For the firm the creation of a capital stock is a *founding* function, since those financial capital resources enables the firm to acquire and organise factors of production in a production or commercial process. Having financial capital gives the firm *capital-* or *economic power* to employ production factors and to organise the employed - buying land, capital goods and materials, hiring labourers and managers, and then organising and directing these towards its business activities.

Everywhere and at all times the establishment of a business enterprise is, by necessity, coupled with the organisation and formation of capital and thus capital power. Capital is necessary for the firm to exist.

Furthermore, during its entire existence the firm's capital (power) continues to provide a *basis* for its activities. As the historical transition from single-ownership to partnership to corporation clearly illustrates, any expansion requires additional capital, and limited capital resources is a constraint on any expansion because capital provides the *foundation* for expansion. And, if during its life the capital stock of the firm is threatened in any way, the firm itself is ultimately in jeopardy. Witness here, for example, the ever-present threat of a take-over raid, where somebody takes over a firm by taking over its stockownership- the economic equivalent of a coup d'etat (see also sections 9.4.4 and 9.5). Generally this implies a high priority on the foundational function at times when the firm is e.g. in a vulnerable position in its industry, making the threat to its capital foundation especially ominous. All this, I submit, is but a *manifestation of the foundational role of capital in the firm.*

A last remark on the prominent role of capital in the firm. We observed that this capital has to be created, formed and *organised.* This means that the firm is, in a literal sense, an *organised* institution, an *organisation.* In this sense all firms are organisations, even a one-man firm. (This use of the word is thus to be distinguished sharply from

the use of the term organisation with respect to the internal hierarchical structure of a firm as well as in so-called organisation theory.) One implication of this, which we will return to later, is that it is this organisation that provides the firm with a more or less *durable existence* independent of the life of individual members.

3.2 Management and managing

In order to analyse the prominence of "management" in both the history of the firm and the controversies surrounding the firm, we have to distinguish carefully between the *office* of manager and the general *function* of managing. The former use of the word relates to the context of internal hierarchical structure and the structure of management - top, middle and lower levels, the lines of authority and communication, etc. - the business organisation context. The latter refers to the general tasks faced by these managers - the undertaking, organising, coordination and administration of the firm's activities, i.e. a production, distribution or service process. Note that for lack of a better word we will use "managing" in its widest sense, i.e. to include what is often understood as entrepreneurial functions - decisions to undertake, to initiate, etc., and not in the narrower sense of only carrying out decisions already made by an entrepreneur. (We will often call it the *overall* managing function to remind of this terminological practice.)

We consider the function of managing first. Intuition suggests that this is an essential business activity, an obvious explanation of its prominence. Indeed, that is how the firm is often defined in texts: "Firms developed and survive because they proved to be efficient institutions for .. organizing resources to produce goods and services .. and organizing their sale and distribution .. In economic theory the firm is defined as the unit that makes decisions with respect to the production and sale of commodities. This single definition covers a variety of business organizations from the single proprietorship to the corporation, and a variety of business sizes".[28] Even where the firm is viewed merely under simple allocation and production theory, managerial decisionmaking (albeit narrowly perceived) is an essential function within the firm: "A firm is a technical unit in which commodities are produced. Its entrepreneur (owner and manager) decides how much of and how one or more commodities will be produced".[29]

However, when we consider the way this overall managing function is displayed in the historical development and unfolding of the firm, we will see that there is more insight to be gained with respect to this function and its role in the firm than the seemingly obvious. We will then also consider the changes that occurred in the positive realisation of this function over the history of the firm, as well as its relation to the form of the enterprise.

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28) Lipsey, R.G. & Steiner, P.O., *Economics, pp.* 148 and 153.
29) Henderson, J.M. & Quandt, R.D., *Microeconomic Theory,* p. 52.

3.2.1 Managing in the historical development of the firm

A. In the small production units/firms of the 1790's -family farms and artisan shops - there are only very simple overall managing tasks: simple product-, output- and input-decisions followed by timely planting and harvesting; timely buying of necessary quantities of cloth, leather, wood, metals, etc. and timely manufacturing of corresponding quantities of the product. As they expanded their productive activities to meet growing local demand, they hired labourers, apprentices and journeymen, adding the task of supervising them to the (owner-)manager's duties. Overall, though, the whole production process is still very simple, and the main function of the manager is more or less limited to simple product and quantity decisions. Due to technological constraints "the volume of output was rarely enough to require the creation of subunits within the enterprise or to call for the services of a salaried manager to coordinate and monitor the work of these subunits" (p.SO). The only appearance, albeit in a simple way, of "subunits" and their coordination as task is on the slave plantations, where the overseer - the first salaried manager in U.S. business history - assists the owner by organising and supervising the work force, coordinating the different slave gangs (while the owner (planter) handles money, accounts and overall decisionmaking).

In commerce opportunities for handling the buying and selling activities of the producing units - distributing crops and manufactured goods, supplying seed, raw materials, tools - give rise to the general

merchant of the colonial period. His main function is to arrange purchases, sales, exports, imports, transportation, loans, etc. After 1790 the cotton boom and resulting increase in the flow of goods and money create opportunities for organising *specialised* commercial enterprises, normally in the form of partnerships. In the specialised merchant's office the overall managing function is still straight-forward: "the partners' task was, of course, to initiate and carry out the commercial transactions involved in the buying, selling and shipping of goods" (p.37). Often partners become responsible for handling only a part of the activities, e.g. "one •• was responsible for the buying and shipping of goods, and the other took care of financial affairs" (p.37). This added the function of coordination the partners, at this stage still a minor task. In banks one or two salaried managers administered simple banking transactions. In canals and turnpikes managing was limited to supervising tollkeepers, lock tenders, engineers, maintenance crews, etc. in addition to routine rate-setting and so on. Technological limits on the speeds of canal boats excluded any need to extend managing to include the careful scheduling and control of traffic - the gain in efficiency would be negligible. Indeed, the overall slow movement of goods was a general constraint on the volume of goods and number of transactions to be handled by commercial firms, and thus limited the potential scope for organising and managing such transactions within these firms. Accordingly the firms remained small and overall decisionmaking tasks simple.

B. In production the opportunity for expanding the scope of the firm comes with the growing demand for cloth and especially the availability of mechanising technology after 1800. In the first factories, the integrated steel mill where all the processes of spinning and weaving were integrated within one establishment (pp.57-60;67-72), a treasurer made production and other decisions and supervised the enterprise as a whole while a mill agent administered the mill. The latter task entailed the supervision, via department foremen/overseers, of the workers and machines in the various departments or subunits of the factory where the different processes were carried out, as well as the efficient coordination of these subunits to ensure a steady low-cost flow of production. This coordination was greatly facilitated by careful design and organisation of the mill.

Thus, with greater demand and especially new technology came opportunities for increases in volume and speed of production and a corresponding expanded (but still relatively simple and "traditional") overall managing function whose expansion was, as such, *essential for the realisation of these opportunities within the firm.*

C. The availability of the new transportation and communication infrastructure after 1840 provides increased opportunities for the firm, as does the availibility of new coal-using technology. In distribution, the new speed and regularity of transportation and communication leads to an unprecedented volume of trade. The telegraph and railroad potentially enable the marketer to coordinate the flow of goods from

producer to buyer more economically/efficiently, and even more so if linked with the internalisation of intermediate market transactions. This implies a corresponding expansion of the scope of the firm's managerial function, which produces the mass marketer. In e.g. the commodity dealer this function now includes the coordination and control of the buying, selling, storing and shipping activities of a huge network of agents, each making its price and quantity decisions more or less independently. Wholesalers respond to the opportunity to handle the large volume of trade by building the first multi-unit enterprises: separate sales, purchasing, traffic and credit departments, all of which operate more or less like independent firms, but with the task of coordinating them efficiently (against the yardstick of turnover) being taken over by the firm and included in its overall managing function (as against their coordination by the market)(pp.220/l). This, however, leaves the opportunity to economise still further on the chain of transactions between numerous manufacturers and consumers by organising trade via only one middleman — an opportunity responded to by the mass retailer: "Their administrative networks were more effective because they were in direct contact with the customers and because they reduced market transactions by eliminating one major set of middle-men" (p.224), i.e. they internalised more market transactions than the wholesaler.

In production the telegraph, railroad and coal energy induce the spread of the factory to other industries, in many cases with scope and managing functions similar to the textile factory's. In others

continuous-process technology allows the first mass producers on the scene. In spite of high speed and volume easy overall managing of the production process is characteristic of such processes - economical coordination and control is achieved by effective initial organizing and design of the plant, leaving mostly standard production decisions to the manager. However, in metal-making and -working the opportunities of mass-production technology do lead to a further development in the firm's managing function (pp.258-272). In the former several processes of production previously in different firms and/or locations are integrated within one establishment, thereby internalising formerly external inter-firm relations. In the latter several processes of production are subdivided and carrier out in specialised departments, followed by assembly of the finished parts. In both efficient plant design and organisation are not sufficient, i.e. effective managerial coordination and control of the foremen and workers in the subunits is necessary for and enables the firm to realise the high-speed and efficiency-enhancing (cost-reducing) potential of the technology. Economies of scale are realised mainly via speed, i.e. by effectively coordinating the flow of materials through the production process, and not by increasing capital outlay and plant size per se (as the pure production theory view would seem to imply). To these firms such coordination is an important part of their overall managing function. Moreover, for the first time we see the serious use of statistical cost data in aid of more economic managing of the production process - as an aid in output, quality, pricing and product decisions, as well as to evaluate and control performance. (Previously accounting was mostly a record of past activities with no attempt to determine costs, for example.)

D. In the last important phase we encounter the modern integrated mass producer/distributor, where the trend to internalise steps in the production process (broadly defined) is taken one step further. Presumably due to pressures to use managers, workers and machines more intensively mass production and mass marketing are integrated, implying that one firm carries out all the processes of manufacturing and distributing a product - i.e. the producer-marketer (and purchaser-producer) dichotomy is internalised. (Compare the internalisation and subsequent coordination-task in the previous phase- it stayed on one side of this dichotomy.) According to Chandler this offers an expanded opportunity for a firm to lower costs and increase the efficiency of its managing of the production process by more effective coordination of the flow through purchasing, production *and* marketing units (as against having purchaser-producer *and* producer-market transactions handled via market coordination) (pp.285/6;364 – this is the basic idea of the Visible Hand replacing the Invisible Hand). The extent of such opportunities is seen as being determined by the state of the market and the state of production technology (whether capital- and energy-intensive, continuous-process, high-speed, etc.).

3.2.2 Managing in the final phase reconsidered

To highlight the changes in the overall managing function as displayed during the historical development of the firm, we will consider this last phase in more detail, to contrast it with the

managing function in the traditional firm. This will also reveal important sub-phases in the development of the modern integrated industrial firm.

The different levels of modern management are illustrative of the latter as well as of the overall phases in the development of the managing function. The tasks of the managers on the lower level, who have charge of the different operating units (which are of three types: purchasing, production and marketing), do not differ much from those of the manager of a single independent factory or commercial undertaking - except that his output-level is decided not by himself but by higher- level managers. The main task of middle managers, secondly, originates (historically) in part in early factory and even slave farms, but mainly in the mass producer and mass marketer firm - the supervision, evaluation and especially the coordination of the functional activities within their departments (in accordance with prior output-decisions), as well as the coordination of the input- and output-levels of their department with others to ensure overall desired levels of high-volume and high-speed flows from raw material supplier to consumer (p.411). (Additional tasks of the middle manager include advertising, sales- and after-sales service, consumer credit, etc.)

Top management really finds its genesis in the modern integrated mass producer/distributor, where top executives' task is to hire and evaluate middle managers, coordinate middle managers and above all make

overall production decisions and allocate resources accordingly for the enterprise as a whole. (The latter part of the task is, of course, the so-called entrepreneurial function which is, as such, not limited to the modern firm.) In this top managing function at least two sub-phases of development can be distinguished. Firstly, in those integrated firms established by internal expansion this function is still relatively undeveloped, at least before World War I. (Chandler argues that one reason for this is that the top executives in this case are *owner*-managers, not professionals; accordingly they look upon their managerial tasks as owner-managers of traditional enterprises did (pp.413/4).) Evaluation of middle manager performance is rarely systematic. Output decisions are not tied to a carefully calculated estimate of demand, and the corresponding coordination of the flow of materials through the departments is achieved largely by personal cooperation between middle managers (department heads). Moreover, there is almost no long-term perspective in the response of the overall managing function to potential opportunities, no systematic planning for the future of the enterprise: "Growth came rather as a response to short-term needs and opportunities as perceived by different sets of middle managers" (p.413). They rarely adopt formal capital appropriation procedures and rarely ask for budgets.

Secondly, in integrated firms established through *mergers,* where salaried executives far more than owners came to carry out top managing functions, the latter displays a marked difference {pp.415-454).

Evaluation of managerial performance is increasingly systematic; sophisticated accounting and statistical methods are used for decisionmaking and control to get a more efficient flow in the whole process; this flow is determined and monitored so as to be tuned to short-term fluctuations in demand, avoiding surpluses or shortages at any stage in the process. Moreover, conflicting demands for capital expenditures during the reorganisation of the merger bring about the need to economise on such expenditures, forcing into the top managing function the systematic allocation of resources between current and future operations - setting up budgets and other systematic capital appropriation procedures to ensure efficient long-run allocation of capital and personnel. For this they have to consider future trends: "the central sales and purchasing office provided forecasts of future demand and availability of supplies; the treasurer's office did the same for financial conditions; the development department provided information on changing technology" (p.451). All this then enables the firm to adjust the flows of production and distribution accordingly, thus achieving also *long-run* economical management of the process.

One last development in top managing needs mention: the post-World War I strategy of integrated firms to move into new products and new markets, i.e. the strategy of diversification (pp.473-483). By expanding the managing function to multiple products the firms endeavour to use their facilities and managers more effectively. As such it has become an explicit top-level *strategy of growth,* adding further refinement to

the long-run side of the firm's top managing function. It also complicates considerably the nature of the production and resource allocation decisions, as well as the overall coordinating tasks of the top manager. (Similar remarks apply to a variation on this theme, the conglomerate form of the enterprise.)These difficulties were, in turn, solved fairly well by the invention of the multidivisional form of administrative structure which allocates different types of decisions to middle and top management.

3.2.3 Changes in the overall managing function: an unfolding

If we now compare the overall managing function in this last phase with that function in the simple traditional firm there is a substantial change to be observed, on a number of levels. First, we can divide the overall managing function into two parts:

(i) *production initiative, production decisions and allocation of resources* - the "entrepreneurial" part -which develops from a simple decision (in a single unit) to e.g. plant a quantity of seed or manufacture a quantity of a craftsman's product, to sophisticated overall product-, input- and output-decisions, broken down into coordinated decisions for numerous sub-units within the (multi-unit)enterprise to correspond to expected levels of demand, to achieve economical use of inputs and overall allocation of resources, etc.; this is more than often complicated by multi-product considerations as well as the complexities of imperfect market conditions (multi- faceted competition between firms, etc.);

(ii) *organising and coordinating the production process* - the "operational" part; although this is more than often associated only with later phases in the development of the firm, where effective organisation and coordination of sub-processes and sub-units feature prominently in being essential to achieve economies of speed and of internalised transactions, it is a task also present in all the earlier forms of the enterprise (if perhaps in a form so simple as to go unnoticed): organisation and coordination of simple processes in the small factories; organising and scheduling buying and selling orders in the merchant's office; coordination of partners, clerks, etc. in all of these; coordination of slave gangs, apprentices and labourers; simple ordering and timing of manufacturing and farming activities, etc. What did change is that in carrying out this task the manager repeatedly *reached out over wider and wider circles,* first covering (often trivially) only processes and transactions within a small unit, then inter-unit but intra-firm integrated transactions, then internalised inter-firm transactions, then transactions across the producer-distributor dichotomy, and so on - a task of increasing scope and complexity.

Secondly we can mention some related aspects of both the above:

{i) *administration and accounting,* which changes from a simple record of transactions to sophisticated statistical and accounting methods as an aid in both the above parts of the managing function;

(ii) the *time horizon* of both parts of the managing function, where we see the latter's extension further into the future, the change from

day-to-day (or season-to-season) decisions in response to general short-term opportunities and circumstances to systematic long-term planning, forecasting, budgeting and capital appropriation, searching for new products, etc.; in addition to planning merely to be prepared for long-term changes (i.e. to ensure the continued health of the firm) this long-term perspective increasingly includes a systematic strategy for growth;

(iii) the *degree of managerial differentiation and specialisation;* the single owner/manager executes all functions, but the planter and overseer on the slave farm start to specialise, as do partners in the commercial office, etc. etc., ending in the modern integrated corporation with a very high degree of differentiation with respect to managerial tasks, as realised in the different levels of management discussed above.

Thus, during the historical period under view the overall managing function, as displayed by the firm during this period, develops from a small set of very simple tasks and decisions to a multi-faceted, complex multitude of tasks and decisions.[30] With respect to each of the levels

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30) This statement does of course not mean that this development happened to the managing function of each actual firm in this period, or that all 20th-century firms display such a developed managing function. Our statement is meant to apply in a general historical context, relating to new (additional) developments in the firm as societal institution. All forms of the managing function, "early" through "modern", can be expected to be encountered today. On the other hand this development *can* also be understood in the context of the life of a particular firm: a firm currently with a "traditional" managing function can and probably will over time undergo a similar development in its managing function, as it develops into, say, a corporation.

and aspects above we see what can be termed a distinct *unfolding* process which exhibits a broadening of scope and increasing complexity, richness and sophistication in that particular part or aspect of the managing function. The implication of this is that the different activities of management observed during the historical development of the firm are *not new* or *different functions as such,* as is often suggested in comparisons of large corporations and traditional firms. They are but *variant positive realisations of the one overall managing function,* and these variants simply reflect the historical *unfolding* of this function which is, as such, an *essential and ever-present feature* in all forms and phases of the firm throughout its history.

3.2.4 The role of the managing function in the firm

There is more to the historical role of the overall managing function than its own development and unfolding, and indeed more to its essentialness in the firm than what the definitions cited earlier and our analysis so far has indicated. This will now lead us to the concept of a characteristic structure as indicative of the nature of the firm.

First, what is the role of the overall managing function in the development of the *firm* per se? And how is this role related to the development and unfolding of this *function* itself? In the historical development of the firm we found that new phases in the development of the firm went hand in hand with new opportunities in production and commerce. These opportunities for the firm are nothing but opportunities

to undertake, organise and coordinate (i.e. manage) the production and/or distribution of goods and services, and can be of at least two not independent kinds. Firstly, the opportunity to manage "more" - more volume of a given product or more products: these are created by e.g. increased demand and new technology. Secondly - and showing increased sophistication in the perception of opportunities - the opportunity to manage more economically/efficiently a given process or chain of processes. This comprises the more or less obvious opportunity to improve the handling of current activities, but especially the opportunity to internalise processes and/or transactions formerly external to the firm, including them under the overall managing function when it becomes more efficient than having the inter-process or inter-unit transactions coordinated in the market.

Note that *all these opportunities can only be realised within the firm by executing the overall managing function with respect* to *these new* areas. Furthermore, such realisation within the firm, while also producing a more developed managerial function, *leads* the firm into a *new phase of existence,* as our discussion of the actual historical development of the firm clearly shows (recall section 3.2.1). Time and again we saw new forms and developments in the firm as resulting from the response to new opportunities. In this way, with managers continuously responding to new opportunities to undertake, organise and coordinate, the managing function recurringly leads the firm into new phases of existence. Developmental changes in the firm can thus be said

to occur under *guidance* of the managing function of the firm. The latter function, which in itself develops and unfolds at the same time, in this way determines the positive form of the firm displayed in each phase. That is, we can say that *managing has a leading role with respect* to *the existence of the firm, that it is a leading function of the firm.*

3.3 Relation between the two functions

This leading or guiding character of the role of the managing function in the firm gains deeper significance when we consider its relationship to the other essential function of the firm that we identified earlier - the function of capital formation.

In section 3.1 we concluded (i) that the formation of financial capital and capital-power has an essential and foundational role with respect to the "activities" of the firm, (ii) that the development of the firm could occur only insofar as capital formation had occurred in sufficient quantities, and (iii) that the need for capital induced the successive creation of the different legal forms of ("ownership" of) the enterprise. We can now restate (i) with more precision and meaningfulness, at the same time arriving at a special kind of link between these two functions. It is now evident that *capital* or *capital-power is foundational specifically for the firm's overall managing function.* Capital formation is a necessary condition for the execution of the managing function. This means that the managing function could develop

(unfold) and thereby develop the firm only insofar as sufficient capital was available to support the more developed "activities". This explains why capital formation was a necessary condition for the development of the firm as such, conclusion (ii).

Conversely (iii) shows that new forms of capital supply were created to allow capital formation at levels sufficient to satisfy the developing needs of the firm. The needs, of course, derive from nothing else but the response of the overall managing function's executors to the kinds of opportunities discussed above. The managing function, in managers' efforts to undertake and manage in an efficient way a production and/or distribution process, determine the required levels of capital and accordingly also the development of new ways and legal forms of capital supply and capital formation. In this way *the development and unfolding of the capital formation function occurred under the guidance of the overall managing function.* It was opened up by the managing function leading it - and the firm as a whole - into new stages.

More generally, *at each stage of its existence* during its historical development the firms displays this *special relationship* between these two functions: (i) the managing function has a leading (or guiding) role with respect to the formation of capital and indeed with respect to the whole firm as such, and, conversely, (ii) the function of capital(-power) formation has a founding or foundational role with respect to the

managing function and therefore with respect to the whole firm. That is, the relationship between this two essential functions of the firm is a *structured* one, a structure of "leading" versus "foundational".

While capital formation and capital power are necessary for the establishment, existence and development of a firm, by itself it is not enough- it has to be made "alive", be unlocked and opened up by managers executing the managing function in order to perform its foundational role in the firm. Conversely the managing function alone does not constitute a firm (notwithstanding the definitions cited earlier). It cannot perform its leading role if it lacks the capital power foundation which enables the firm to acquire, employ, organize and direct production factors towards the production and/or distribution process. There is evidently an *unbreakable coherence* between these two essential functions of the firm. Indeed, it is not possible to conceive of each function's role in the firm - leading versus foundational – outside this structured coherence.[31)]

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31) A most poignant manifestation of this unbreakable coherence and the role of each function therein lies in the situation where the viability of the firm is threatened due to a threat to its capital foundation. As we will see in section 9.5, in our discussion of the role of the stock market, this generally stems from a failure to generate "sufficient" earnings for capital suppliers (bondholders, shareholders), which in turn depends on the way the managing function is carried out. The ability of the firm to safeguard its capital foundation thus depend on its execution of the managing function which, conversely, is dependent upon a healthy capital power foundation. See especially remark vii, section 9.5.2.

We can thus summarise the main thrust of our observations up to this point on the firm in its historical development as follows:

(i) In all stages throughout its history the firm displays two essential functions, *managing* (in its widest sense) and *capital(-power) formation;*

(ii) In each stage of existence each of these functions has a *specific role* in the firm: managing has a *leading* or guiding role with respect to the existence of the firm, and capital formation has a founding or *foundational* role;

(iii) Moreover, in each stage of existence the firm displays an *unbreakable coherence* between these two functions, and they can indeed only be conceived of within this coherence, which is *structured* by the leading versus foundational relationship that it embodies.

(iv) The actual process of firm development displays the development and *unfolding* of both the managing and capital formation functions;

(v) The unfolding of the latter function occurred in response to and was initiated by the guidance of the (developing) managing function;

(vi) In its development the firm as such was led into new phases by the managing function, with the capital formation function providing the necessary foundation for that development.

Thus, in both a current (existential) and a development context these two functions are prominently displayed, and displayed in an unbreakable coherence of leading versus foundational.

3.4 The notion of a characteristic structure of the firm

We can now repeat the questions asked at the beginning of this chapter: why are capital and management, and in particular these two functions, so prominent in both the history of the firm and the controversies surrounding the firm? What are the implications of this prominence?

Firstly, note that both these functions are essential to the existence of the firm - their specific roles make them both necessary for the firm to exist. Neither alone is sufficient (compare the text- book definitions again). Secondly, with the managing of the production or distribution process having a leading role, and capital formation a foundational role with respect to the firm as such, then– as suggested by their significant historical influence on the positive form of the firm – they, in their coherence, seem to *shape* all other features, activities and relations within the firm as organised institution (as defined before, section 3.1.2). *It is precisely this determination and shaping which seem* to *bind together all the features activities and relations into an identifiable societal institution and organisation of people which can be called a firm.*

Indeed, *my thesis is that these two functions together capture the essence of the typical nature of the firm,* of what is perceived as the broad typicalness displayed by this societal institution; that they are indeed more typical and more defining than other features of the firm,

that both together are in principle sufficient to constitute a firm, and that the identifiability of the firm derives from the fact that the managing function, in conjunction with the capital formation function, *stamps* its activities and relations as typical recognisable firm-activities and firm-relations.

We will call these two functions in their particular roles and special coherence the *characteristic structure* of the firm. Managing (the leading function of the firm) and capital formation (the foundational function of the firm) can thus be called the characteristic structural functions of the firm. It is this structure which forms our basic framework which will be used extensively and fruitfully in the rest of this study.[32]

It must be noted that other features of the firm are not being dismissed as unimportant•. Other features, which we consider in the rest of this study, can and will be seen as the flesh around the backbone formed by these two prominent features of the firm. One could even say that a complete characteristic structure of the firm would embody all relevant

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32) Students of the theoretical approach of the Dutch philosopher of law Dooyeweerd may recognise the resemblance between this notion of a characteristic structure and what he calls the individuality structure of societal institutions. This study was indeed prompted and influenced by his applications of the latter concept to the State, and the basic framework derived in this chapter is the application of a related approach to the firm. Our analysis in later chapters of the implications of the firm being a voluntary association also draws upon his analysis of such associations. See his voluminous *A New Critique of Theoretical Thought,* The Presbyterian and Reformed Publishing Company, 1969, notably volume III.

features of the firm, but will do so within the basic framework of these two functions which, owing to their special roles and coherence, shape all other features.

The thesis formulated above is thus my answer as to why capital and managing feature so prominently in the historical development of the firm. The latter process essentially involves the *unfolding and opening-up* of the firm which, as such, allows and induces the emergence and *display of its characteristic features,* with the more typifying ones more prominent. The same applies to their prominence in the controversies surrounding the firm. These concern, in the last instance, the nature of the firm, and the recurrence of the two concepts is, I submit, but a manifestation of their typifying importance,

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In the rest of this study we intend to show that this characteristic structure-idea can be utilised fruitfully to generate useful insights into various aspects concerning the nature of the firm, that it provides the beginnings of a powerful and coherent framework for understanding and analysing the firm. We will consider a number of important aspects of the firm and its environment: the difference and distinction between the firm's internal relations and its market relations; the nature of the employment relation; vertical integration and transactions costs;

the contractual aspect of these relations; the question of authority in the firm vis-a-vis the market; the role of purposes and goals in the firm (and its implications for the different "theories of the firm"); the role of "ownership" in the firm; the nature of the relation between owners and management; etc. In each case we will consider other approaches, discuss their contribution and shortcomings, and show that the notion of a characteristic structure - the two characteristic functions in their special roles and structured coherence – provides new and clarifying insights into the issue, the controversy surrounding it and the shortcomings of the other approaches. Our concern at this stage is thus not so much the explanation of individual or firm behaviour as to understand and explain the nature of the "environment" within which the firm and individuals related to it operate - the fundamental relationships between various aspects of the firm, and between groups of individuals in and around the firm.

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PART II. INTERNAL VERSUS EXTERNAL RELATIONS, EMPLOYMENT AND AUTHORITY

4. INTERNAL VERSUS EXTERNAL RELATIONS

We stated above that the main thrust of this notion of a characteristic structure is that it shapes and determines all activities within the firm, i.e. internal to the firm. Another way of saying this is that the basic internal relation is the structured relationship between the managing and capital formation functions, and that all other activities and relations exist "inbetween" them, and thus become shaped by this characteristic (internal) structure of the firm. We will pursue this matter further in this chapter, in particular by contrasting the internal relations with the external relations of the firm.

4.1 Distinguishing external relations

The most obvious and prominent external relationship is the inter-relationship between firm and customer (the final consumer or another firm), i.e. the familiar market- or exchange relationship. This external relation, which is where the firm sells its product or service, is a necessary *correlate* of the internal structure of the firm (which embodies the production process). The two types of relations come together in the managing function of the firm, so that one can view the managing function as the nodal point for what is the *interlacement* of the internal and external relations. In a similar way the leading function can be seen to serve as nodal point with respect to the firm's external relations with its suppliers of raw and manufactured inputs. (A third

kind of external relation, which is not an exchange relation, is the intra-industry inter-firm relationship. We will not discuss this relation at this point.)

Because of this interlacement between the internal relations and the external market-relationship these two are also interdependent. Since the market-relationship is where the firm sells its product or service it is crucial to the existence of the firm. Recall, for example, how the emergence of market or trade opportunities was a moving force in the historical development of the firm, repeatedly eliciting responses from the unfolding leading function. Generally the ability of the firm to execute its overall managing function (and to safeguard its capital foundation) depends crucially on its relative position in such market relationships. Conversely its performance in the market depends on how well it executes its managing function.

The two kinds of relations, though interlaced, are nevertheless different and should be clearly distinguished as such to avoid confusing the analysis. Indeed, a major thesis of this and the following chapter is that a theory of the nature of the firm can only be viable if it can provide a clear distinction between the two kinds of relations. This is so because without that distinction, without being able to say what is inside the firm and what outside, any discussion of, e.g. "markets" versus "hierarchies" or "organisations" (as often encountered in e.g. transactions cost approaches in Industrial Organisation) becomes

nonsensical. One cannot conceive of the firm as such without this distinction, as we will see when we consider other approaches. A crucial test of our and other approaches will thus be whether they do provide such a distinction in a consistent way.

4.2 Coase: "The Nature of the Firm"

In his celebrated 1937-article[33] Donald Coase ventures to explain the nature, existence and growth of firms using an internalisation of external transactions argument. He notes the distinction between allocation of resources in the economic system as a whole (i.e. by the price mechanism) and within the firm (by the manager): "Outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within a firm, these transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production"?[34]

But if the market can coordinate production and allocation, asks Coase, *why do firms exist or emerge in the first place?* Noting the costs of using markets to effect exchanges and transactions he answers that the latter will be included under the coordination of the firm whenever the

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33) Coase, R., "The Nature of the Firm", *Economica,* Nov. 1937.
34)*Ibid.,* p. 388.

costs of using markets are greater than the costs of using authority and direction.35) Accordingly Coase states that "the distinguishing mark of the firm is the supersession of the price mechanism".36) Firms are established because there are costs of using the market mechanism. That is why firms exist, according to Coase. Similarly expansion of the firm is defined as the internalisation of additional transactions, with the equilibrium boundary determined by transactions cost considerations.

It is clear that the Coasean view of the firm and the framework we developed are based on perception of the same phenomenon, i.e. the internalisation of external relations when that (presumably) becomes more economical than carrying out the transaction in the market. And we have no quarrel with his main point concerning a transactions cost determined boundary between internal and market relations. But there is a source of confusion in his analysis which serves to illustrate our point concerning clear distinctions between internal and external.

If the firm emerges because it will be a less costly way than the market of carrying out the exchanges and transactions necessary to coordinate

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35) Williamson, O.E., in *Markets and Hierarchies*, provides an exposition of the transactional factors underlying the costs of using markets. *Klein, B., Crawford, R.G. & Alchian, A.A.*, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process", *Journal of Law and Economics*, Oct. 1978, provide additional insights into the costs of market contracting.

36) Coase, R., *op. cit.*, p. 389.

production, as Coase argues, then the existence of such production logically and temporally *precedes* the emergence and existence of the firm. This, however, is inconsistent with the nature of both the market and the firm. Market transactions, market exchanges and market relations are by definition *between* firms (or between firm and customer, or firm and supplier), and between-firm relations can as such only exist if firms (already) exist. The "market" cannot produce, it can only link producing unit and buyer. As our framework and development perspective show, any producing unit - however small or simple, thus also a one-man producing unit - is in principle a firm since it has to possess and perform the two characteristic functions of the firm. This is a very fundamental insight. Markets and firms can thus not be alternative modes of production,[37] but only alternative modes of coordinating exchanges and transactions between producing units. *The market relation is by necessity external* to *the firm, and as such has the internal relations of the firm as a necessary correlate.* Accordingly the emergence and existence of the firm cannot be logically or temporally preceded by market relations. The Coasean definition of the emergence and nature of the firm is not consistent with the nature of the firm and the market.

The problem with Coase's analysis is that it fails to incorporate the logical consequences of the difference and interlacement between

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37) Marris, R. & Mueller, D.C., *op. cit.,* p. 37, characterise the Coasean and related approaches as having this view.

internal and external relations of the firm consistently, even though he does distinguish the two kinds of resource allocation. However, we can agree that the Coasean argument does hold for the expansion and development process of a firm, and also, of course, for a developed firm (i.e. with an unfolded enough form to embody internalised transactions). To paraphrase Coase, the distinguishing mark of the to some degree unfolded firm may very well be the supersession of the price mechanism, but not in the first instance of *the* firm. It cannot be a definitional attribute of the firm in general. We do, however, agree with Coase that many firms - indeed most firms today - do embody internalised formerly external (market-) relations. As we said before, one can expect all or most of the forms in the developmental spectrum to exist in the present, and many firms have the "modern" form in terms of both capital formation and managing functions. A viable definition should, however, be able to accommodate the simplest forms, even the one-man firm.

In spite of this weakness in his view Coase does suggest a distinction between internal and external relations, e.g. between already internalised and still external relations. Coase argues that there is an essential difference in that once internalised these transactions are carried out using an entrepreneur-coordinator's *direction* and *authority* as against using the operation of the price mechanism in free market inter-relationships. For him the bounds of the firm is the range of exchanges over which authority takes care of resource allocation, so that the

latter delineates the border between external and internal. {See chapter 5 for our discussion of authority in the firm vis-à-vis in the market relationship.)

4.3 The firm as a contractual "team"

Other approaches take a different viewpoint. Alchian & Demsetz[38] object to the Coasean notion that authority governs the firm's internal transactions. "It (the firm) has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people."[39] Focusing on the employer-employee relationship, they emphasise its *contractual and voluntary* nature and thereby its similarity to firm-customer or firm- supplier relations (where a contract serves to formalise the voluntary market exchange). The only difference, in their view, is that with respect to the former some party is in a centralised position in the contractual arrangements with all other "inputs" (i.e. employees), and that there is *"team* use of inputs" {i.e. employees) in the (by assumption joint-input) production process. (Indeed, they argue that firms exist in order to exploit the advantages of such team work - the "team process" induces "the contractual form called the firm".)

We will defer discussion of their views on authority and contracts to the next chapter, making only the following comments at this point.

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38)Alchian, A.A. & Demsetz, H., "Production, Information Costs, and Economic Organization", *American Economic Review,* December 1972.
39)*Ibid.,* p. 777.

Firstly, their theory rests crucially on the assumption of joint-input technology, and has thus been described as "too narrow and therefore misleading"[40] - it indeed excludes many business enterprises from their definition of a firm (especially in services), and such technology is also much less widespread than they would indicate; moreover, it "can explain only a small fraction of the behaviour of individuals associated with a firm"[41] Secondly, and most importantly, the other difference they note - the centralised position of one party in the contracts - does not distinguish intra-firm from extra-firm relationships either. It is just as true for the contractual relationships between their illustrative grocer and all his customers and suppliers as for his employees (even if you do have joint-input production). *This leaves the relationship between grocer and employee indistinguishable from that between grocer and* customer or *supplier,* and raises the question on what grounds can they call one "employee" and the other "supplier" or "customer"? If there is no distinction left between internal and external these terms cease to have legitimacy, since no viable concept of the firm as identifiable societal unit remains. Thirdly, they fail to consider inter-employee and inter-subunit relations and transactions (many of whom may be internalised former market transactions) where there need not be a centralised party either.

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40) Jensen, M.C. & Meckling, W.H., "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics,* 1976, p. 310.

41) *Ibid.,* p. 310. See also Williamson, O.E., *Markets and Hierarchies,* pp. 49/50.

4.4 The firm as a set of inter-individual contracts

Jensen & Meckling[42] treat the firm under the theory of principal-agent relationships and the associated agency costs. Like Alchian and Demsetz they emphasise the contractual nature of firm relationships – "contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc.[43] They do so, however, in a much stricter way which concentrates *exclusively* on the contractual aspect of the firm. The firm is viewed, as are organisations in general, simply as a "legal fiction" (i.e. an "artificial construct under the law" which allows the organisation to be treated as an individual) which serves "as a nexus for a set of contracting relationships among individuals", (with the firm in particular "also characterized by the existence of divisible residual claims on the assets and cash flows of the organisation which can generally be sold without permission of the other contracting individuals").[44]

This view implies that there is truly no difference or distinction between internal and external relations of the firm: "Viewed this way, it makes little or no sense to try to distinguish those things which are "inside" the firm (or any other organisation) from those things that are "outside of it",[45] say Jensen & Meckling (although in just the

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42)Jensen, M.C. & Meckling, W.H., *op.cit.*
43)Ibid., p. 310.
44)Ibid., pp. 310/311.
45)Ibid., p. 311.

previous sentence they refer to "changes exogenous to the organization"!). To them there is only a multitude of *inter-individual* contractual relationships - all "structures" or organisations are artificial. Thus it is not surprising that their view is that "the behaviour of the firm is like the behaviour of a market; i.e. the outcome of a complex equilibrium process".[46] Accordingly they also object to the "personalisation" of the firm implies in questions about e.g. the objective function or social responsibility of the firm.)

The consequence of reducing everything to a series or set of inter-personal transactions is to *eradicate any distinction between internal and external,* between structure and non-structure, between form and formless, between firm and market. Although Jensen & Meckling may, for their purposes, not find this to be an impediment- for they seem to be fully aware of this consequence — for a general theory of the nature of the firm such an approach has serious shortcomings. The inescapable logical consequence of eradicating the internal-external distinction is that it *dissolves any form* or *organisation* within and into an ocean of inter-personal transactions, implying that one cannot legitimately talk about the firm nor about the market, cannot distinguish managers, employees or outsiders (as they themselves frequently do!), cannot talk of owning a firm, residual claims on a firm, the equity of a firm, cannot distinguish between inside or outside equity and debt, endogenous and exogenous changes, etc., etc. Ironically their view and definition of the firm are inconsistent with concepts they use in the rest of their

46)Ibid., p. 311.

article. Moreover, and keeping Joan Robinson's test for economic concepts, i.e. "do they correspond to the real world?",[47] in mind, the inconsistency of this scenario with the way firms and other organisations are experienced and have been experienced historically in economic life is glaringly self-evident.

The basic failure of a Jensen & Meckling-type approach to the nature of the firm is that it fails to explain the commonly observed *inner unity* of firms vis-a-vis the absence of any durable solidary unity in inter-individual exchange relationships. This - and we will return to this in the next chapter - is due to its failure. to provide the insights and *distinctions* with respect to the two kinds of relations that are necessary to explain and understand the phenomenon of the firm as against the market. This, in turn, is due to their attempt to give an exclusively individualistic explanation of all "firms" or "structures", i.e. only in terms of simplest elements, the elementary interactions between autonomous and separate individuals. This is done *without regard for the nature of any structure* or *form within which individuals operate,* e.g. the typical "environment" they face within the firm. Hence Jensen & Meckling's effective denial of the existence of such cohesive structures.

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47) Quoted in Coase, R., *op. cit.,* p. 386.

4.5 The characteristic structure solution

The power of the notion of the firm's characteristic structure, which we derived from its historical development, is that utilising it provides a way out of such a nihilistic quagmire. Recall that in this structure the managing function has a leading role with respect to all other aspects of the firm, with the capital formation function having a foundational role. As such these two functions, in their typical coherence, *shape* and *stamp* all features within the firm, *binding them together* into an identifiable organised institution called a firm. This means that all internal relations of the firm - i.e. relations and transactions between individual members of the firm (employer-employee as well as inter-employee) and between sub-units of the firm - are shaped by this structure, under guidance of the firm's overall managing function. As such the members and sub-units of the firm are *bound together* (i.e. integrated) into a *solidary whole,* into a recognisable societal *unit* shaped by its characteristic structure. This inner unity and also continuity amidst changes in individual membership are guaranteed by the firm's organised capital foundation (which makes it an *organisation):* it has and provides durable existence.

The market relationship, on the other hand, is an exchange relation between two firms (or between firm and customer). Its main distinction is that it *does not unite the participants into a solidary whole,* but leaves them to interact freely in cooperation, neutrality or antagonism -

in any case interaction characterised by divergent or at least separate interests and rewards. Also, by nature such a two-participant non-solidary relationship guarantees *no continuity* amidst changes in participantship - any change in participant implies a totally new relationship, implying recurring formation and disintegration of such relationships. Moreover, the participants in these interactions, e.g. the two firms, are not members of the same whole - each firm has its own capital foundation, managing function and goals. As such the interaction (i.e. the market relationship) is *external to any whole,* in particular external to the firm, and only externally interlaced with any firm's characteristic structure.

This means that when a market relationship is internalised by the firm (or more precisely when the firm on the other side of it is internalized),[48)] as we witnessed in the historical development of the firm and as Coase propounds, its character changes from an extra- and inter-firm relation to an intra-firm relation, i.e. *intra-"whole".* It becomes shaped by the characteristic structure of the particular firm, with the initially separate firms/units (and the performers of the initially separate functions) *becoming bound together in one (new) "whole".*

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48) To be even more precise, what is internalised is the functions previously carried out by another firm; only in some cases does this involve internalisation of that firm as such - i.e. the difference and distinction between internal expansion and merger.

The character of the interaction between the units (i) changes from a two-way exchange to one-way transfers between subunits (not quid pro quo), and (ii) changes from interaction between two divergent-interest units to cooperation between units with common or converging interests and rewards: "Unlike autonomous contractors, internal divisions that tradewith one another in a vertical integration relationship do not ordinarily have pre-emptive claims on their respective profit streams.[49] The intrinsic character of inter-unit becomes not that of separate goal pursuit by each unit in its choice of what tasks to perform, but dependence on the goals that the "whole" pursues and the corresponding overall managing function as determinants of what each unit does (in joint goal pursuit): *divergent interest interaction becomes common interest cooperation within one "whole"* - the units and individuals are *bound together* under the guidance of a common leading function.(The observation that in actual firms units or members may have feelings of antagonism or competition towards each other does not change the essential fact that such inclinations exist between members of the same "whole" whose activities are still shaped by the actualised characteristic structure of that firm.)

This new "whole" is thus no "market system" connecting autonomous individual producers (one-man firms) in divergent-interest inter-individual exchanges, nor an artificial (legal or other) construct as

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49) Williamson, O.E., *Markets and Hierarchies,* p. 29.

Jensen & Meckling would argue, but an identifiable solidary economic organisation *bound together* by its (common) organised capital power foundation and its (common) leading function. There is a clear difference and distinction (though interlacement as well) between internal and external relations, units and individuals, thus *preserving the unity and integrity of the firm* in an otherwise disintegrating Jensen & Meckling-type scenario. This makes it legitimate and meaningful to distinguish between firm and market, inside and outside, employee and supplier, etc.

Similarly our framework provides the distinction with respect to Alchian & Demsetz' grocer that they themselves are unable to provide. A centralised party in contracts does not explain the inner unity of the firm in general, nor does team production. As we said, the grocer is in a centralised position with respect to all employees, customers and suppliers alike. However, employer and employee are members of the same cohesive whole, while employer and customer are on opposite sides of an essentially non-integrating interactive relationship, as are employer and supplier. Our analysis also shows that Coase, while not necessarily being incorrect in his observations about authority inside the firm as against in the market, does not penetrate to what we perceive to be the real source of the distinction between internal and external relations. We will discuss this matter in the next chapter. Lastly, this explains why we can sustain the difference and distinction between internal and external relations amidst internalisation of the

latter - the character of the transactions undergo a fundamental change upon internalisation.

The difference and distinction between internal and external is more complex than what we have observed so far, however. The reason for this is that the internal relations involve the employment relation, which often accompanies any internalisation process (and which itself concerns, in a way, an internalisation). We thus have to investigate the employment relation itself, and then its coherence with the process of internalising a market relation if we want to gain full insight into the internal versus external issue. This will then also bring us to a discussion of the questions of voluntarism, contracts and authority in the firm vis-a-vis the market.

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5. AUTHORITY AND THE EMPLOYMENT RELATION

The internal relation within the firm that we discussed just now - and for which internalisation of another firm is one way in which it can be established - comprises the inter-subunit relationship. As such it is only one of the types of internal relations found within the firm, all of them shaped by the firm's characteristic structure. Interwoven with this relation is the relationship between "employer" and "employee", as well as between the employees who work in the various subunits. The former is the basic employer-employee relation, which as such encompasses the latter, where we refer specifically to the fact that these employees are normally employed in a structure or ranking of "positions" – assemblyman, shift foreman, general foreman, supervisor, apprentice, department manager, general manager, etc. This brings us to the second context in which *management* features prominently in both the history of the firm and the controversies surrounding the firm - the internal structure of jobs and positions, of *offices* {as against managing *functions* - recall section 3.2).

The structure of management is a feature of the firm which has been studied extensively in the fields of management and business organisation theory. The historical development of business structure has also been analysed thoroughly, notably by Alfred Chandler in his book *Strategy and* Structure.[49] Accordingly we will not devote much time to this feature,

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49) Chandler, A.D., *Strategy and Structure* {1962).

apart from a few necessary remarks to relate it to our current analysis. We will, however, discuss the encompassing employer- employee relation and the question of whether it embodies real authority extensively, as this will prove to be central to a unified and consistent conception of the firm. (Note then that when we use the term authority in the next section we do so provisionally, without implying it is anything that we have not as yet established.)

5.1 The structure of offices

Our first observation relates to the fact that, throughout its historical development, the firm displays its members working in a number of jobs, positions, offices or capacities. This is true from the simple owner-manager firms to the large modern multi-unit or multi- divisional corporation. (This is true even for the one-man firm - one person occupies both offices of manager and worker.) Secondly, each office carries a certain task and *function* as well as a given *authority* (where the latter is, in the first instance, the authority to do something, to execute the accompanying function). These offices are normally structured in a ranking the rough shape of a pyramid, with at the top the chief executive - the person who delegates authority to lower level offices, and who is the de facto employer of all the individuals in these offices. In the one-man firm the one person is both employer and employee, both chief executive and lower level worker, and executor of all functions within the firm. At the other extreme, for example,

> "The executives in a modern "decentralized" company carry out their administrative activities from four different types of positions. Each of these types within the enter- prise has a different range of administrative activities. Normally, each is on a different level of authority. At the top is a *general office.* There, general executives and staff specialists coordinate, appraise, and plan goals and policies and allocate resources for a number of quasiautonomous, fairly self-contained divisions. .. Each division's *central office,* in turn, administers a number of departments. Each of these departments is responsible for the administration of a major function ... The *departmental headquarters* in turn coordinates, appraises, and plans for a number of field units. At the lowest level, each *field unit* runs a plant or works, a branch or district sales office .. an accounting or other office, and the like."[50)]

For such and other firms the normal pattern is that each office has a specified sphere of authority, competence and responsibility. Such a sphere is normally determined and circumscribed by a higher office, and its competence may include authorisation, determination and supervision of one or more lower level offices' spheres of activities. (This establishes the basic ranking or hierarchy of offices.) An implication is that the offices have to be connected with lines of authority and communication along which delegation is exercised and, in return, responsibility is accounted for.

Most relevant for our purposes in the *development context* is a comparison between the simple, "traditional" firm and the complex modern multi-unit corporate firm. In the latter, as against the former, we see a large pyramid with a large number of offices with different spheres of delegated authority and, correspondingly, different functions. We noted

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50) *Ibid.,* p. 9.

before that during the unfolding of the firm the overall managing function itself unfolded, among other things via increased differentiation and specialisation with respect to managing tasks (section 3.2.3). Now we can add that there is an accompanying increased (and more sophisticated) delegation of authority - which is nothing but *specialisation* with respect to *authority* - in the relatively more developed firm. In the simple firm, on the other hand, there are fewer offices and little specialisation. Its hierarchical structure is a (partially) *collapsed* and simplified version of the modern firm's pyramid, with the one-man firm an extreme case. Accordingly, and conversely, the hierarchical structure of the modern firm can be described as *unfolded* vis-a-vis that of "earlier", i.e. less-developed, firms, and the process of development of this structure an unfolding process.

It is important to realise that this unfolding of the "organisation" or bureaucracy is no independent process. It can only be realised within the framework of the characteristic structure of the firm. This is clearly revealed in the relation between the firm's hierarchical structure and its overall managing function, as displayed during the firm's historical development. The correspondence of each office with a certain function - all of which are indeed part of the characteristic functions of the firm - would predict a close relationship, and this is borne out by the facts. Chandler's historical studies propound the thesis that in the creation of new offices it is a case of *structure* following *strategy* (the latter being the basic (long-term) managing decisions), with this

new structure being necessary for the full and efficient realisation of the new managing tasks.

So, for instance, when a company expanded (in response to new opportunities) by either building or obtaining geographically dispersed units, creation of departmental headquarters and the clear definition of the lines of authority and communication between headquarter and unit was necessary to ensure efficient overall management. In a similar way a central office had to be created to administer numerous departments efficiently. And when, due to further expansion into new functions, geographical areas or product lines the problems of decisionmaking, coordination, appraisal and policy formulation became too complex for the small number of top officers to handle, they developed the multi-divisional structure (which separates "entrepreneurial" from "operational" decisionmaking offices - see section 3.2.3) to again achieve efficient overall managing of the whole production and distribution process.[51)]

These observations support our basic contention about the leading role of the firm's managing function. In our terminology, the unfolding of the firm's hierarchical structure occurs under *guidance* of the (unfolding) overall managing function, the former being necessary to accommodate the "new" and unfolded functions in sufficiently specialised offices (and

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51) *Ibid.,* pp. 283-314; 14/5; also *The Visible Hand,* pp. 7; 339.

with the necessary delegated authority) to attain economical management. Accordingly the structure of offices is continuously *shaped* by the leading function of the characteristic structure of the firm.

An important implication is that one cannot consider and analyse such a hierarchical structure and its development *in isolation,* i.e. purely as an "organisation" or bureaucracy which somehow exists and especially grows by itself, like a self-driven force. Its coherence with the typical nature of the societal institution in which it is inherent should never be lost sight of, since only the latter can provide insights and distinctions crucial to an understanding of the hierarchical structure of the *firm* (as against that of another societal institution). This is a mistake often made by so-called organisation theorists who seek to concentrate on a single, exclusive viewpoint, and invariably implies the levelling or at least ignoring of the differences between different societal structures. (Also see closing remarks of this chapter.)

5.2 The employer-employee relationship

All the persons who work in these offices are employees, and they are the de facto[52)] employees of the top executive, e.g. the president or the corporation or the owner/manager ("boss") of the small traditional

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52) We leave the question of whether the actual employer of corporate employees is the top executive, the board of directors or the shareholders to our discussion of ownership and control, chapter 9.

firm. Since all the office-holders first have to be employed, the employer-employee relationship encompasses and precedes the structured inter-office and inter-employee relationship of the previous section. Similarly, each process of internalisation or integration (chapter 4) requires either current employees to execute the new internalised functions or the employment of additional employees. The employer-employee relationship is quite ubiquitous.

As such the employer-employee relationship is fundamental to our study and any attempt to develop a consistent and unified framework of the nature of the firm. We noted earlier that without a distinction between what is internal and what is external to the firm a consistent conception of the firm cannot exist. Definition of employeeship establishes who is "in" and who is "outside" the firm, and is thus *essential for delineating the bounds of the firm.*

One side of the employer-employee relationship is thus the *establishment* of the relation by the parties – it is the question "what is an employee?". The other side of it is the *nature* of the relation once employeeship has been established, and concerns (among other things) the question whether this relationship is characterised by *authority* of employer of employee. We will see that these questions can only be resolved by simultaneous consideration of both sides. Moreover, utilisation of the concept of a characteristic structure will be shown to be of cardinal importance.

5.2.1 The issues illustrated - other approaches

To illustrate the issues involved and the problems and pitfalls one may encounter in attempting to resolve them we consider three other approaches in some detail.

Oliver E. Williamson considers how the choice between handling a transaction in a *market* vis-a-vis within a *"hierarchy"* can hinge on transactional (cost) factors, namely so-called bounded rationality paired with uncertainty, opportunism (an attempt to gain from misrepresentation during contracting) paired with small numbers, and information compactedness (information asymmetry between transaction parties). These factors cause transactions in various markets to be costly, initiating a shift to internal organisation or hierarchy as an alternative mode of transacting. (It thus resembles and expands the Coasean internalisation argument.) Williamson considers three separate situations:[53)]

i) *the labor market:* assuming that "in the beginning there were markets"[54)] with ubiquitous autonomous contracting, these transactional factors "impede autonomous contracting between *individuals*" and are "the reasons for *workers* to be joined in simple hierarchies"[55)] (my italics); hierarchy, which embodies authority and subordination, can

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53) Williamson, O.E., *Markets and Hierarchies,* and "Markets and Hierarchies: Some Elementary Considerations", *American Economic Review, May 1973.*

54) Williamson, O.E., *Markets and Hierarchies,* p. 20; also, on p. xi, "the transaction is the ultimate unit of microeconomic analysis";recall also sections 4.2. and 4.4.

55) *Ibid.,* p. 56.

overcome these transactional impediments; thus "simple hierarchy can be regarded as substitutions of internal organization for failures in the *labor* . . markets"[56] (my italics).

(ii) the *employment relation:* Williamson considers four alternative modes of *labour contracting* between employer and employee: contingent claims contracting ("contract now for the delivery of x. contingent on event e_i obtaining in the future"), recurrent spot contracts wait until the future materialises and contract for immediate delivery of the appropriate specific x), the so-called Simon authority relation[57] ("contract now for the right to select a specific x from within an admissible set X, the determination of the particular x to be deferred until the future") and the internal labour market (a form of collective organisation where wage rates are attached mainly to jobs rather than to workers, internal labour agreements are reached through collective (not individualistic) bargaining and internal promotion serves as reward for overall performance and cooperation, i.e. not transaction-specific rewards)[58] of these alternative modes only the last does not experience transactional difficulties caused by the above-mentioned factors, explaining corresponding choices to overcome these problems.

(iii) intermediate product markets or *vertical integration:* starting with technologically separable production units and the exchange

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56) *Ibid.,* p. xvi.
57) Cf. Simon, H.A., *Models of Man,* pp. 184/5.
58) Williamson, O.E., *Markets and Hierarchies,* pp. 72-81.

> of components produced by them, Williamson argues that the same transactional factors "which impede autonomous contracting between individuals also impede market exchange between technologically separable work groups"[59]specifically, these factors impede the alternative types of sales contracts - e.g. contingent claims contracts and sequential spot sales contracts all experience difficulties; for these reasons merging the simple hierarchical production units into a (complex) multi-stage hierarchy is chosen since it overcomes these problems; so vertical integration "can be regarded as (the) substitution of internal organization for failures60)in the .. intermediate product markets",[60] and moreover as the extension of the employment relation to include department managers[61] e.g. a previous inside contractor.

The problem which is at issue here is the following: *what is the difference and distinction between (a) employing one* or *many individuals and (b) internalising a market transaction by integrating the (one-* or *many-person) production unit on the other side?* And, does Williamson provide this distinction? Consider the following reasoning: firstly, situation (i) describes *workers* joining a hierarchy to overcome failures in the *labour* markets; if this is an employment process, why treat it separately from situation (ii)? If it is not an employment process, what is it? Secondly, if (i) does not concern employment, is it perhaps

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59)*Ibid.*, p. 56.
60)*Ibid.*, p. xvi; see also pp. 56; 82 et seq.
61)*Ibid.*, p.99.

the integration of one-man firms? If so, why treat it separately from (iii), and why call it a *labour* market situation? Or is employing an individual equivalent to integrating a one-man firm? Thirdly, in (iii) contingent claims and sequential spot contracts are contrasted to merging the parties into one hierarchy, which implies that these contracts do *not* merge them into hierarchy - they are forms of market transacting; on the other hand, in (ii) those exact kind of contracts are regarded as an alternative kind of labour/employment contract between employer and employee, implying that the parties are both in the *same* firm/hierarchy - they are now forms of non-market transacting. How is that possible? What is the source of this inconsistency? Are the contracts considered in (ii) all really alternative *employment* contracts, and is Williamson really discussing the employment relation in particular? Or is he perhaps confusing and mixing employment and integration? (Note that, when describing Coase, he calls the *employment* agreement a single incomplete contract substituted for many complete ones with suppliers.[62]) What is employment proper? What is integration proper? That is the issue.

A second major issue can be illustrated best by a rather lengthy quotation from the article of Alchian & Demsetz which explains their view concerning the voluntary and contractual nature of both the employment and market relations (cf. section 4.3 above):

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62) *Ibid.*, p.4.

> "The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. I can "punish" you only by withholding future business or by seeking redress in the courts for any failure to honor our exchange agreement. That is exactly all any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products. What then is the content of the presumed power to manage and assign workers to various tasks? Exactly the same as one little consumer's power to manage and assign his grocer to various tasks. ..
>
> 'To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like telling a grocer to sell me this brand of tuna rather than that brand of bread.
>
> 'I have no contract to continue to purchase from the grocer and neither the employer nor the employee 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."
>
> "The employee can terminate the contract as readily as the employer, and long-term contracts, therefore, are not an essential attribute of the firm."
>
> "My grocer can count on my returning day after day and purchasing his services and goods ••• and he adapts his activity to conform to my directions to him as to what I want each day .. he is not my employee."[63]

The question is whether there is a difference between the *employer-employee relation* and the *market relation,* in particular with respect to the following:

- the question of authority and punishment;
- the voluntary and contractual nature of the relations;
- directing and assigning as continuous renegotiation of contracts;

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63) Alchian, A.A. & Demsetz, H., *op. cit.,* pp. 777; 783; 777 respectively.

— the importance of the term of the contract: long vs. short.

If there is no difference, as Alchian & Demsetz argue, *what is the distinction between an "employee" and an (inside or outside) contractor?* Since an inside contractor qualifies as a team member under their joint production scheme, they cannot provide this distinction.

Our third case is actually a non-illustration: the view of Jensen & Meckling boils down to the simple nihilism of "there is no such thing as an employment relation because there really is no such thing as a firm". For them only inter-individual exchange contracts exist. Thus they define the problems of employment versus integration or sub- contracting out of existence. Any so-called firm is only a one-man "firm" with a multitude of one-man "subcontractors". Accordingly none of the distinctions we have been considering are given or acknowledged.

5.3 Authority, voluntarism and the durability of contracts

We will now show that a clear and consistent understanding of these issues, with the necessary distinctions, can be derived from "first principles", i.e. from the basic framework of characteristic functions that we have shown are displayed by the firm throughout its historical development. To do this we go back to our basic characterisation of the firm as an organised societal institution within which members of the firm are bound together into a solidary "whole" which is shaped and stamped by its characteristic structure - with its organised capital

foundation guaranteeing its continuity amidst changes in individual membership, and with the overall managing function guiding and stamping all its activities as typical firm-activities.

To this we now add the fundamental insight that the firm can be described as a *voluntary association* an association of people with voluntary membership, based on the principle of freedom the join or leave. As such the firm is to be contrasted with e.g. the family (into which one is born and thus becomes and remains a member independent of one's will) and the State (where citizenship normally derives from birth and cannot be changed at will {and if at all, only subject to various restrictions)).

From this follows that membership of this association originates from an implicit or explicit *contract of membership* or, in this case, employeeship. Moreover, this contract, which constitutes membership of the firm, is nothing else than what is normally known as a labour or *employment contract.* That is why, as observed by Alchian & Demsetz, the employment relation typically displays, like the market relation, a voluntary and contractual nature.

An *employee* is thus a person who has voluntarily entered into such a contract of membership with the employer or founders of the firm, thereby becoming one of the *members* of this organised societal *whole,* within which they are *bound together* - members of the same solidary unit. As a member the employee then occupies a certain office where his task is to

execute the functions of that office, as noted before. He also receives part of the income generated by the firm in its market relations in accordance with some salary scheme (which can take various forms depending on the norms and criteria adopted, as well as the size and stage of development of the firm).

Once his membership has been contractually established, the member finds himself in a typical employer-employee relationship. This relationship typically displays the relation of *authority and subordination,* as often realised in the offices of manager versus worker (or higher versus lower manager). Although Alchian & Demsetz, stressing its voluntary and contractual nature, strongly suggest that the firm is therefore not characterised by any authority relation, I submit that their arguments and conclusions are based on a profound *misconception of the typical nature of the authority relation in the firm* - basically due to their lacking insight into the typical nature of the firm as such - leading them to believe that there is no authority *at all.*

We can explain the existence and nature of authority in the firm as follows. The fact is, first of all, that the relation of authority and subordination is implied by the fact that the firm is an organised whole with a more or less continuous existence. It is a *durable organisation* (the latter in the sense of section 3.1.2), and its durability implies the existence of durable membership with durable

contracts which cover and allow a range of possible tasks. For if the firm has to negotiate a separate exchange contract for each specific task as it arises, no "worker" ever becomes a (durable) member - it can only be a series of momentary contracts/exchanges. Indeed, *the concept of membership per* se *implies continuity and durability in the employment relation* as against a more or less instantaneous market exchange relation (which does *not* establish membership of an organised whole. As indicated by Coase[64] and Simon,[65] and as Williamson as well as Alchian & Demsetz acknowledge, such durable contracts (i.e. (membership-type) contracts which allow a range of tasks) imply the relation of authority and subordination, whence Alchian & Demsetz' insistence that durable or long-term contracts are not an essential attribute of the firm, and that recurrent spot contracting is typifying of the employer-employee relation. (See note on long-term sales contracts on the next page.)

The point is that Alchian & Demsetz are absolutely correct when they say that the employer has no authority over a person with whom he contracts (spot contract-style) for a single and specific task. However, *such a person* is *not an employee,* not a member of the firm. What they say amounts to the truism that an employer has no authority over non-employees, e.g. subcontractors. For if the contract is only for delivery of a single, specific task that "worker" never becomes a member of the

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64) Cease, R., *op. cit.,* pp. 391/2.
65) Simon, H.A., *op. cit.,* pp. 184/5.

firm, but *remains a contractor/supplier* external to the firm who simply exchanges a single specific finished product (the results of the task he performed) for a specified price in a more or less instantaneous market exchange relationship. There is no durability, no mutual membership, and especially *no authority relation* in such and other market exchange relationships. (Note that a so-called long-term sales contract must be regarded not as a long-term or durable *exchange* relation as such, but only as an implicit or explicit[66)] agreement to repeat the non-durable exchange relation at certain intervals, say. The "worker"/supplier remains external to the firm, not a member, and not under the firm's authority. This is the same kind of situation as in the interim period between a person's agreement to become an employee and the actual commencement of membership - the employer has no authority over the future employee in this period.)

A *true employment* contract, a *membership* contract, on the other hand, is not for delivery at a specified price of a specific and single task or product to the employer or the firm. Instead it enters the individual into a durable societal whole where, as a member, he performs the tasks delegated to him at the time (according to his office) by the employer, receiving a corresponding income. As such the employer can change the delegation or details of these functions, i.e. he can assign the employee to various tasks, all which fall within the category of the

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66) Cf. Klein, B., Crawford, R.G. & Alchian, A.A., *op. cit.,* for a discussion of implicit vs. explicit contracts.

characteristic functions of the firm and which are covered by the one contract of membership. He has authority over the employee. In the quotation from Alchian & Demsetz above the employee's typing the letter or filing a document are both covered by one membership contract, whereas buying tuna or bread from the grocer implies two separate non-durable exchange relations ("contracts").

The crucial insight here is thus that the actual employer-employee relationship is not contractual - only its original *establishment* is. The contractual *aspect* of the employment relation is thus typically different from the contractual aspect of the market relation. Alchian & Demsetz' problem is that they fail to recognise and incorporate this distinction. In addition, whereas it is quite true that one has no agreement to continue to buy from one's grocer (which would in any case not be a durable *exchange* relation as such, as noted above), a true employment/membership contract does imply a durable relation. Once again - Alchian & Demsetz' "employee" is no real employee, no member of the firm, hence their false conclusion.

So - to paraphrase Alchian & Demsetz - to speak of the employer being continually involved in renegotiation of (spot) contracts with "employees" is a deceptive and incorrect way of noting that the employer is managing, directing and assigning employees to various tasks under a single durable *membership* contract with an implied *authority* relation.

The fact, duly noted by Alchian & Demsetz, that an employee can terminate the membership contract does not change this fact. Its voluntary nature does not imply that the membership is not durable ("long-term"), nor that the employer does not assign employees to certain tasks *during* their voluntarily entered into membership of the firm. In voluntarily accepting membership the employee just as voluntarily accepts the authority of the employer to assign and direct him for the duration of his membership. As Williamson notes,[67] the employment relation is associated with voluntary subordination. And as long as he remains a member the employee is subject to direction and assignment by the employer. The fact that the firm is a voluntary association does not rule out the existence of an authority relation per se. It does, however, have important implications for the *nature* of this authority relation - it places bounds on the exercise of authority, as we shall see in the next section.

5.4 Authority and the characteristic structure of the firm

Most important, however, is that *this relation of authority and subordination is not to be understood apart from the characteristic structure* of the societal institution in which it is present. The typical nature of authority in the firm will be *determined* by the firm's characteristic structure. The principle of a characteristic structure

67) Williamson, O.E., *op. cit.,* pp. xv; 54.

implies that the authority relation in the firm is quite unique and unlike any other kind of authority - especially unlike authority in the State - because, being inherent in the (internal) employer-employee relationship, it is qualified and shaped by the typical nature of the firm, and in particular by its unique characteristic structure.

Thus, firstly, this authority relation is stamped and guided by the firm's leading function, the overall managing function. It is authority to direct, assign to, organise and coordinate employees in all activities and functions related to the production and/or distribution process of the firm. It is *authority only with respect to activities that fall within the range of the characteristic functions of the firm,* i.e. the typical firm-activities of the employees.

Secondly, and crucially important, this authority is founded in the organised capital power of the firm. Recall (section 3.1.2) that the firm's capital foundation gives it the kind of power necessary to employ production factors and organise these. Thus the employer's authority over employees *has organised capital power as its foundation.* Only capital (or "economic") power, which is in the first instance the power to employ. This is a particular *kind* of power which provides the employer with a particular *kind* of authority that enables him to direct and organise the employees.

Thirdly, and perhaps obviously, this authority is valid only with respect to members of the firm, the employees. They are, as such, only voluntarily subject to this authority and that only as long as they remain members of the firm. This implies a constraint on the exercise of authority which, together with the "economic" nature of the power, rules out compulsion.

All this means that the top manager of the firm has a typical and specific *internal sphere of competence and authority,* where his competence and authority are circumscribed and characterised in (at least) three ways which are typical of the firm as societal institution:

- it is authority only with respect to voluntary members of the firm;
- it is authority only with respect to the typically firm-related activities of these members;
- it is authority based only on organised capital power.

This authority and competence can be delegated to lower level managers and employees, so that the offices that we discussed in section 5.1 each carry, in addition to delegated functions, a similarly shaped and circumscribed delegated authority over those in offices under them in the hierarchical structure. The latter is, accordingly a true *structure of authority,* not just of functions.)

As such the firm's authority relation is radically different from that in any other societal institution and, especially, different from the authority relation in the State. In the latter the government's authority is based on organised *military and police power,* i.e. power of physical *force.* (In addition membership of the State-institution and thus subjection to this authority is not voluntary.) That this *kind* of power and associated *kind* of authority is radically different from that in the firm is crucial to understanding the authority relation in the firm. The fact that the firm does *not* have physical force or power as foundation of its authority relation does *not* imply that the firm does not have *an* authority relation at all. Authority does not necessarily presuppose *physical* power.

Such a misunderstanding may be at the root of Alchian & Demsetz' denial of the existence of authority in the firm. Note their use, in this context, of the terms "authoritarian", "dictational" and "fiat", words commonly associated specifically with the State and with physical coercion. Absence of *physical* power does not imply absence of authority in the firm. It merely points to the *nature* of this authority relation.

Insight into and clear distinction between different kinds of power- and authority-relations is thus essential. As further illustration, consider Alchian & Demsetz' remark that the firm does not *own* all its inputs (meaning labour), whence they argue for an absence of authority. Although this difference between physical inputs and "labour" is accurate - only the former can be owned by the firm - they yet again

fail to see the relevant distinction, which is with respect to the power-aspect of the employer-employee and firm-input relations respectively. The latter is usually characterised by ownership of the inputs by the firm, which implies a relation of physical power between employer (or employee) and physical input. A production process, for instance, embodies nothing but the exercise of human formative *power* over the "dead" physical materials, thereby forming and creating a product. That this is not true of the relation between employer and employee is absolutely correct, but that does not imply that the latter relation does not contain *authority* (presumably for lack of power upon which to found an authority relation, in turn presumably due to lack of ownership). It has capital power as foundation of its authority. And the relation between employer and materials is, in any case, not one of *authority,* even though it embodies (formative) physical power. It is yet another quite different *kind* of relation which has to be clearly distinguished from the others. In general it should be noted that power and authority are not identical, and authority does not presuppose ownership or physical power. Without these insights and distinctions false arguments like that of Alchian & Demsetz can easily be made.

To return to our central distinction between internal and external relations we note, again, that there is *no relation of authority and subordination inherent in inter-individual, inter-firm, firm-supplier* or *firm-customer (exchange) relationships.* This is so precisely because

the participants are not bound together in any durable solidary whole which could have an *organised power foundation* to *found such authority.* (The same applies to the pre-contract relationship between firm/employer and prospective employee.)

A last remark on the constraining effect of the in principle voluntary nature of the firm on its authority relation. Situations in actual labour markets may frustrate the formal freedom of individuals to join and especially to leave the firm, for example due to very limited or one-sided skills (the idea behind the notion of so-called structural unemployment). In such conditions membership of the firm may seem to assume a more or less "compulsory" nature, allowing a less constrained exercise of authority in the firm. This, however, does not change the fact that the typical nature of the firm entails voluntary membership, in principle. Similarly market conditions in inter-individual-type exchange relations may introduce inequalities into these relations which may give the *appearance* of authority, e.g. the case of a monopolistic producer or a monopsonistic demander of a certain kind of labour. This *pseudo-authority* has to be clearly distinguished from real intra-"whole" authority, especially in discussions of the so-called "power of the corporation" (see the introduction to chapter 6).

The last aspect of the employment relation that we will consider is the punishment issue. Once again certain distinctions will be crucial.

5.5 Authority and punishment - internal legal relations

Authority is quite commonly associated with the ability to punish, as the passage by Alchian & Demsetz illustrate. In this section we will consider the exact meaning of punishment, its relation to authority, and its realisation in the firm vis-a-vis the market. This is essential to an understanding of the nature of the employment relation in particular and of the difference between internal and external relations of the firm.

The term punishment is often used very loosely, leading just as often to confusion about the punishment aspect of different relations. To avoid this we will attempt to give a more precise meaning to the term, and will point out the usefulness of doing that. First of all true punishment will be understood as a typical *legal* or *juridical* concept. True punishment can be seen as the response to violations of a law, in particular the infliction of deserved pain on the violator to restore respect for the violated law and order. A common example of this is criminal punishment which is the response to violations of the State's criminal law.

Corresponding to the internal and external relations of the firm one can distinguish between internal and external legal (or juridical) relations of the firm - a very important distinction. The latter refers to the legal relations embodied in the *external* relations of the firm with

(external) individuals or institutions, e.g. exchange relations with suppliers and customers (whose legal aspect is often formalised in a legal contract). Such contracts and their enforcement fall under the civil legal authority of the State - the latter provides a stable legal order and framework for harmonious inter-firm or firm-individual relations, providing for the enforceability of such contractual relationships via the disciplinary competence of governmental authorities. Legal disputes following breach of contract, for example, have to be settled under the legal authority of the State, and form the only juridical way to settle such disputes (and obtain redress, say).

In contrast to this are the *internal legal relations* of the firm. These concern only current members of the firm, exist not in the legal sphere of the State but in the firm's internal legal sphere and are governed by the internal law of the firm. Although one customarily associates "laws", "legality", etc. with the State, it is important to realise that other institutions like the firm have their own *internal* rules and regulations which are quite different and separate from the rules and regulations (laws) of the State, but are nevertheless *legal* or juridical in nature. An example of the difference and distinction between the two legal spheres is the fact that the legal employment contract itself — the actual *contract of establishing* the relation, not the employer-employee relationship that exists afterwards - falls under the civil legal authority of the State, as does violations of the terms of the contract by either party. But actions *within* the bounds of the

already established contract fall within the *firm's* internal legal sphere. Breach of contract is a civil law matter, but internal juridical "wrongs" that occur within the bounds of the contract - breaking an internal rule of the firm, say - cannot be redressed in a civil legal way by suing, for example, since it is a matter of internal law and as such does not fall under the legal authority of the State.[68]

The internal law of the firm may comprise things like: rules concerning the inner constitution and order of the firm, rules concerning the legal competence of offices, conditions for occupation of offices, conditions concerning promotion and demotion, conditions for membership and expulsion, stipulations regarding disciplinary and grievance procedures, and so forth. All these are in principle *juridical* in nature. They are not, however, of a civil law character and differ radically from law in the State (and other institutions). This is so in particular because, as implied by the principle of a characteristic structure, the firm's internal law and internal legal relations will be *shaped by the characteristic structure and typical nature of the firm.*

Firstly, the firm's internal rules and regulations receive their positive contents from "lawmakers" in the firm under *guidance* of the overall

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68) The legal spheres of the firm and the State are, however, interlaced in the sense that a civil judge does have the competence to judge *whether* a rule has in fact been broken, i.e. whether the decision to punish the offender is in fact lawful *in terms of the internal law of the firm.* But he has no competence to judge the material content of this law.

managing function and are as such directed towards orderly execution of this function. The rules and regulations are *firm-typical.* Similarly they have their foundation in the organised capital power of the firm, which provides for their enforcement.

Secondly, the authority relation of the firm, also, is expressed in the internal legal sphere of the firm in the form of the *legal* authority of the employer/top manager (and others to whom it is delegated) over members of the firm, i.e. the authority to make and enforce internal law. In the latter, which is the *disciplinary authority* of the employer - a disciplinary competence limited to the internal legal sphere of the firm - we find the true relation between authority and punishment in the firm. That is, *real punishment presupposes legal authority* of the punisher in the firm. (It concerns, of course, only the legal aspect of the firm's internal authority relation.)

Recall that punishment in general was described as the infliction of deserved pain on the violator to restore respect for the violated law and order. Within the firm, in the employer-employee context, punishment assumes a *special character* which can only be understood in accordance with the characteristic structure of the firm - the latter completely determines the typical nature of punishment in the firm. Thus, firstly - in the light of the firm being an organised and ordered whole - true punishment in the firm is directed towards *restoration* of the violated organisational order, and not merely towards compensation, revenge or

retaliation. Internal order must be restored to facilitate orderly execution of the characteristic functions of the firm. Secondly, the punishment (the inflicted "pain") has a *firm-typical character* which derives from its guidance by the leading function and especially its foundation in organised capital ("economic") power– unlike in the State, where punishment is based on physical power and in the last instance entails physical incarceration of the violator.

Punishment in the firm can then take either of two forms. The extreme form is expulsion of an employee from the firm, i.e. termination of his membership by the employer (who stops using his capital power to employ the person - he "fires" him). But then - and this is the kind of punishment not acknowledged by Alchian & Demsetz - there is punishment *within* the firm, within the internal legal sphere of the firm, with the violator voluntarily remaining a member and thus subject to *internal punishment.* As such it is very different from either suing or firing an employee. It can have many forms, depending, among other things, on the size, complexity and stage of development of the firm – legal relations, laws and punishment-procedures also "unfold" as the firm does. The so-called internal labour market provides one such form: punishment by emotion or non-promotion, inflicting decreased authority, income, prestige, etc.[69] Simpler forms of firm-typical punishment may be withholding of bonuses or wage-increases, say. (Such direct financial punishments are often precluded by contract and/or

69) Cf. Williamson, O.E., *Markets and Hierarchies,* pp. 74-79.

union stipulations - hence the transition to other forms of internal punishment? - but in simpler forms of the firm they are likely to be of much more importance.) Most important is the fact that all such internal punishments have a firm-typical character - the employer does not and cannot imprison the employee, for instance - and these are inflicted by an internal authority with limited competence (recall section 5.4).

The option of internal punishment is only available within the firm. In the firm's *external* relationships, as in inter-individual relationships, the (exchange-) participants are not bound together in a societal "whole" which could have an authority relation based on organised power. *These relationships lack any internal legal authority,* which is presupposed by real punishment. One party in the exchange can thus not inflict real punishment on the other. The only punishable juridical "wrong" in these relationships is a breach of contract which, just like a breach in the employment contract, can only be redressed in civil court, i.e. under the legal authority of the State (whose internal order, in fact, is the one that has been violated by the breach of contract).

This, however, is not true punishment of one party by another. One sign of this is that the dispute-settling is not directed, as such, towards restoration of the violated (exchange-) relationship, but towards compensation (redress) of one party. Similarly one party's decision

not to repeat the exchange-relation (not to buy from the grocer, say) is in principle not true punishment by that party of the other. It is also not directed towards restoration (i.e. recurrence) of the relationship. Moreover this action only has the appearance of punishment, of inflicting "pain", in situations where the buyer, say, has market power (as a monopsonist, say), and then it is only pseudo- punishment. In general this embodies at most the notion of market discipline. This is quite unlike legal authority and punishment within the firm and is, in turn, a typical feature of the market relation.[70)]

5.6 Employment, subcontracting and integration

We have derived, with the aid of the notion of a characteristic structure of the firm, a number of typical features that characterise the employment relation, at the same time pointing out its differences from the market relation. In this section we can now combine these conclusions without discussion of internal versus external relations in chapter 4 to consider, finally, the complex relation, coherence and distinctions between the employment relation, the process of vertical integration and the market (-contracting) relation. This, as we noted earlier, is crucial to the viability of a theory of the nature of the firm (as such and vis-a-vis the market). We will also give final consideration to the other approaches we have been referring to.

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70) Klein, B. et al, *op. cit.,* pp. 302-307, is an example of failure to make this distinction when discussion market- vs. legal *enforcement* of "long-term contracts".

The basic source of confusion with *employment* and *vertical integration* is that the two go together so often that they are just as often confused with each other. Integration, as noted before (section 4.5, footnote 48), in the first instance involves inclusion by the integrating firm of certain new functions (previously performed ("for" it) by another firm, say) in its own overall managing function. These functions require people to perform them, either current or new employees. The latter can be individuals unrelated to the other firm, or - for example in the case where the whole firm on the other side of the previously external market relationship is internalised - the same individuals who performed the tasks in the other firm. In all cases employees are involved, but only in the latter two do new employment relations concur with the integration process. The point of this is that *integration does not necessarily imply (new) employment* - it is only one of the instances when employment occurs. Similarly *employment as such does not imply integration,* but merely membership of an additional individual. The two processes are *distinct,* even though and even when they occur simultaneously in some cases. One concerns internalisation of an individual, the other of a firm. This is true even in the extreme case of integrating a one-man firm - it involves two different processes. (Recall that an individual producer is, in principle, a firm because his "unit" has to possess and perform the characteristic functions of the firm.)

Moreover, in terms of the *internalisation of transactions* the two processes differ markedly. When a producing unit is integrated, a formerly external exchange relation is internalised at the same time. Accordingly, in this process all the transactions cost factors, as enunciated by Williamson and Klein, Crawford & Alchian, can be of utmost relevance in determining the extent of internalisation. In contrast the employment process *per se* does not comprise internalisation of a formerly external transactions-relation. Even though employment can be viewed as the internalisation of an individual (but, note, not of a one-man firm), the transition is from the *absence* of any exchange- or transactions-relation to the existence of an employment relation. Consequently *the decision to employ per* se *has nothing to do with transactions costs* and cannot be explained by the latter. Similarly one cannot, as one would compare an inter-unit intra-firm transaction with its execution in the market, compare an employment relationship "under authority" (i.e. within the firm) with one "in the market". True employment is by nature and in principle *intra-firm.*

This is the major and fundamental misconception in Oliver Williamson's treatment of employment and vertical integration, and - valid as his analysis of transactions cost may be - the source of the apparent inconsistencies outlined in section 5.2.1. Thus his discussion of the "labour market", with individuals/workers being joined in simple hierarchies to overcome transactional impediments, concerns in the first instance the joining of one-man firms (producers), and is thus simply

a view of integration - but a preview of his later discussion of vertical integration. It is not the labour market proper that he is discussing at all. Secondly, his transactions cost explanation of the "employment relation" harbours a confusing mix of the employment and integration processes: he regards recurrent spot or contingent claims contracting as· alternative modes of *employment,* while they really are only alternative modes of *subcontracting,* i.e. of exchange relations. Again he mostly explains and describes integration, not employment. Thirdly, his definition of vertical integration as the extension of the *employment* relation to include department managers (e.g. inside contractors) displays the same confusion. (See also the quotation of footnote 62, section 5.2.1.)

The other fundamental distinction is between *employment* and (sub-) *contracting* (or between employee and subcontractor), whose differences we have discussed amply in this chapter. Failure to take account of these differences and distinctions lies, of course, at the root of Alchian & Demsetz' problematic view of employer-employee vis-à-vis firm-supplier or firm-customer relationships and their lack of any real distinction between these two kinds of relationships.

Jensen & Meckling, not unexpectedly, do not provide *any* distinctions with respect to employment, integration and (sub-)contracting, since all but the latter are defined out of existence. As we indicated before, they have this extreme view that acknowledges only inter-individual

market exchanges. Accordingly they see only a multitude of individual producers (one-man firms) contracting with each other. For them the choice between integration and subcontracting does not exist. (As an aside, note that the latter is the only real choice facing the firm in this regard; employment versus either integration or subcontracting are not as such the relevant options. Employment merely accompanies integration in some instances, and is not the real alternative to subcontracting, even of a one-man firm.)

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With their failure to fathom the differences and provide the distinctions between the external and internal relations of the firm the authors we considered lose the ability to provide insight into the nature of the phenomena of the firm and the market. What lacks explanation, notably, is:

- the *inner unity* of the firm versus the absence of such unity in the market relationship;
- the *durability* of the firm and its internal relations versus the non-durability found in market relationships;
- the presence of *authority* in the firm versus its absence in market exchange relationships;
- the presence and nature of *punishment* in the firm as against the market;
- the *contractual nature* of both, and the difference in these;
- the different way in which both are *voluntary* in nature.

These failures are intimately linked to their failure to make clear distinctions between the different kinds of relations in and around the firm. The characteristic structure-approach that we developed here, by contrast, does succeed in providing such distinctions and does expose and identify the nature of the firm (as such and vis-a-vis the market). A major reason for this is that it does not attempt to understand the firm solely from so-called "elementary elements", e.g. inter-individual relations, in which case the existence of forms and structures in society within which individuals live and work are effectively denied. Secondly, our approach does not attempt to study the firm and the market from a single exclusive viewpoint, e.g. the contractual aspect of both. (Recall the statement of Jensen & Meckling that "contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc.", section 4.4, footnote 43.) Focusing exclusively on a single *aspect* invariably leads to the disregard of other relevant features and distinctions which bear on the typical nature of each contractual relationship. The danger is always that one may ignore the typical nature of the firm or the market when considering a specific *aspect* of it. But such an aspect will always display a certain typicality due to it being an aspect *of the firm* or market, and ignoring this eradicates differences and boundaries between different kinds of structures and relationships, precluding identification of the typical nature of each.

Accordingly our approach was developed utilising the historical development of the firm. In an attempt to capture the broad typicalness displayed by this societal institution we derived from its historical development the firm's characteristic structure - the characteristic functions in their special roles and coherence. This was done ensuring as far as possible that it captures the way the firm is and has been observed and experienced *in its totality* (taking care not to deny or distort the latter by focusing exclusively on a single aspect of the firm) and that it has *general validity* with respect to firms of all forms and stages of development. So far this approach has been both useful and powerful in providing insights into and distinctions with respect to the issues of the last two chapters, simultaneously clarifying the weaknesses of other approaches. Other issues, however, remain to be considered.

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PART III. OWNERSHIP, CONTROL AND PURPOSES

6. OWNERSHIP, MANAGEMENT AND CONTROL: INTRODUCTION

One major feature of the firm that we have not considered yet also derives from the role of capital in the firm, i.e. the role of the so-called "owners" in the firm. Especially relevant here is the relation between the "owners" and management - the "control"-issue. The nature of this relationship has profound implications for what is known as the theory of the firm. It also deeply concerns the issue of the role of modern corporations in society - the power, legitimacy and responsibility of management, for instance - an issue on which there is little or no consensus. We will argue that no clear picture of these relations has yet been presented, and that the source of much of the confusion and controversy is a *false conception of the problem.* We will then use our structural approach to suggest, as part of our general theory of the nature of the firm, a clarifying, consistent and quite general view of the whole picture.

Historically the problem surfaced with the creation of the joint-stock company, which alerted economists to possible opportunities for managers of such firms to depart from the classical entrepreneurial model when "ownership" becomes dispersed and separated from "control". Adam Smith disapprovingly noted that "directors of such companies, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance ... Negligence and profusion, therefore, must always prevail,

more or less, in the management of the affairs of such a company".[71] Alfred Marshall similarly acknowledged that a joint-stock company may deviate from the entrepreneurial profit-maximisation model by negligence or subordination of profit objecives.[72] Keynes also pointed out that if and when stockholders become dissociated from management "the direct personal interest of the latter in making a profit becomes quite secondary.[73]

Modern revival of interest in the issue of the separation of "ownership" and "control" lies in Berle & Means's classic 1932-study *The Modern Corporation and Private Property,* in which they document, with considerable alarm, the extent to which economic "power" has become concentrated in large corporations, the significant degree of dispersion of stock ownership, the transfer of effective control to non-owner managers, and then ask the key question: "have we any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of the owners?".[74] This is a crucial question, for an affirmative answer would destroy, as they put it, the very foundation of the economic order of the last three centuries. This study provided the intellectual basis for a growing dissatisfaction with the neo-classical assumption (and implicit prescription) of single-

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71) Smith, A. *The Wealth of Nations,* p. 700.
72) Marshall, A. *Industry and Trade,* p. vi.
73) Keynes, J.M. *The General Theory,* p. 316.
74) Berle, A.A. & Means, G.M., *op. cit.,* p. 113.

minded pursuit of profits by the manager, particularly in those situations where the manager is insulated from both product market and stockholder pressures - the position the modern corporation is not unlikely to find itself in. Several alternative theories of the firm, all incorporating managerial discretion and maximisation of something other than profits subject to some minimum performance constraint, have been suggested, as we noted in chapter 1. Baumol, Williamson, Marris, Galbraith and others all build on the heritage of Berle & Means's empirical findings, in particular its implications for the interests, objectives and purposes of groups of people connected to the firm.

Another level of debate, but with similar origins, concerns the role of the corporation in modern society, in particular because those in "control", which some say lack legitimacy and accountability having become separated from "ownership", seem to have so much "power". No consensus exists. For example:

> "The 'viewers with alarm' are approximately balanced by the 'pointers with pride'. On the one hand, we hear much talk of 'a new feudalism,' and of 'self-perpetuating oligarchies,' of 'irresponsible private power,' and of 'the euthanasia of the capitalist owner.' But one the other, we are told of 'the twentieth-century revolution,' the 'professionalization of management,' the various 'public' whose interests are sedulously cared for, and the beneficiency of the 'corporate conscience.'"[75)]

Others, on yet another hand, reject both of these views as well as the Berle & Means interpretation, and see corporations as not-so-powerful and aligned to stockholder interests. For instance, Friedman:

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75) Mason, E.S. (ed.), *The Corporation in Modern Society,* p. 2.

> "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for the stockholders as possible.
>
> "The corporation is an instrument of the stockholders who own it.
>
> "A major complaint made frequently against modern business is that it involves the separation of ownership and control - that the corporation has become a social institution that is a law unto itself, with irresponsible executives who do not serve the interests of their stockholders. This charge is not true."[76)]

Central to these debates is the relation between, on the one hand, the whole ownership-management-control issue, and on the other hand, the interests, objectives and purposes of (groups of) people connected to the firm as well as of the firm as a whole. Herein lies its importance for the study of the behaviour of the firm, the so-called "theory of the firm", which seeks to deduce and predict firm-behaviour from individual objectives and motivations.

We consider, firstly, the role of interests, objectives and purposes in the firm.

6.1 The role of goals and purposes and the nature of the firm

Our primary concern in this study is to gain insight into and an understanding of the general, typical nature of the firm as societal

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76) Friedman, M., *Capitalism and Freedom,* pp. 133; 135; 135 respectively.

institution. For these purposes we have been developing our structural theory of the firm. The reader must have noted that in our derivation of the characteristic structure as the essence of the typical nature of the firm we made no mention whatsoever of profit-maximisation or other goals which are so central to theories of the firm. This must seem like a critical omission, especially in the light of orthodox economic theory's (implicit if not explicit) acceptance of the goal of profit- maximisation as the one clear common element in all firms, which would seem to make it a *typical* feature of the firm and thus an essential element in a theory of the nature of the firm. (The traditional dichotomy between firms and "non-profit institutions" is but one manifestation of this view.) If our theory is to be useful and also general, it must be able to clarify the position of goals with respect to the firm - they are too prominent, indeed dominating in controversies surrounding the firm to be left unexplained.

We thus have to ask: what place do goals and purposes have in the general nature of the firm as such? Does the objective pursued by the firm explain or determine its inner nature? Is "leading function" just another name for goals or purposes, making the firm's objective or goal its main characterising and identifying feature (as against other societal institutions)? (Whose goals? "The" firm? Owners? Management? Labour? Individuals?) We will show that significant new insights are to be had from our characteristic structure approach.

One note of caution. In considering these questions it must be kept in mind that we are trying to transcend the diversity of the variable positive forms of the firm displayed through history and at any point in time - to penetrate to the constant features common to all these variability, as such indicative of the general typicalness of the institution. We must not be misled by peculiar features of positive firms in particular situations or economic systems, for that will confuse any attempted analysis of the inner nature of the firm per se.

The question of "control" makes it necessary to distinguish, at this stage, between the goals actually pursued by a firm in its policies, and the purposes of (groups of) people connected to the firm (who may or may not "control" it). Whether and how these may differ will be considered later.

6.1.1 Purposes actually pursued by the firm

Firstly, consider the objectives actually pursued by a firm in its policies. It is important though very simple to dispense with the notion that the firm's general, typical inner nature is characterised, determined or explained by any objective actually pursued, e.g. profit-maximisation. For it would imply that a "firm" that is not pursuing maximum profits, say, is not a firm, thus excluding (most) government corporations, socialist firms, Yugoslav-type worker-firms, and also any non-profitmaximising private capitalist firm from this category. Each

"firm" would in effect be a different kind of societal institution, and will change if its objective changes during its lifetime. The same applies to any other particular goal (salary, security, status, etc.): it can never explain or determine the inner, typical nature of the firm, cannot be a characteristic feature of the firm in general, cannot be an inherent part of the typical nature of the firm. *The typical character of the firm as societal institution has* to *transcend firms' particular goals and purposes* which are, as such, subjective and dependent on, for example, product market conditions and/or, as Berle & Means suggest, the degree of separation of ownership and control. As such they are a matter of policy to be determined by each positive firm during its actual existence.

6.1.2 The purposes of the founders of the firm

A group of persons with particular significance is the founders of the firm, and this present one way in which purposes as such do have a general role with respect to the firm. This derives from the fact that the firm is by nature a voluntary association, as discussed in section 5.3, where we noted the principle of freedom to join or leave the firm, i.e. voluntary membership. The wider significance of this voluntarism lies in the initial formation and organisation of the firm, which as such requires *voluntary cooperation* between individuals in the inter-individual relations between them.[77] For these individuals, who are the

77) A firm can of course also be founded by one individual, or by another organisation. The latter is discussed in section 9.2.

founders of the firm, purposes which they want to pursue are to be regarded as the prime motivation behind their actual organisation and constitution of the voluntary association called a firm. This is inescapably implied by the category of voluntary association. The founders of a firm can thus be seen as voluntarily choosing this particular societal institution as an eminently suitable *means* to achieve their *ends.* When founders voluntarily get together in a cooperative effort to found a firm, they in effect make a formal or informal contract of association, or "social contract" - the "constitution" of the firm - in which they specify, in an act of consensus, the way in which this firm will be constituted as *means* to achieve a common purpose. (A modern corporate charter is an example of such a constitution.) We thus see that ends or purposes (i.e. in general, no particular one) have a *constitutive role* with respect to the firm and are, as such, essential to the initial formation and thus existence of any firm. In this sense they are indeed very important with respect to the firm.

So, for instance, the subjective common purpose of the founders of a private manufacturing firm may be to make profits from the production and sale of certain goods. Getting together and founding a firm is thus the establishment of the means to achieve their end. The father of a traditional family may start/found a (subsistence) family farm as the means to achieve his purpose of providing for him and his family. The purpose of the founders of a community-type worker-organised firm is

perhaps the provision of certain products (food?) to the community, or providing jobs for community members. The founders of a government corporation (the State) perhaps see it as the means to achieve their end of relieving unemployment, or developing a middle-class, or laying the foundation of an industrial economy (e.g. in the case of a steel corporation), or developing the infrastructure (a government railroad company, say).

In each of these cases the initial formation of the firm is dependent upon the purpose(s) of the founder(s), and such purposes in this way have a crucial role with respect to the firm. In is for this reason that, in the capitalist system and with respect to the private capitalist firm in particular, the pursuit of profits have had such prominence. For it is undeniably true that the founders of the modern private capitalist firm in all likelihood see the firm as the means to achieve the end of profits. But it is just as true that, in this founder context, purposes other than profits can be and often are pursued by founders in the establishment of firms.

This again implies, also in this context, that *the particular purpose of the founders does not explain or determine and is not part of the typical nature and identifiability of the firm as societal structure.* Even though the different founders noted above have different purposes in mind, the voluntary associations established as the means to achieve these ends are all *firms,* which means that the founders are bound to

its unique inner nature. The typical nature of the firm is thus, in itself, quite independent of any subjective purpose of the actual founders of any firm - it does not determine the latter nor is it determined by it. This means that the question "what is the firm?" or "what is the nature of the firm?" cannot be answered by looking at the purposes pursued by the founders of the firm (or anybody else, for that matter).

6.1.3 Purposes and the characteristic structure

Accordingly, what we call the firm's characteristic structure, as embodiment of its typical inner nature, cannot determine or be determined by any objective or purpose either, since it transcends the latter. In particular, it should be clear that the leading function of the firm (i.e. managing), by definition its essential identifying feature, cannot be identical to and should not be confused with any purpose pursued by the firm or (groups of) people connected to the firm.

Firstly, such a purpose can also be achieved in non-firm activities (e.g. profit from selling one's house) or associations (e.g. a numismatic society created to provide profitable mutual trade opportunities for its members). Were one to seek the leading function of the firm in the pursuit of any particular purpose, it would make the firm indistinguishable from some other organised associations as well as from activities/relations between individuals or organisations (i.e. "external"-type relations) in which the purpose can also be achieved.

One cannot explain the nature of the firm from the purposes individuals connected with it may have. (Such an error is implied in the Alchian & Demsetz- or Jensen & Meckling-type approach which views the firm as but a set of inter-individual (exchange-)contracts, with each individual pursuing his own purpose - maximising his utility function[78] - and seeks to explain the nature of the firm, accordingly, from the range and purposes of the contracts. See sections 4.3 and 4.4 above.) Secondly, for purposes to be actually pursued by the firm it must first exist, which implies that the founding and leading functions have to be performed *for* objectives to be actually pursued.

Because the characteristic structure thus transcends particular purposes, as a theory of the nature of the firm our structural approach meets the requirements of general validity. It is able to accommodate all kinds of firms (private, government, socialist, worker-founded) and any objective that may be pursued by founders and/or in actual firm policies, as well as any historical form of the firm.

A firm's founders, who choose the firm as suitable means to an end, are thus bound to the unique characteristic structure of the firm, to its unique inner nature. If they want their means to be a firm, they have to have the capital formation and overall managing functions performed - a requirement quite independent of the particular purpose in mind, which it transcends.

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78) The fallacy of this approach is apparent in the fact that to specify the utility-functions of the individuals so that they are suitable for the analysis, they have to incorporate firm-specific elements, as such presupposing some idea of *what the firm is* before the whole exercise.

6.1.4 Purposes and the positive form of the firm

The *positive form* of actual firms, on the other hand, will of course not be independent of founders' purposes. The particular way a firm is organised and constituted - its line of business, the product or service, financial structure, incorporation or not, internal organisation, size and location, and above all *how* the characteristic functions are to be formed and executed - all that will be determined by the particular purpose in mind. But in all the cases the particular positive form of a firm is inextricably bound to the structural typicalness of the firm, to its characteristic structure, because it is but an *actualisation and manifestation* of the latter. Similarly, if the actual objectives pursued by a firm differ from those of the founders, these objectives will affect the positive form of the firm, but this positive form will also be a variable manifestation of the firm's characteristic structure, apart from which the firm as societal institution could not be realised.

Moreover, all objectives and purposes have to be pursued in a way consistent with the typical nature of the firm, otherwise the firm itself may become threatened. These functions imply a norm, a *task.* In particular, the managing function has to be performed at least such that the capital foundation of the firm is not threatened, which implies

a "structural" constraint on the positive form that may be given to the managing function in pursuit of objectives. (The potentially destructive role of speculators is a case in point. Also see section 9.5.)

This, incidentally, also applies to an individual who becomes a member of a firm with certain personal purposes as end - salary, prestige, etc. Once a member of a *firm,* he has to operate within the (characteristic) structure of the firm, and the general pursuit of individual interests without regard for the "whole" will threaten its unity and ultimately its existence. (Recall section 4.5.) On this point a Jensen & Meckling-type contractual view of the firm is again disqualified. Because they cannot see beyond two-participant inter- personal exchange contracts, they cannot make the necessary distinction between such a contract and, on the one hand, the formation of a voluntary association when founders get together to constitute a firm as means to a common end and, on the other hand, an individual joining an existing firm by means of which and within which he may want to achieve certain personal ends. Accordingly they cannot provide any perspective on the various contexts in which purposes may have a role in the firm. Their extreme individualism limits their vision of purposes to individual purposes individually pursued by "autonomous" individuals outside of any structure or organisation.

This concludes our analysis here of the role of goals and purposes in the firm, with as main result the typical relation between the founders' purposes and the typical nature or characteristic structure of the firm. It should be noted that, when we emphasise the voluntary nature of the firm when discussing the choice of purposes by the founders we do not intend to imply that because it is voluntary whatever purpose is chosen is all right or "good" in some sense. Although it is true that the traditional theory does carry such a judgement of profit- maximisation in terms of a wider concept of social welfare (i.e. in terms of efficient resource allocation), our main intent in this section has been to show that there is no intrinsic "naturalness" or "natural goodness" in the goal of profit-maximisation, as is often suggested in traditional arguments. The same is true for any other suggested goal. Which purpose *should* be pursued is a different question, an important one, but it is not our concern at this point.

A next step would be to try to explain or understand which particular purposes are actually pursued by the firm, which would bring us to the "theory of the firm" and related issues. To do this, however, one has to analyse the basic relations between (groups of) people connected to the firm who may determine these objectives. In this kind of analysis "owners" and "management" have traditionally been at the center of discussion. To this we now turn our attention, starting with Berle & Means' classic analysis, to be followed by a "structural" analysis of the situation. In chapter 10 we will then return to the issue of goals.

6.2 Berle & Means's analysis of ownership and control

In this section we consider the Berle & Means analysis of the ownership-control issue, both with respect to actual changes in U.S. firm history and with respect to traditional views on the matter. Even though it is somewhat dated, we will discuss their analysis in considerable detail, since it is a perfect and still classic vehicle for highlighting the crucial questions surrounding an important underlying feature of the firm, i.e. "ownership". This will form the basis for a structural analysis of the whole situation.

The two main observed empirical trends underlying their whole study are well-known. On the one hand the tremendous increase in the size of corporate firms (resulting in an increased "concentration of economic power"), and, on the other hand, the accompanying ever wider dispersion of stock ownership, often among hundreds of thousands of individual shareholders. "Dispersion in the ownership of separate enterprises appears to be inherent in the corporate system"(p.47).[79] Moreover, the numerous owners of these firms are not its managers, and its managers are not (significant) owners. In the latter lies the first separation, i.e. between ownership and actual managership of the firm. Of larger significance is the owners' subsequent loss of control over the management of "their" firm, i.e. the separation of "ownership" and

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79) Bracketed page references in this section refer to Berle, A.A. & Means, G.M., *op. cit.*

"control", to which a gradual regrouping of rights and relative legal positions have contributed. The result is a large "powerful" corporate organisation with a management in full control, effectively unchecked by shareholders' desires and potentially able and likely to pursue interests other than those of the owners of the firm. This, in a nutshell, is what Berle & Means call the *corporate revolution.*

The reality of this situation strongly challenges traditional views about the (private capitalist) firm and the relations between ownership, managership and control, hence Berle & Means's clear dismay at these developments. It is my thesis, however, that both the traditional view and Berle & Means's interpretation of the factual developments are based on a misconception of the "problem", indeed on a false conception of the *nature* of the relationships between the "owners", "managers" and "control", and that the only way to a clear understanding of the situation is an inquiry into the underlying typical nature of these relationships (which implies, again, an inquiry beyond any specific legal system, specific positive law concerning the firm, and positive forms of these relationships in specific economic systems or periods of history). For this our structural approach will prove to be eminently suitable.

6.2.1 The traditional view

The traditional view is rooted in the concept of individual or personal property:

> "From earliest times the owner of property has been entitled to the full use or disposal of his property, and in these rights the owner has been protected by law. Since the use of industrial property consists primarily of an effort to increase its value .. the owner of such property, in being entitled to its full use, has been entitled to all accretions to its value - to all profits which it could be made to earn."[80]

Ownership of property implies full control over it and entitlement to any benefits deriving from its use. With regard to the firm this concept is applied directly - the firm is regarded as being *owned,* as the property of some individual(s) who is/are entitled to its full use and benefits. This is also how the traditional (colonial) firm is constituted - the "owner" of the firm (single-owner or partner-) is also its manager and receiver of any profits generated. In perfect harmony with the above-mentioned concept of property "ownership", "managership" and "control" are united. (This is also the Adam Smith view of the firm.)

Upon the historical creation of the corporate form of the firm this view of ownership of the firm is simply extended to accommodate it:

> "From earliest times, also, the stockholder in the corporation has posed both as the owner of the corporation and the owner of its assets .. (C)ollectively the stockholders, through their participations were entitled to the whole of corporate assets and to the whole of any corporate profits which could be made. The corporation was theirs, to be operated for their benefit."[81]

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80) *Ibid.,* p 294.
81) *Ibid.*

A share of stock, in this picture, represents a fixed participation in the property (i.e. the firm) accompanied by a corresponding degree of control over the management of that property, as manifested in the right of the shareholder to vote to elect a board of directors (whom Berle & Means see as the group in charge of direction over the activities of the firm). Even though the shareholders themselves thus do not manage the firm - ownership is separated from managership - the powers of the appointed managers are given and limited as powers in trust, since the owners are seen as only entrusting the managers with *their property:* "the corporation was merely .. machinery by which the property of individuals was managed by other individuals" (p.296), for the benefit of the owners, and subject to their approval and control. Ownership of the firm and control of the firm, says this view, are to remain united, in accordance with the concept of property outlined above: ownership implies control and benefit.

6.2.2 Berle & Means's interpretation of the factual developments

This view of ownership, managership and control has been strongly challenged by developments in the United States economy (and others) since 1840, the beginning of the mass producer and mass marketer era, and especially since 1880, the era of the integrated mass producer/ distributor.

The root cause, according to Berle & Means, is the multiplication of owners of firms - the dispersion of stock ownership, with individual stockholders owning only a relatively insignificant share of the enterprise, and thus a relatively insignificant vote, i.e. a relatively insignificant degree of control over the management of "their" firm. They identify four steps or cases in the separation of ownership and control:

(i) Since control is normally exercised by majority vote, "the concentrating of control in the hands of a majority means that the minority have lost most of the powers of control over the enterprise of which they are part owners. For them, at least, the separation of ownership and control is well-nigh complete"(p.68); (It is not clear why this is, in Berle & Means's view, not true for a dissenting owner in a situation where, say, three persons hold all the stock and elect by majority vote. If the situation they describe indeed implies a separation, it must also be true in the small numbers case. This implies that not stock dispersion but rather the decision rule of the voting process is the main cause of separation, at least in this phase of separation. All in all it is strange that they see a minority voter in this light, for this kind of "separation" from control has nothing to do with a breakdown in "corporate democracy"!

(ii) When control is exercised through a legal device, e.g. pyramiding, the eventual effective controller(s) can have an effective ownership of only a fraction of a percent (.51 x .51 x ..), i.e. effective

control does not rest in significant ownership; (however, the corporation just "above" the "bottom" one normally must own a majority of the latter's stock, so that the bottom corporation is controlled by a majority stockholder as far as it is concerned - it is still control by majority vote, as in (i));

(iii) Under so-called minority control, the owner(s) of a minority of stock have control via their access to a sufficient number of proxy votes[82] to control a majority of votes during an election; for a majority of the large number of shareholders control has thus been separated from their ownership;

(iv) When ownership is so widely distributed that no shareholders have even a meaningful minority interest, we have so-called management control - management selects the proxy committee, and the numerous shareholders, having little incentive to vote personally, fail to vote or vote by proxy; the separation of ownership and control is virtually complete.

Berle & Means classify respectively 5%, 21%, 23% and 41% of the largest two hundred U.S. companies in 1930 under these four categories.)

The result of this development, say Berle & Means, is that it "has destroyed the unity that we commonly call property - has divided

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82) The right to vote by proxy, to delegate one's vote to someone else (often nominated by management) is thus seen by Berle & Means as one of the principal instruments not by which the stockholder exercises power over the management of the enterprise, but by which his power is separated from him"(p.129), especially in the large number case where apparent insignificance removes the incentive to vote. Here share dispersion does seem to be a cause of the separation.

ownership into nominal ownership and the power formerly joined to it"(p.7) - control has become a separate and separable factor. The property owner who invests in a modern corporation in doing so effectively surrenders control over his wealth and property to the unified direction by those "princes of industry" in control of the corporation, implying a revolutionary shift in the property relationship: the owner of the firm no more controls the use of his property. The position of ownership has changed from that of an active to that of a passive agent; all the owner now holds is a piece of paper representing a set of rights and expectations with respect to an enterprise. In Berle & Means's view the modern shareholder is effectively at the mercy of management, "bound" to a contract which often weakens his legal rights even further, and left with a mere symbol of ownership.

> "The stockholder is therefore left as a matter of law with little more than the loose expectation that a group of men, under a nominal duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation. In almost no particular is he in a position to demand that they do or refrain from doing any given thing ... And they have acquired under the corporate charter power to do many things which by no possibility can be considered in his interest...
>
> As a result, we have reached a condition in which the individual interest of the shareholder is definitely made subservient to the will of a controlling group of managers."[83]

Accordingly the corporate form subjects, to a drastic degree, economic rights, or property rights, to the decisions of a group of managers or directors, the "dictators of industry", whose "power" has ceased to

83) Berle, A.A. & Means, G.M., *op. cit.,* p. 244.

be legitimised either by direct ownership or by owners' votes.[84] Indeed, say Berle & Means, this subjection of individual property rights to group interest is matched only by that in the communist system: "the corporate development represents a far greater approach toward communist modalities than appears anywhere else in our system" and modern corporate directors (and managers) "more nearly resembles the communist in mode of thought than he does the protagonist of private property"(p.245)!

The contrast of this position, as Berle & Means interpret it, of the owner of the firm to that in the traditional situation and traditional view is vivid. Ownership of the firm has become completely separated from control of the firm, and the status of the owner has changed radically - all as a result of the historical development of the corporate form, it seems. It is this separation which so challengingly and disturbingly confronts the traditional view and orthodox economic theory and which is at the core of the whole controversy about the theory of the firm.

The inescapable question which this development, as documented and interpreted by Berle and Means, presents is this: is the traditional picture of the firm and its ownership-management-control relationship

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84) Cf. Mason, E.S., *op. cit.,* pp. 5-7; this view derives from the idea that "(l)egitimacy can ultimately be conferred only by the sovereign, and in the American tradition only the people are sovereign".

"correct" in some sense, with the modern corporation consequently a deformed and distorted form? Or are Berle & Means just plain wrong in their interpretation, has there been no real separation of ownership and control, and is the traditional view of the firm-as-property thus still applicable to all forms of the firm (recall the Friedman-quotation in the introduction of this chapter)? Or, as Berle & Means eventually suggest, is the modern corporation a major new societal institution not comparable to the traditional firm and which cannot be accommodated in traditional concepts of property - do we need a new concept of property? (And what about the ownership-control issue in the case of e.g. socialist firms and government corporations?)

We will consider these questions from a structural viewpoint, in two phases. First we will consider the historical development of the firm, now in a different way which utilises the notion of different societal structures. In this we will consider the historical relationship between the firm and the family unit. This analysis will suggest a first thesis concerning the so-called ownership-relation and historical changes in it. In a second phase we will develop a quite general structural and theoretical analysis which will also provide an explanation of Berle & Means's observations, at the same time showing that misconceptions in their and others' views of the issue in itself created much of the perceived "problem". In the last chapter we will link this up to the issue of purposes and goals, to the "theory of the firm".

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7. THE CHANGING RELATIONSHIP BETWEEN THE FIRM AND THE FAMILY

A first step in our structural inquiry is then to consider the historical relationship between two different societal structures, the firm and the family. The reason for this is that concurrent with the firm's historical development per se - the basis of Chandler and Berle & Means's work - there is a substantial change in the relationship between these two institutions. A careful understanding of and distinction between the two processes (as well as their inter-action) will provide an insight essential to understanding the way the firm displayed certain features during its historical development. This insight will be particularly relevant for the ownership-control issue.

7.1 The initial relationship

The beginning of the period under view displays a very close relationship between family and business enterprise. Indeed, they seem to be *interwoven,* so much that it may often be difficult to distinguish the two. Consider, for a moment, an extreme case - the subsistence family farm. This case, where the family raises all its own food and manufactures all its own clothing, furniture, etc., is the purest and most extreme form of such interwovenness. This interwovenness or interlacement exists specifically via the following factors:

- the family lives on the same *land* on which they work, i.e. the land on which they live as family serves at the same time as the land used as input and main asset in the farm "business";
- the *owner* of the family land is, at the same time, the owner of the business land;
- the *head* of the family (the father-figure in traditional society)is at the same time the head of the farm business;
- the *members* of the father's family are at the same time the workers in his business (i.e. "under" the same person, but now in his capacity as businessman);
- these together imply the following concurrence: ownership of the firm (the land and other non-labour production factors) and decisionmaking authority rests in *one and the same person,* the single-owner/manager, who is at the same time the father of the corresponding household, i.e. the figure in whom traditionally rest family authority as well as ownership of the home:
- ownership and management is thus confined to one family, at this stage moreover to only one member of that family, the father;
- the main purpose of the farmer is to provide, in a very direct way, for his family.

In fact, the interwovenness in this extreme case is so complete that some may even doubt whether one can call such a farm a business in the common sense of the word, since there is yet no trade, no commercialisation. This is incorrect, though. It is only that the exchange relation, usually realised through a market relationship, is confined to this single family at this stage.

Overall this (extreme) picture is of two societal institutions so closely interwoven that they are barely distinguishable as two different institutions:

- all internal relations of the firm (person-to-person and person-to-object) coincide with the internal relations of the family; relationships between individuals in their business capacities coincides with (and is determined by) the relationship between them in their family capacities;
- all external (exchange-type) relations of the firm are limited to this same family: these relations are still "closed".

We can term this an *integrating* or *coinciding interlacement* of the two institutions. Moreover, the family institution seems to more or less dominate the other to the extent that the farm business is almost *submerged* in the family. On the other hand one can clearly point out the presence, if only seminal, of the business enterprise: both characteristic functions of the firm are being performed, albeit at a very un-unfolded level. This firm as such is of a very "closed" form, but it is unmistakenly a firm.

7.2 The relationship in transition

Between this extreme form of the firm and the other endpoint, the modern industrial enterprise, lies a whole *spectrum* of different forms of the firm. Concurrent with this is a spectrum of corresponding relationships between firm and family, with large variance in type and degree of interlacement.

The extreme form of interwovenness discussed in the previous section is not the pervasive form of the colonial era, of course. The colonial farm-business shows some measure of exchange and trade - "goods manufactured in the home were often sold to neighbors and nearby towns"(p.51).[85] Albeit initially on a limited scale, this shows some opening-up of the external (market-)relations of the firm - there is some measure of "business" in the common sense of the word. Besides that the family and the farm-business are still tightly interwoven: the internal relations are still coincident, the father still single- owner and manager, the family still the basic unit.

However, increasingly the farm-business starts to go outside the narrow family circle, thereby "loosening" the interlacement between family and firm: firstly, and rather obviously, in the use of hired labour; secondly, and less trivially, the practice on southern plantations where, apart from the presence of slaves, we see the appearance, for the first time, of managers to assist the owner- entrepreneur/father in his management of the farm-business(p.17). The latter is limited to some slave-farms though, and in historical context an exception at this point. It is nevertheless an important development, a forerunner of things to come.

85) Bracketed page references in this chapter refer to Chandler, A.D., *The Visible Hand.*

The other major form of manufacturing in the colonial period is the artisan (pp.17;51/2). By definition the specialised craftsman produces not mainly for own consumption, but for purposes of trade - specialisation as such forces the firm to direct itself outside the family circle and enter into opened market relationships, and here we find them already fully opened, quite unlike the case with the traditional family-farm. However, with respect to *internal* relations the family remains the basic unit, although the interlacement is much looser than with the family-farm. Single-ownership is the prevailing form, and the father owns the shop. But he is often assisted by non-family apprentices or journeymen who are, nevertheless, "treated as part of the family"(p.17), showing the persistent influence of the family-idea over the business relationship. Most artisans also work and live on the same premises, but locational mobility enable some to set up shops separate from home, or work on location, or become travelling journeymen.

In commerce the dominating unit is the all-purpose general merchant of the time(p.17/8). The existence of this type of firm is due to opportunities created by the unfolding and opening-up of the market-relationships of producing firms. (In an "economy" of closed subsistence farms there are no opened external relations to provide an environment within which such a merchant can operate as agent/intermediary.) As such the external relations of the merchant-firm (backward as well as forward) are fully opened. Internally it resembles the artisan-firm in all respects, with the family the basic unit, but with e.g. non-family agents.

Compared to the fully coinciding interlacement of the subsistence farm the traditional enterprise of the 1790's display a somewhat looser interwovenness with the family. This partial loosening appears with respect to two internal aspects, i.e. land - firm and family do not always share the same premises - and on the employee-level - workers and staff-members are not limited to the narrow household-circle. External relations are not limited to the producer-family either. In two respects the family-influence is still strong, though: *ownership* and *managership* both are confined to a single family, and moreover to only one family-member, (usually) the father. As we follow the transition we shall pay particular attention to these two aspects.

Between 1790 and 1840 both manufacturing and commerce undergo a process of specialisation and expansion to meet growing demand. Expansion requires more apprentices, craftsmen, agents, clerks, etc., so that family membership becomes less and less relevant on the employee-level. Still, for example, "even the more specialized merchants continued to prefer to have sons arsons-in-law, or men of long acquaintance, as partners or agents handling their business in a distant city"(p.38). The enlarged artisan-shop was also still a personal, family-style enterprise: "Work continued to be done in or near the home of the master who remained responsible for feeding and housing his apprentices and journeymen"(p.53).

The more relevant development among merchant- and artisan-shops alike is with respect to owner- and managership, where we see the first

loosening of the tight interlacement with the owner/manager's household-family - the emergence of the *partnership* as standard legal form of the enterprise (which it remains until well after 1840). As such it implies co-ownership of the firm's assets by two or more associates who pool their capital resources. The partnership is normally a family affair, but with a difference. It is normally not confined to a single household, but rather to the wider kinship-family: brothers, uncles, cousins, in-laws, etc. (each a member of his own household-family, of course).One characteristic of the single-owner case remains: the same individuals who *own* the firm also *manage* the firm - in each partner rest both functions of owning and managing.

Two variants on this basic form need cursory mention here, since they point to further changes in the firm/family relationship. First, the extension of the associateship outside even the wider kinship-family to acquaintances (which is, of course, also a limited circle). Secondly, the case of the "expanded partnership" where one or more of the associates become "sleeping partners", sharing ownership but not managing responsibilities. (The limited liability partnership is another variant.) Their relevance is that they will be seen to be intermediate forms between the "pure" partnership-form and the next, the corporate form of the business enterprise. As such they also represent intermediate forms of the changing relationship between firm and family.

Primarily due to an increased need for pooled capital, more than the partnership-form could easily provide, the *corporate form* of the firm appears. During its reign the relation between the family and the corporate firm varies a great deal, notably on the levels of owner- and managership.

In manufacturing the pooling of capital by the owners of the first corporations generally involves a small number of associates (who often are family, kin or acquaintances) and their families - the shares of the firm are closely held by a small number of families{p.60) {as against a single kinship-family in the pure partnership case and the same plus acquaintances in the intermediate form). The first of these corporations, the textile mills, continue to be managed like partner- ships, however {pp.68;248), with one, two or more of the major stockholders or associates as full-time managers, complemented by a mill agent, say. (Compare the sleeping partner case.) With the spread of the factory after 1800 this continues to be the pattern. Even with the coming of the mass producer the entrepreneurial families continue to be major stockholders, and the entrepreneurs continue to be the top managers in what has become, by now, an increasingly manager-intensive enterprise. With the incorporated mass marketer the organisation of speed and volume requires many full-time managers as well. At the top, however, the owners/entrepreneurs continue to manage, and their families remain the major stockholders (pp. 237/8).

The next phase in the development of the firm itself is the coming of the integrated mass producer/distributor after 1880. Most prominent of its characteristics is the hierarchy of salaried managers who administrate these large multi-unit enterprises. This does not necessarily lead to elimination of a family role in management, however. In the case of the firm that grew by internal expansion (integration) "the entrepreneurs, their families, and the associates who created these enterprises continued to control them. They personally held nearly all the voting stock in a company. Thus, although day-to-day operations had to be turned over to full-time salaried managers, long-term decisions as to investment, allocation of funds, and managerial recruitment remained concentrated in the hands of a small number of owners" (p.298). At the top the owner/entrepreneur continues to manage. The situation is still exactly like the first corporations. Indeed, "these entrepreneurs and their families continued to look on their enterprises much as the owner-managers of traditional enterprises did"(p.414). Ownership is confined to a small number of families, and so is (top) management. Both ownership and management are however not vested in *all* family members/owners (compare the pure partnership case) - (top) management rests in only a few individual members of these founding families, namely the original entrepreneurs. The rest of the family members/owners are, in effect, "sleeping partners" (albeit with shareholder voting rights). Compared to earlier the only really significant change in this tradition of owner- and managership is the increased size and importance of the lower and middle management levels, where these are generally occupied by professionals, not family members/shareholders. This means

that also on the) Management-level (albeit below top-level) these firms increasingly go beyond the entrepreneurial family-circle. (Sometimes non-family even occupy some top management positions, but then only "close associates who had been personally selected by the family"(pp.414;331).)

The conclusion of this trend is to be found in the large integrated enterprises that grew by way of *merger,* as well as the major post-1917 forms of the enterprise. "In the new consolidations a family or single group of associates rarely held all the voting stock. It was scattered among the owners of the constituent companies and the financiers and promoters who had assisted in the merger. It became even more widely held after the company sold stock to finance the reorganization and consolidation of facilities"(p.415). On management-level "the men who engineered the merger, their close associates, and their families were unable to provide the large number of managers needed to operate the consolidated enterprise"(p.451). Initially, though, the leader-entrepreneurs do become at least the core of top management. Eventually, however, they are replaced by salaried career managers with no or little stock and with little personal acquaintance (let alone kinship) with the by now widely scattered owners.

7.3 The modern relationship

We have thus arrived at the other end of the spectrum of changing relationships between firm and family. We will now characterise this relationship more systematically.

In the modern corporate enterprise we have a large number of people working together in a business relationship. Sheer numbers in itself implies that this firm is likely to transcend any family relationship (household- or kin-). But there is more to it, i.e. with respect to the internal relationships within a modern firm. Firstly, the firm is managed by a large number of top, middle and lower managers; occupancy of these offices is not confined to any particular family, nor is it related to any family membership (or share-ownership, for that matter) but instead to professional abilities. Promotion, for example, is based on training, experience and performance rather than on family links (or money) (pp.8/9). Secondly, the firm's capital is provided by hundreds or thousands of shareholders who are generally not relatives of each other nor of managers. Ownership is also not confined to one or a few founding families any more, but has become unrelated to any family relationship. At this stage both ownership and managership are generally not vested in the same individuals (as Berle & Means point out). Thirdly, the workers in the firm are generally not members of any manager's family, so that the relationship between manager and worker is not a family relationship at the same time. Fourthly, the premises of the

firm does not serve, at the same time, as the living place of any relevant family. Lastly, the external(market-)relations of the firm are not confined to any family either.

Thus, in significant contrast to the case of the colonial firm, neither the internal relations of a modern corporation - between manager, worker, capital and land - nor its external relations - between firm, customer and supplier - is confined, determined or shaped by family relationships. The family and the modern firm exist as two quite different and quite separate societal institutions (the only remaining interlacement being purely external, as we shall note in a moment). The firm has emerged as a well-identified, well-structured societal institution within which a group of people work together in a typical relationship to execute typical firm functions (as outlined in chapter 3). These internal relationships and accompanying functions are quite different, independent and separate from those in the family. To be precise, the relations between individuals within the enterprise (i.e. in their business capacities) do not *coincide* any more with the relation between them in their family capacities - there is no integrating or coinciding interlacement between firm and family.

The two institutions as such have thus become "separated out", differentiated. Accordingly one can view the historical change in the firm-family relationship as one of *differentiation.* And, given the initial dominance of the family and the initial "submergence" of the

firm in the family, it is apt to see this process, moreover, as the *emancipation* of the business enterprise from the family. While occurring concurrently with the firm's development per se, it is a different process which should be distinguished as such.

Some clarifying remarks are in order.

(i) The emancipation process does not imply that in the final stage the family and the modern firm operate in total isolation. In the place of integrating interlacements of varying degrees there now exist only purely external (or "differentiated") interlacements like the (perhaps trivial) fact that all firm members are at the same time members of their own respective and separate families. The buyers/consumers of the firm's product are themselves also families or members of families (unless they are other firms, say).

(ii) Although there is a clear sense of direction in the historical emancipation process not all cases fit neatly into the historical progression just described. For example, the shares of the specialised finance and transportation enterprises of the early 1800's (among the first U.S. corporations ever) were closely held by the founding families, but already full-time salaried managers rather than the owners administered the enterprise(pp.28;41). And the huge railroad enterprises already had, in the 1850's, in their relation to the family, all the essential elements of the modern firm.

(iii) Similarly, the historical context in which we described the phases does not foreclose the existence of "earlier" forms of firm-family

interlacement in modern times. Indeed, all of these can be expected to exist and they generally do, as casual observation confirms. The relevance of this chapter is precisely that it enables us to identify different degrees of such interlacement when we consider actual current firms.

(iv) It may be objected that it is not at all uncommon for family relationships to exist between members of the most "modern" firm. This is not disputed. As long as the working relation between such relatives in their business capacities is unrelated to their kinship the characterisation above of the modern relationship is still valid. To the extent that it is not it is validation of our view that all the forms of the spectrum of firm-family interwovenness still can and do occur. In our discussion we intentionally focused on the purest form, to illustrate the changes clearly.

7.4 The changing interlacement and the form of the firm

We have stressed the importance of distinguishing between the two processes of development per se and emancipation from the family. This is so because the two processes are interrelated, an interrelation which gives rise to two questions:

(i) To what extent did the interlacement of the firm with the family influence or determine the form of the firm itself - the way it displayed its features - during its development?

(ii) To what extent did the firm's development per se *cause* the emancipation process by "pulling" the firm from total or partial submergence?

Consider the relation between the firm's emancipation from the family and the way the firm displayed the capital formation and overall managing functions. The development of the firm was seen to have been constrained by the availability of capital, in particular that provided by the single-owner- and partnership. To the extent that the transition from these forms to the corporate form (and/or more advanced forms of the corporate form) was retarded by the firm's close interlacement at that point with the family, we can say that this interlacement retarded the unfolding of the foundational function of the firm. This means, consequently, that the unfolding of the managing function and also the firm as a whole may have been retarded in this way. Conversely the desire of the managing function to respond to new opportunities, in inducing a need for higher levels of capital formation, may have been instrumental in the emancipation of the firm by putting pressure on the firm to break out of the confines of the family on the ownership and capital supply level, thereby leading the firm out of the submerging interlacement.

Secondly, the degree of interlacement on the management level may have influenced the extent and form of the managing function. A striking example here is the difference in the unfoldedness of the managing function

between the two main sub-phases of the modern integrated firm: the relative unsophisticatedness of the managing function in the internal expansion case, where top management is still permeated by the family influence, as against the expansion-by-merger case, where there is no such interlacement remaining, and where we find the managing function in a much more unfolded state. Conversely the trend to go beyond the family circle on the management level was brought about in part by the need for professionally qualified persons to execute the increasingly complex and sophisticated (i.e. unfolded) managing function. In this way the unfolding managing function led the firm outside the family-circle also on the management level.

7.5 Family, ownership and control - a first thesis

Our analysis suggests that the extent of firm-family interlacement did indeed influence the way in which the firm displayed its characteristic functions during its historical development in the United States, as well as the way these features changed. That is, it appears that the varying degrees of interlacement with the family did significantly influence the positive form of the firm. This would then suggest that this changing interlacement may also have been a formative factor with regard to the way "ownership" and ownership-control relations were manifested during the firm's historical development.

An important characteristic of the traditional form of the firm is that ownership of the firm (and firm-assets) and decisionmaking authority rest in one and the same person, the single-owner entrepreneur. Each owner is also manager. Our analysis of family- interlacement shows that this situation concurred with the firm's coinciding or integrating interwovenness with the traditional family, where authority and property-ownership rest in the father in his capacity as head of the household. At the other end of the spectrum the family has eventually lost its hold on all aspects of the firm, including (especially) ownership; here ownership and managership are completely separated. Between these two forms is a spectrum which includes the sleeping partnership- and entrepreneurial corporation-cases, with significant family-domination on the ownership level and significant participation of owners in management (but with loss of "control", in Berle and Means's sense, for the sleeping partners and sleeping shareholder family members).

This strongly suggests the following proposition: that the traditional form of the private capitalist firm, with the traditional interwovenness of ownership and managership - and indeed the corresponding traditional *view* of the firm - was only a consequence of the family-role in the firm, and nothing more than that. That so-called owners had a role in management only insofar as the family still had a significant hold on ownership and only to the extent that the family was interwoven with the

firm. That, consequently, *the traditional coincidence of "ownership"* and *managership is not a typical* or *necessary characteristic of the firm as such,* but only a by-product of the dominating role of another societal structure, the family. That, similarly, the separation of "ownership" and managership in later stages occurred only when the family started to lose its hold on ownership and on the firm in general, notably when the firm was forced to go to the capital market to finance further expansion. vThis implies, of course, that this separation, as observed by Berle & Means, is *not a distortion of what is "natural"* and on which the clock should thus preferably be turned back - that the fact that "owners" manage in simpler and smaller businesses does simply not imply that the shareholder/"owner" of the modern corporation has a corresponding "right" (or duty?) to control. The former is simply a symptom of a historical peculiarity, and the corporation as form is too persistent to be rejected as an aberration; it must tell us something about the intrinsic nature of the firm, which it still is. (In this regard the so-called corporate revolution provides a supreme opportunity to gain insight into the nature of things. To find, among the seemingly radical changes that occurred - the breaking apart of what the traditional view regards as a crucial characteristic of the firm, for one - the common, surviving features which generally characterise the firm.)

These conclusions, however, do not clarify the nature of the concerned relationships. It only suggests that the traditional view fails to grasp

it correctly. We have no explanation yet of exactly why and how the extent of family-interlacement may determine the extent of separation between "ownership" and "control". How does the family-influence dovetail into the complex set of relations concerned? And is there indeed need for a new concept of property? What we need is an analysis of the underlying nature of these relations, something only a structural analysis can provide.

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8. A STRUCTURAL ANALYSIS OF "OWNERSHIP"-RELATIONS

We have seen, as did Berle & Means, that the concept of ownership of the firm has serious difficulty in accommodating the corporate form of the firm, especially the modern corporation. Strictly speaking this concept only seems to fit the traditional form of the firm, with the "owner" also managing. As such it fits only an early period in the historical development of the firm and only a relatively small section of modern economic activity (modern traditional-form enterprises). For any corporation (except perhaps the smallest, those which are really only incorporated single-owner- or partnerships) the notion of ownership of the firm is indeed problematic, as Berle & Means have indicated: "ownership" is separated from managership (at least for most owners), and furthermore there is lack of adequate control (by owners over managers) to bridge this separation, thus rendering it harmless and preserving the "legitimacy" of management.

We shall show that our structural approach to the nature of the firm provides a way out of this dilemma, and that because it can grasp the basic nature of the relationships involved, providing a view with validity with respect to all the forms of the firm. We already have all the observations we need on the way the ownership-relation changed during the historical development of the firm. We can proceed directly to a structural analysis, combined with our previous results on the nature of the firm, to derive definitive and consistent conclusions regarding

what is one of our main topics, the set of relationships between the various (groups of) people, capacities and functions relevant to the ownership-issue- shareholders, directors, managers, founders, "owners", "controllers", etc.

8.1 <u>Ownership of the firm and its assets - who owns what?</u>

The cardinal question we have to resolve is: what is in principle the typical nature of the relationship between a so-called "owner" (e.g. a shareholder of a corporation) and the firm? And note immediately that we are not talking about the legal rights that shareholders may have in a particular legal and economic system, but about the general character of this relationship which as such transcends particular legal customs. It is essential to keep this in mind at all times during the discussion.

Two inferences regarding this crucial question can be drawn from our previous structural analysis of the nature of the firm, each bearing on the typical nature of this relationship. These fall under two capacities: ownership of the firm and its assets, and capital-suppliership. (A third relevant capacity will be introduced in section 9.2.)

8.1.1 The fallacy of the concept of ownership of the firm

Our first inference embodies a radical departure from the orthodox view, but is very simple and indeed fundamental to the whole issue: *a firm cannot be owned,* and the use of the words "property" and "ownership" with respect to the firm as such is a complete and fatal *misconception.* This applies to all firms, (modern) corporate as well as traditional, not just to the former, as Berle & Means suggest.

This follows inescapably from previous insights into the typical nature of the firm. A firm was shown to be not merely a collection of land, buildings, machines and other assets, but a *societal institution* comprised of a group of people organised into a solidary "whole" within which they exert their formative and managing power over assets and inputs. Such and organisation or association of people is simply not to be regarded as anybody's "property", and the application of the concepts of ownership or property to the firm as such is *contrary* to *its typical nature.*

This does not imply that the "old" logic of property is or has become deficient and/or has become non-applicable, as Berle & Means suggest. There is nothing wrong with the traditional view of property as such. It does imply that it was a mistake to apply the concept to the firm at all, a mistake to use the notion of ownership of the firm as the basis for the orthodox view of the firm and of the relationship between "owners"

and managers and, most of all, that this misuse of the concept is the source of its apparent inability to accommodate the (modern) corporate form of the firm. In fact it is not applicable to the traditional form either. The apparent suitability of the concept of "ownership" to the latter, as such the probable reason for its original application to the firm, will be shown to lie in certain historical concurrences within the relevant relationships, concurrences which disappeared during the historical development of the firm, thus exposing its general non-applicability with respect to the firm.

8.1.2 Personal versus firm-property

If the firm is not the property of its "owner(s)", what is then the position of a shareholder, say? And what about the assets of the firm? In short, who owns what?

The answer to this lies in the distinction between two kinds of ownership or property, namely *personal* property versus firm-property. Although the latter is usually acknowledged in the limited sense of the firm having legal title to certain assets, the notion of *private* property is all too often restricted to individual or personal property - the shareholder, for instance, is regarded as the only real (i.e. ultimate) owner of these assets. That is, a highly individualistic view of property lies at the basis of many if not all of the arguments around the ownership-control issue. The result of this is to preclude the insight that a societal

organisation or organised institution as a whole can also own property - private property. Private property is not equivalent to personal or individual property, but includes property owned by private - i.e. non-State - institutions such as a church, club or firm. Such property is not owned by the individuals who are members of the organisation - which is what an extremely individualistic Jensen & Meckling-type view would argue - but by the organisation as such, as a whole.

With respect to the firm-shareholder relation we then have the following result. Firstly, the firm as institution owns property - land, buildings, machines and other assets - and (as owner) has control over it. Secondly, the firm's assets are not owned by the managers of the firm. Members of the firm, managers and others alike, do not own property *in their capacities as members of the firm.* In that capacity they are at most officers of the firm - executing the typical functions of the firm, exercising its economic power over inputs. As officers of the firm managers may, for instance, buy or sell property *for* (on behalf of) the firm, but cannot own that property *personally.* It is *firm-property,* and any powers of management in this respect should not be taken out of this context.

The managers and other members do, however, also function *outside* the sphere of the firm, and outside this sphere they can and do own *personal* property - a car, house, land - and exercise full control over their use. The same applies to a shareholder or so-called "owner" - neither the firm

as such nor its assets are his personal property, but he has full personal ownership of his car, house, etc. and notably his "shares". He personally owns the latter and has full control over their use or disposal (by sale, for instance). His personal property is different from and separate from the firm's property, and he does not "participate in ownership of the firm" in any sense at all.[6] Indeed, *the term "share" is a misnomer.*

Given this distinction there is no reason why the "old" logic of property should present any problem. For this logic implies that each owner has (or should have) control over (and benefit from) the use of his property, and his property alone. This exactly fits the case with the two kinds of property (and two kinds of owners) *once they are distinguished.* The firm owns and controls (and benefits from) its property, the shareholder his. The relationship *between* shareholder and firm is then not to be approached from any notion of control *arising from*

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86) It is perhaps worth remarking on a related distinction made by Berle and Means *(op. cit.,* p.304) in their final suggestions in an attempt to adapt the "old" concept of private property to the modern economy. *Passive* property roughly corresponds to what we have called personal property (but includes only stock and bonds): it implies no control over the firm (but not for the same reasons as ours). Then they define the possession of *active* property - "plant, good will, organization, and so forth which make up the actual enterprise" - as possession of the power of control over an enterprise by one or more individuals, apart from ownership - the domain of the modern corporate manager. In this distinction their lack of insight into the nature of the firm as institution, the different ownership-relations and the role of management in the firm, as well as their wholly individualistic .view of private property, are abundantly clear. The failure of this distinction to clarify the concerned set of relations should be equally obvious to the reader.

ownership of the firm or its assets. Stock-ownership as such implies no intrinsic property-right of control over the *firm*.

It is worth noting the true nature of the relationship, generally (i.e. not just in the firm context), between control and ownership. Ownership, as the traditional logic of property proclaims, implies control over the use of the object of ownership, plus the benefits from that use. Control over something, on the other hand, does not necessarily imply or presuppose ownership of that something. There are other possible sources of "control of" or "power over" (of which an authority-relation is one), and careful distinction between such sources is essential for a clear analysis of "ownership"- and "control"-relations. (Also see section 9.2 below.) Accordingly, when we say a firm cannot be owned we do not imply that someone or some organisation may not have control over the firm, only that if such control exists *its true foundation is not to be found in the notion of ownership proper* - it is not a property right (even though positive law may assume exactly that). We will have to look elsewhere for its explanation (cf. section 8.2 and chapter 9).

8.1.3 The "separation of ownership and control" reconsidered

The implications of this result for the ownership-control issue are straightforward. *Any absence of control by so-called "owners" over the firm is not equivalent to and should not be interpreted as an absence or abrogation of property rights* (notably the right to control one's

property), and is not contrary to either the nature of the firm or the nature of the shareholder-firm relationship. In this sense any description of historical changes in this relationship as the "separation of ownership and control" is a complete misconception, and any "problem" thus perceived is a false problem (although it may be technically correct in terms of actual if erroneous legal views and rights in a particular legal system). Conversely any presence of control, of whatever degree, can in principle not be due to any ownership-claim over the firm.

This produces the thesis that both the traditional view of firm-ownership and Berle & Means's interpretation of factual developments are based on a false conception of the nature of these relationships. The concept of a "share" alone reveals this most pregnantly. Accordingly almost every conclusion by Berle & Means is in principle erroneous in the sense that it does not reflect the true nature of the relationships within which changes undoubtedly occurred. There has been no real separation of ownership and control - each owner still controls his/its own property; also no dissolution of the atom of ownership into its component parts, control and beneficial ownership - each owner controls and benefits from his/its property, etc.

It may be argued that it is of no consequence in what terms we interpret the change, that the important thing is that there *has* been as substantial loss of shareholder-control over the firm, with Berle & Means's main

conclusion - regarding the ability of a modern corporation's management to operate the firm in interests other than those of the "owners" - basically intact. This line of argument misses the point, which is whether this loss of control should be regarded as an aberration in the development of the firm, whether it is something to be remedied or not. The latter judgement, which is what the whole controversy is all about, rests inescapably on one's premise regarding the nature of the shareholder-firm relationship, regarding the "rights" of shareholders, and so forth.

The issue does not merely concern control as such, but control *as a property right.* The principle of ownership is rich in terms of its implications with respect to the rights of owners to control and receive benefits and with respect to the legitimacy of control over an object, and these implications have been fundamental in the orthodox view of the firm and in the "economic order of the past three centuries" ?) However, the fallacy of the notion of ownership of the firm shows that such implications are not applicable to the firm, any firm, as such. *The shareholder* or *"owner" has no intrinsic ownership-right* to *control the firm* (or to have it run for his benefit by the manager-as-trustee), and the legitimacy of a manager's control over the activities of the firm is not to be sought in ownership.

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87) Berle, A.A. & Means, G.M., *op. cit.*, p. 8.

Accordingly both the traditional view of the firm and the "economic order of the past three centuries" was based on the false premise of ownership of the firm. It is not that factual developments have made this concept outdated, as Berle & Means argue - it was false from the beginning. This is not to say that at the time of its inception the ownership- and control-relations were not such as to closely resemble ownership proper. The mistake was to *regard* it as ownership - the fact that the "owner" manages in simpler forms of the business firm simply does not imply that, in the corporate form, the shareholder has, as so-called "owner", a similar right to control the firm.

The actual loss of shareholder-control over the firm is thus not to be regarded as the loss of an intrinsic property right or the loss of legitimisation-by-ownership of the managers' control- in terms of ownership- and property rights there is no reason to be alarmed at the so-called "separation of ownership and control". Whatever changes there were should not be interpreted as a revolutionary shift in *property* relations or *property* rights, and most of all not as any suppression of individual property rights by quasi-communist "dictators of industry"(!).

We can thus conclude, generally, that it is not useful to analyse the "problem" of the control-relation between "owner" and firm from the perspective of a property-relation and its implications with respect to "rights", etc. Moreover, attempts to define new concepts of property are more likely to further confuse rather than clarify. It represents a

futile channel of inquiry which goes contrary to the typical nature of the concerned relationship. (The latter will be considered in more detail in section 8.2 and chapter 9.)

8.1.4 The separation of overlapping ownerships

From these basically negative conclusions we must now proceed to provide a constructive reconsideration and reinterpretation of the nature of the factual developments observed by Berle & Means. A first explanation, to be developed further in later sections, lies in the distinction between personal and firm-property we made earlier - with the former being controlled by the individual by right of ownership, the latter by the manager as authority-bearer within the firm, which actually owns the property.

A comparison of the traditional form of the firm with the (modern) corporate form reveals that the separation-process observed by Berle & Means can be seen to involve a *separation* or *differentiation of these two kinds of property,* each with its particular "controllership" (about which we will be able to be more specific in the next section). In the traditional form the property used as input by the firm is personally owned by the manager, who controls "both" - compare e.g. the family-farm. The manager of the firm thus owns the assets of the firm - but does not do so in his capacity as manager. He does so only indirectly - his personal property and the firm's property coincide, as do their "controllerships".

(It is from this concurrence that the firm and its assets originally appeared as the property of this individual, the "owner-manager", that the concept of ownership came to be applied to the firm as such. It was, however, not to endure.) In the modern "managerial" corporation, on the other hand, firm-property and personal property have become completely separated, as have their respective controllerships. In intermediate forms, e.g. the entrepreneurial corporation, the two kinds of property have been separated, but the corresponding controllerships still coincide in (some) individuals who are shareholder-managers. Only when this concurrence disappear is the differentiation process complete, leaving scope for inter-controller influence or "power" *not* based on property rights. In this sense the "managerial revolution", the so-called "separation of ownership and control", was only the separation of two previously overlapping ownerships, and especially the separating out of firm-property from individual (i.e. personal) ownership.

From this perspective it is evident that the inception of the legal device of the corporate form was a critical factor in the historical separation process, for it secured a separate (legal) sphere for the assets of the firm, independent of personal ownership-claims, and as such contributed significantly to the ability of the firm to emerge as a separately constituted societal institution, as against merely a piece of property. Berle & Means argue that the corporate device in itself does not necessarily imply any separation of ownership and control, any

"radical shift in property tenure", and cite the one-man corporation as example. It is clear, however, that the incorporation of the one-man firm immediately separates that person's personal property from the firm's property, as evidenced in the principle of limited liability (even though he does occupy both "controllerships"). Conversely, non-incorporation implies that firm- and personal property still overlap, that the firm has not been constituted as a separate institution with its own property.

8.2 The second capacity: capital-suppliership

We have seen that the first capacity we considered, i.e. ownership of the firm, and property rights in general, do not provide a clear understanding of the nature of the "owner"-firm relationship. Our next step is then to consider other aspects of this relationship which may provide clues to its typical nature. We ask: what notions are really embodied in the (false) concept of "ownership of the firm"?

As we noted during our derivation of the founding function of the firm (section 3.1), in the capitalist system "ownership" of the firm has from the beginning been associated with capital or, more precisely, the supply of capital to the firm. This is true for the single-owner or partner in a traditional firm as well as for the stockholder of a corporate firm. This suggests that the "ownership"-capacity cannot be understood without acknowledgement of this aspect of "ownership", and its implications for the relationship between "owner" or shareholder and firm must be examined. These are simple but far-reaching.

Consider once again our basic characterisation of the firm - as a voluntary organised societal association of people within which members of the firm are bound together into a solidary "whole" within which all internal activities and relations are shaped and stamped by its characteristic structure. Subsequently we identified, as a correlate of this internal structure of the firm, the external relations in which the firm stands, stressing the difference and need for clear distinction between the two kinds of relations. In that discussion we focused on the firm's external exchange- or market-relations with, on the one hand, the buyers of its product or service and, on the other hand, the suppliers of its raw and manufactured inputs.

The key insight is then that a *capital* supplier per se is in a relationship to the firm the nature of which is not any different from that of any other supplier to the firm. It is an exchange-relationship in which financial capital is supplied in return for some form of payment (or promise to pay), the nature of which my depend on historical and legal conventions. What seems to make this exchange different is that traditionally the actual "payment" has not taken a form commonly associated with an exchange-transaction, and has been regarded as an ownership-claim, as the benefits of ownership - the notion of a share, for instance. This, which is clearly a result of the traditional view of the firm as property, with shareholding as a participation in ownership

of the firm, has obscured the fact that we have to do with a supply-relation, and has precluded what is a fundamental insight into the notion of "ownership".

It is fundamental because it implies that *as capital supplier* the "owner" is *external* to the firm, is not a member of the firm, and moreover, that *as capital supplier he has no authority over the firm.* The classic picture of shareholder-management relations does not take account of the distinction between internal and external relations, and commonly views the shareholder as having authority over management. However, the nature of an external exchange-relationship, as shown before, precludes the presence of any inherent relation of authority or subordination (basically because the participants in such a relationship are not bound together in any solidary "whole" with an organised power foundation to found such authority; section 5.4). That is, the inner nature of the relationship is such that a shareholder or "owner" has, *as capital supplier,* no intrinsic authority over "his" firm, no authority-"right" to control management, etc. (The existence of non-voting stock, as well as of capital supply by bondholders indeed acknowledges this fact.)

Can this conclusion be reconciled with unincorporated forms of the firm, i.e. owner-manager single-owner- and partnerships? From our development perspective it is evident that in these forms the capital supply-relationship is still totally "closed" in the sense that it is

contained within a member of the firm, the manager. This containment is broken when in the sleeping partnership the supply-relationship becomes opened somewhat, extending to persons other than the manager(s), although it is limited to his/their family circle(s). In the entrepreneurial corporation the situation is essentially the same, only with the firm having been incorporated - which implies than when the managers also supplies capital it formally involves "another person" - and with perhaps more families' members and some close friends involved.

In the most-developed form of the firm, the "managerial" corporation, this supply-relationship has been opened fully, not being limited to managers, their family or their friends, or any circle for that matter. The identification of "ownership" in the sense of capital-suppliership and managing authority in the traditional firm can thus be seen as the sign of a still closed supply-relationship, a result of the ununfolded state of the firm at that point. The manager just happens to be a capital supplier. Secondly, Berle & Means's "revolution", the so-called separation of ownership and control, can be seen to involve the opening-up of the capital supply-relationship, with the manager ceasing to be a capital supplier as well, and the latter becoming "merely" an investor.

The latter process can thus be understood in terms of *capacities* or roles, namely those of manager (authority-bearer) in the firm and supplier of capital to the firm - as such two separate roles. In the traditional

form the two capacities happen to coincide (be interwoven) in one person. In the managerial corporation the two have been separated completely. In intermediate forms some persons fulfill both roles, while others are only capital suppliers, say. That is, we have a process involving the separation or *differentiation of capacities.* This differentiation process is implied by the unfolding or opening-up process occurring in the capital supply-relation, with the traditional firm being respectively undifferentiated and closed in these respects.

Moreover, it is evident that in these two respective capacities we have the more precise meaning of the two "ownerships", each with its differently-founded "controllership", that we have been looking for. The capital-supplier owns and (as owner) controls the payment or promise to pay he received from the firm (e.g. his "shares"); the manager (as authority-bearer) controls the capital now owned by the firm. Accordingly the separation of the two kinds of ownership, each with its controllership - our interpretation in 8.1.4 - is now seen to be equivalent to the current section's capacity-separation process, and is thus similarly implied by the opening-up of the capital supply-relationship. The latter thus proves to be quite basic to the developmental changes we and Berle & Means have observed.

In sum, we have investigated two roles or capacities intimately associated with the shareholder - so-called "ownership" of the firm and capital-suppliership - in our search for an explanation of the nature

of the shareholder-firm relationship. The former has proved to be a false concept, while the latter provides no basis for any intrinsic authority- or control-relation between shareholder and firm either. Secondly, we have seen that a shareholder ("owner") having a role in management is to be regarded as the interwovenness of two different capacities in one person due to a not fully opened capital supply- relationship - i.e. as a developmental peculiarity, a historical and developmental concurrence likely to disappear if and when further development occurs, thereby manifesting their typical differentness. In any case such interwovenness thus provides no general basis for concluding that the shareholder/"owner" has an :intrinsic "right" to control the firm. Consequently, and thirdly, any loss or absence of control cannot be regarded as the violation of an intrinsic "right" of the shareholder. Moreover, since capital- suppliership is as such something *voluntarily* entered into, Berle & Means's description of modern corporate managers as "dictators" (who "suppress" the rights of "owners") is totally inappropriate.

Lastly, it is now clear that the origin of the erroneous use of the term "ownership" with respect to the firm lies in the historical coincidence of the two capacities of managership and capital-suppliership, as such a consequence of a closed capital supply-relationship. Its misuse, also in current orthodoxy, originates in the failure - due to a lack of a development perspective - to see the traditional form as an ununfolded form, with an ununfolded capital supply-relationship.

9. CORPORATE DEMOCRACY, VOTING AND CONTROL

The notion of shareholders electing management, or what is referred to as "corporate democracy", plays a central role in the way the corporation is viewed, and accordingly also in discussions around the shareholder-firm and shareholder-management relationships, the role of the board of directors, etc. It is generally accepted that "management" consists of the board of directors plus some top executives of the firm: "universally, under the American system of law, (management) consists of a board of directors and the senior officers of the corporation".[88] "Legally the function of the board is to operate the company … we define the management as the particular in-group, consisting of directors and others, which effectively carry out the functions legally vested in the board."[89] The board, which employs the executives (who may themselves be directors), "commonly secures its legal title through election by the stockholders"[90] - the "owners" are viewed as delegating certain powers of management under certain rules which protect their property rights;[91] with the right to vote providing control of management by the "owners".

Is the board of directors thus the servant of the stockholders? On this there is, perhaps surprisingly, considerable disagreement. On the one hand is the traditional view that the board/"management" is to be

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88) Berle, A.A. & Means, G.C., *op. cit.,* p. 196.
89) Marris, R., *Economic Theory of Managerial Capitalism,* pp. 14/5.
90) Berle, A.A. & Means, G.C., *op. cit.,* p. 196.
91) *Ibid.,* p. 125.

regarded as trustees of the shareholders/"owners": "From the point of view of legal and economic orthodoxy, …(t)he law books have always said that the board of directors owes a single-minded duty of unswerving loyalty to the stockholders, and only to the stockholders".[92] Others argue that this view is "not supported by legal authorities"[93]: "(t)he law (says) that the management stands in a 'fiduciary' capacity towards the corporation";[94] "(t)he directors … are servants of the company, not apparently, of the shareholders".[95](Others go even futher and propound a "social responsibility" towards various groups in- and outside the firm, including creditors, suppliers, customers, etc.[96]

However, we concluded in the previous chapter that the shareholder/"owner" has no intrinsic right to control the firm, thus not by vote either. Does this mean that the whole voting-idea is in principle inapplicable, that the whole debate above is therefore irrelevant? We will consider this question by a careful structural analysis which will clarify the whole picture, also showing that the root of this controversy lies in a misunderstanding (and failure to distinguish between) relevant capacities and relationships. We will also show that there are two other

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92) Rostow, E.V., "To Whom and for What Ends Is Corporate Management Responsible?", in Mason, E.S., *op. cit.,* p. 63.
93) Marris, R., *Economic Theory of Managerial Capitalism,* p. 14.
94) Berle, A.A. & Means, G.C., *op. cit.,* p. 197.
95) Marris, R., *Economic Theory of Managerial Capitalism,* p. 12; also Rostow, *op. cit.,* pp. 61/2.
96) Cf. Friedman, M., *op. cit.,* pp. 133-135 and Mason, E.S., *op. cit.,* notably Kaysen, C., "The Corporation: How Much Power? What Scope?", and Rostow, E.V., *op. cit.*

channels of shareholder-power or -control, neither deriving from any notion of ownership of the firm, but one and perhaps both involving the principle of voting. This will also suggest a conclusive explanation of the historical developments observed by Berle & Means.

9.1 The role of the board of directors

As the different views quoted above show, a clear understanding of the role of the board of directors is not self-evident. This is attributable, in no small way, to the tremendous variation one finds in actual boards, both historically and currently-active boards, passive boards, boards with "inside" (i.e. manager-)directors, boards dominated by insiders, effective governance by insider-dominated executive committees of the board, etc. Conversely this variation may be due to confusion regarding the proper role of the board. Especially the cases with both inside and outside directors easily impede one's ability to penetrate to the typical nature of the role of the board per se and vis-à-vis both the firm and the shareholders. A structural analysis of the relationships will, however, provide a basic (prototype) framework from which we can develop insights into more complex forms, which often are the result of structural interlacements.

In terms of the typical nature of the firm there is a distinct problem with the view of the board of directors being the "management" of the firm, with "management" then being elected by the shareholders. We have

argued that the managers are those members of the firm who occupy offices of authority in the internal authority-relation within the firm. The question is: do directors satisfy this description? If they do, why call them directors? If not, how can they be the firm's managers proper? And if they are indeed the managers of the firm, how can they be elected by shareholders who are, by the nature of the capacity of capital-suppliership, external to the firm, i.e. not members of the firm?

The essential insight here is that *the very notion of an electoral process presupposes membership of an association* of body *within* which members elect their leaders or representatives (according to electoral rules specified in the constitution of this body). An individual *as* individual, in isolation, cannot vote for something or somebody - voting presupposes some societal structure, e.g. the State whose citizens vote *within* that organisation. Moreover, voting is available only to the members of such a body, and the significance of a vote is confined to the internal sphere of that body - it represents a voice only with respect to the decisions of that body and with respect to the election of officers *of that body.*

9.1.1 The notion of a shareholder-association

Applied to the shareholder-firm relationship this implies, firstly, that the notion of a vote is meaningless for an individual shareholder per se - it can only be realised within some association, a shareholder-

association or shareholder-union, say. Is the individual shareholder-firm relationship, which is external to any association or organisation and has a non-integrating character, voting is a meaningless concept. Thus, in principle the possession of a stock certificate by an individual cannot, per se, "in isolation", imply any voting right. Secondly, voting by shareholders can only produce electoral decisions of an association of which they are members, and can only elect officers of that association. This means that shareholders, who are, as capital- suppliers, external to the firm, *cannot elect the managers of the firm* – the latter are the officers of another association of which the voter is not a member.

The key structural insight is that we have to conceptualise two *separate* associations if we want to talk about voting by shareholders. In a shareholder-association (as against the firm} the shareholders can then exercise a vote to elect the officers of that association, who are then presumably responsible to the shareholders. In the latter we find, I submit, the original meaning of the term *director* - the elected official of a shareholder-association (which, in turn, may be a useful way of looking at the "Corporation", as distinct from the concomitant firm). As such the director occupies an office within this association, not within the firm - the director per se is not the manager of the firm. The offices of director and manager, and thus the board of directors and management, have to be distinguished as clearly as the two corresponding separate associations or structures themselves.

9.1.2 The "legitimacy" of management

This distinction undercuts one controversy around the notion of "corporate democracy", namely the idea that owner/shareholder voting provides legitimacy to the authority of management. (In this idea the view of the shareholder as owner of the firm is constitutive.) We have seen that "corporate democracy" at most concerns only the role of voters within a shareholder-association, in electing its directors and in coming to decisions of that association. These votes can thus provide "democratic" legitimacy only to the board of directors, not to the management of the firm. The whole squabble about "self-perpetuating oligarchy" versus "corporate self-government"[97] thus rests on a false conception of the relevant capacities and relationships. Improving "corporate democracy" (by e.g. better informing of shareholders and reformation of electoral rules) can, accordingly, only affect the legitimacy of the authority of the directors within the shareholder-association: those "orphans of the business system, the scattered small stockholders, now doomed to impotence in most corporate environments"[98] will only have a revived voice within the shareholder-association, will only have better control over their directors.

(This also implies that the phases that Berle & Means identify in the separation of ownership and control have to be understood within this

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97) Cf. Mason, E.S., *op. cit.*, pp. 1-9.
98) Rostow, E.V., *op. cit.*, p. 55.

framework. The consecutive losses of control by shareholders can only relate to their internal control over their directors who then achieve approximate autonomy upon too wide distribution of stockholdership.)

9.1.3 Internal versus external relations again

It is evident that the distinction between internal and external, and between intra- and inter-associational, as derived and discussed in chapters 4 and 5, is of fundamental importance here. Internal to each societal structure we find an "organ" of officers, each with only internal jurisdiction - the board of directors within the shareholder- association, and management within the firm. From the viewpoint of each association the other association, its officers and its members, are external.

That is, assuming that a shareholder-association does exist, it can explain only one part of the overall shareholder-firm relationship (apart from the direct person-to-firm relationship, outside of any association, as in section 8.2) - from shareholder to shareholder- association (or board of directors). The other part can only be found in what is its external correlate, the inter-associational relationship between shareholder-association and firm, which boils down to the inter-relationship between the respective organs, board and management. This relationship is ultimately the crucial one, and its nature will be the final clue to clearing up the question of shareholder-control over the firm.

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This relationship, being an inter-associational relationship, is of the same type encountered before when discussing firm-supplier and firm-customer relations - it does not unite the participants into a solidary whole, and leaves them free to interact, from positions of legal equality, in cooperation, neutrality or antagonism (recall section 4.5). Accordingly there is also no relation of authority and subordination inherent in such a relation - the participants are not bound together in any durable solidary whole with an organised power foundation to found such authority. The latter may be found only within an association or organisation, i.e. intra-associational. There is, consequently, *no foundation to be found in the typical nature of this interrelationship for any intrinsic control* or *authority of a shareholder-association over the firm.*

The orthodox view of shareholder-director-management relations, by contrast, fails to see the crucial distinction between internal and external relations, and consequently view the directors as having *authority,* delegated by the shareholders, over the firm and management proper. Hence also the view of the directors as the "managers" of the firm, with the function of operating the firm. In a similar vein is the view of directors *employing* the firm's executives. As we have shown in chapter 5, true employment implies membership of one societal "whole" by both employer and employee. Since director and manager are not bound into one "whole", but are members of two distinct associations, the concept of employment proper is not applicable in this context. This does

not rule out a contract between directors and managers, but such a contract should not be regarded as a true employment contract, and any control that may be implied by such a contract is not true authority. (Compare section 5.3 and see section 9.2 below.) The board may perhaps control management, but cannot *be* the "management" of the firm, nor have authority over management. (This is true even if some of the directors are from management, i.e. inside directors - it remains a separate organ within a separate association, not part of the firm itself.)

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With no basis for any intrinsic formal control or authority in this interrelationship, and with no other intrinsic right of control of the individual shareholder which could have given the association derived formal control of the firm (the results in chapter 8), we are led to conclude that the only basis for formal control that can be found is an explicit control-contract between shareholder-association and firm, effectively giving the directors direct contractual control over the firm. (There is of course always room for informal relations based on e.g. influence due to expertise, status, etc.)

We will show that this channel can explain, to a significant degree, the nature of actual board-management relations, and also explain the historical developments in these relations - the "separation of ownership and control". To do that, however, we have to investigate the nature,

origin and existence of a shareholder-association in some detail. The question is: why would a shareholder-association exist, and how would it come into existence? The clue to this lies, in turn, in the original organisation of the firm itself, which brings us to the third relevant capacity.

9.2 <u>Foundership</u>

The reader will recall our earlier discussion, in the context of goals and purposes (section 6.1), of the significance of the firm being a *voluntary association.* Firstly we noted the principle of voluntary membership; secondly the notion that the association is being organised and constituted by the *founders* because they see it as the suitable means to achieve their subjective end, and thus voluntarily choose this particular organised societal institution.

Consider then one or more persons getting together, voluntarily, to found a firm as means to their common end(s). In an inter-individual act of consensus they come to an implicit or explicit contractual agreement, a "social contract11 say, the 11 constitution11 of the firm, in which is specified the subjective purpose of the founders and the actual means by which it will be pursued: what line of business, how it is to be conducted, the structure of offices, duties and responsibilities, etc. - a corporate charter, for example. In this way they constitute the firm. Note, however, that only their chosen purpose is subjective. The nature

of the association to be constituted, the firm, is bound to the typical nature of the firm, as manifested in its characteristic structure (see section 6.1.3). Accordingly the actual act of foundation has to involve the supply of capital to the firm, plus provision for a manager to execute the managing function. In a partnership, for instance, the partner-founders together supply the founding capital, and also assume the offices of (top) management. As managers they may then employ other persons who are, as such, non-founders.

Before proceeding we should note that in general a variety of arrangements can exist with respect to foundership and capital-suppliership. Formally these are two different capacities, and one can imagine situations where they are separate, e.g. if, in the case of a worker-founded firm, the founders use external financing (from government, perhaps); or the founders may be the managers who then use equity or bond financing. But in all cases foundership must involve *providing* for the supply of capital, whose foundational function in the firm makes the latter a crucial requirement. In our analysis we will proceed mostly in terms of the way a private capitalist corporation is (usually) formed, with the founder providing his own capital. But it is to be understood as an illustration of a more general structural way of looking at the foundership and capital-suppliership situation.

9.2.1 Non-member non-manager founders

Ordinarily one would expect the founders of a voluntary association to comprise the initial membership, e.g. in the case of a social club, and also the simple partnership-firm. It is necessary, however, to analyse the foundership-role as distinct from membership, because the firm - and the corporate firm in particular - is one instance where the founders need not be, and often are not, members of the association (the firm) itself.

This introduces two complications. Firstly, suppose we have a single founder who does not intend to be the manager of the firm he is founding (as means to his particular end). He then has to provide a manager, which implies an inter-individual contractual agreement whereby the founder contracts with ("hires") some individual to serve as manager of the firm. (This is what is usually called, erroneously, the "employment" of the manager by the founder. It is evident that this is not employment proper because the founder is not a member of this firm and is external to it; recall section 9.1.3.) The contents (positive form) of this contract is arbitrary and basically depends on the relative (bargaining-)positions of the participants. Essentially it involves the conditions of the agreement, notably the conditions under which either party can terminate the relationship, i.e. "firing" and "quitting", while being within the stipulations of the contract. Minimally these stipulations must specify certain levels of performance

(in terms of the purpose of the founder) which, if not maintained, allows the founder to "fire" the manager, terminating his managership.

However, the hiring-contract may, depending on what is agreed upon, also allow more comprehensive control of the internal operation of the firm. From the point of view of the founder he is founding the firm, and supplying his capital resources, to achieve certain purpose. Accordingly he may, presumably, want further control over the firm to ensure that the positive form of this firm is and remains consistent with achievement of his end (bound to the demands of the characteristic structure, of course). From the point of view of the firm and its manager the founder is supplying the initial capital so essential for its existence. In return the manager would presumably be willing to give the founder such control as can be voluntarily agreed upon. (He may not have much choice, for the founder does seem to have the stronger bargaining position in the initial establishment of such control-"rights", even though they bargain from positions of legal equality.)

We see here, as part of the conditions of the hiring-contract, the origin of what can be called a *control-contract* between the founder and the (top) manager. (In cases where the founder himself acts as manager we see a coincidence of the two capacities, which implies an absolute or automatic control-"contract".) Although the control-contract is a part of the hiring-agreement, it will be useful to distinguish the part which gives control over internal operations (if this part exists) from that which merely stipulates, say, the minimum-conditions for continued occupancy of the office of manager- the managership-contract, that is.

Note that whatever control results from these contracts derives not from any notion of "ownership" of the firm, i.e. from intrinsic property rights, nor from any kind of authority, nor from foundership per se, but from a voluntary inter-individual contractual agreement between founder-capitalsupplier and (top) manager, the stipulations of which are at their discretion.[99)]

9.2.2 Multiple founders (non-member)

The second complication follows from the presence of multiple founders. As such the supply of founding capital by many individuals presents no problem. However, the firm/manager cannot make separate hiring-contracts (especially control-contracts) with each founder-supplier individually –

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99) In these agreements the parties can, in principle, set the "how's" and rules ("laws") of their interaction- this is the internal law of the inter-individual relation. Only by its interlacement with civil law does it acquire a civil legal aspect, i.e. when they agree to embody it in a civil legal contract enforceable by the State. But civil law cannot dictate the terms of the contract, which is outside the civil legal sphere and of an inter-individual character. It can only judge whether the terms are honoured by the parties.

This is not meant to imply that any contract is "all right". In terms of the nature of the firm an important consideration, not examined here, is when the extent of contractual control may begin to compromise the integrity of the firm, especially by compromising the managing authority of management, as such an essential element in the typical nature of the firm. That is, when does the use of this institution as means to an end become misuse, resulting in distortion of its positive form outside the bounds of its typical nature and characteristic structure? Equivalently, *should* founders/shareholders have any right to be concerned with anything other than a minimum level of achievement of their purpose, e.g. earnings?

for one, individual plans and intentions may be irreconcilable. The idea of voting immediately springs to mind, but this would necessarily require the formation of a *founder-association* within which the multiple founders can come to a single collective decision, and which can enter into a single hiring- (managership- and control-) contract with the manager.

This presents no problem however. Indeed, it should be clear that such an association is already implied in the founding of the firm by multiple founders. For when these founders get together in a cooperative inter-individual act of consensus to constitute the firm, they are (implicitly or explicitly) forming a founder-association which then becomes the actual formal founder of the firm - supplying the pooled capital resources of its members and contracting with a person to be (top) manager of the firm (and including a control-contract if it wants one). That is, these individuals' actual act of founding is that of organising not the firm, but the founder-association as means to achieve their common end of (first) founding a firm. In the formation of the founder-association the common purpose of founding a firm is thus constitutive. (This is thus another example of how a voluntary association is organised by its founders with a certain purpose in mind.)

This founder-association, membership of which is contingent upon being a founder(-capitalsupplier), then becomes the formal founder of the firm itself.

Conceiving of the founding of a firm in a such a two-phase manner is useful in that it clearly separates the two voluntary associations involved, at the same time emphasising the coherence of their origins, as well as the nature of the resulting inter-associational relationship.

Since these founders (usually) are initial capital-suppliers to the firm, i.e. what one would call initial shareholders, this explains the existence of a shareholder-association and a hiring-contract between the latter and the (top) manager of the firm. From this contract then derives any formal control that a board of directors, duly elected and authorised by the shareholders, may exercise over management. (A further matter is the question of non-founder shareholders, and how their presence may affect the situation. This is discussed in section 9.5.3.)

It is clear that the notion of "ownership" of the firm is not at all relevant in understanding this relationship, no matter how much such a contract, and especially the control-part of the contract, may seem to resemble a property right. Nor do the notions of real authority and subordination enter the picture. What matters is the relative power-positions of the participants during the initial contracting process, which is when the extent of the control-"rights" of the founder-association vis- -vis the firm is specified. As we noted before (see footnote 99) these specifications are arbitrary, involving a voluntarily entered into contractual agreement between two parties of equal legal standing.

9.3 Relation to positive forms of the firm

This general structural analysis - the clear distinctions between different societal structures and different kinds of relationships - provides the insight necessary to understand the nature of these relationships in actual, positive forms of the firm. What makes this somewhat difficult is that the actual legal arrangements surrounding an actual firm in the U.S. (and elsewhere) are based on the traditional misconceived views that we have exposed, and accordingly attempt and profess to establish relations with a corresponding (erroneous) nature - e.g. regarding them as ownership- and authority-relations. For instance, although the contents of any managership- and control-contract is at the discretion of the two parties in actual practice these contracts seem to assume a customary form, and is often included in so-called "Corporation Law". In this the extent of contractual control-rights often reflects the idea that the firm is the founder's property, that these are property rights, giving the founder full authority over all aspects of the firm's activities [100)]

Also, partly because of these misconceptions, the different constitutions and contracts are usually not clearly distinguished, but are merged into a single "charter", say, which formally establishes both of the concerned associations as well as the inter-associational contract. The latter thus occurs more or less automatically, not acknowledging

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100) Cf. Berle, A.A. & Means, G.C., *op. cit.,* Book II.

the fact that if a "separate" control-part in the contract is not agreed upon there is in principle no basis for any control over and above the ability to "fire" the manager under agreed upon conditions. An actual stock certificate thus usually embodies both the capacity of capital-supplier and of member of the founder-stockholder association, and usually also seems to imply a direct ownership-founded control-right (by vote, say) over the enterprise.

One finds, however, that in spite of this the typical nature of these relationships do prevail ultimately. Despite distortion what really happens do (and must) reveal the typical natures of the relevant associations and relationships. That is, what seems to be authority (of the founder-shareholder) based on "ownership" of the firm really is and can only be voluntary (albeit almost automatically) and contractually agreed upon control by a founder-association of which he is a member, as such having the right to elect the board of directors which actually exercises this control. What seems to be one big self-governing organisation of workers, managers and owners is in fact two separate associations linked by a contractual agreement. What seems to be a single "management"-body of directors and executives is in fact two separate organs linked by a (perhaps automatically agreed upon) managership- and control-contract. Et cetera, et cetera.

Two remarks are in order. Firstly, one often observes a board of directors in which a number of these are from management, so-called

"inside" directors. If these are true directors in the sense of being elected by the shareholders (ignoring for the moment the problems connected with proxy-voting), our analysis still applies. The board is still an organ within the shareholder-association, still quite separate from the firm and from management proper, still exercising contractual hiring-powers over management. Even when the insiders are in the majority a decision by this board is still formally a decision of the shareholder-association, and not of management. (Compare the partnership-case with its founder-manager and implied automatic control-contract.)[101]

Secondly, while our analysis has proceeded in terms particularly applicable to the (private capitalist) corporate form of the firm, it also applies to the unincorporated firm. We have repeatedly found that these firms, i.e. single-"ownerships" or partnerships, involve interwoven or coinciding capacities and ununfolded or closed relationships. This insight has prevented us from making erroneous conclusions regarding the nature of capacities and relationships, basing them on what is an ununfolded form of the firm. It is again the case here.

In the single-"ownership", one person is founder (a collapsed founder-association!), capital-supplier and manager, with and absolute managership-

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101) Alternatively one can conceive of such a mixed organ as having come about as a separate (third) body created in the inter-associational relationship, e.g. as a consultative or bargaining forum between the board and management, in which case it has no control-powers of its own (unless, of course, a contract to that effect is agreed upon, which would again imply a contractual inter-relationship between two separate organs).

and control-contract "with himself" due to a totally closed founder-manager relationship (and capital supply-relationship, as shown before). In a partnership a few persons form an implicit founder- association (of which they are both members and directors) and supply founding capital to the firm, but all of them together also act as management - they "hire" themselves - implying complete structural overlapping and automatic/absolute control. In the sleeping partnership only some of the founders are also managers; in such a case a separate (though perhaps not formally constituted) founder-association is distinguishable, with a (informal) board of directors - i.e. the founder-association itself has unfolded - but all the directors are also managers (i.e. the respective organs are interwoven/overlapping) so that control between board and management is automatic. This is not unlike the case of the so-called entrepreneurial corporation, although the latter is more formally constituted, and the board of directors has a more formal role.

However, when in the next phase we find only a minority of directors also being managers, the control-relation becomes "opened" and non-automatic - that is, the so-called "managerial revolution" occurs. This is also the case in the last phase when *no* person occupies both capacities, i.e. when the structural interwovenness has disappeared completely - not even the two internal organs overlap at all. The opening-up or unfolding process, again involving a differentiation of capacities - and this is all that is involved in the "managerial

revolution" - is complete: no overlapping or interlacement of capacities, and all relations fully opened - a "clean" structural picture. What is essential, though, is to keep a clean structural understanding even when the picture is not so clean, when structural interlacements are present. Otherwise false conclusions regarding the nature, consequences and appropriateness of actual conditions and developments are highly likely. The Berle & Means-study provides a prime example.

9.4 The dynamics of a contractual control-relation

We will now show that this structural approach provides a particularly insightful explanation of the mechanics and dynamics of control-relations, for instance as in the historical developments observed by Berle & Means. How and why do "ownership" and "control" separate so completely, resulting in so-called management control, where management selects the proxy committee and the large number of shareholders fail to vote or vote by proxy, thus electing the directors of management's choice, often managers themselves? The answer lies in the typical nature of a shareholder-association.

9.4.1 Internality of the "problem"

It should be noted immediately that this problem is not really that of control-loss between the board of directors and management. On the

contrary, the board still exercises its formal hiring- (managership- and control-)powers over management - only with the difference that most of the directors are from management, so that the control-relation is more or less automatic. (Note also that this situation is not quite the same as with the entrepreneurial corporation where most of the founders/directors are also managers - here it is a case of the managers also being directors, a subtle but significant difference that shows this case can be regarded as a retrogressive development beyond the "clean" endpoint of the developmental sequence described above, resulting in overlapping "from the other side".) It is also not that there is a problem between the shareholders and management.

The so-called "problem" is *internal to the founder- or shareholder-association,* in the relation between its members and its elected officers, the directors. The members fail to actively and forcefully exercise their electoral rights specified in the constitution of the association. Consequently management can get their nominees elected via a nominal voting procedure utilising proxy machinery. In this way the poor "orphans of the business system" are "doomed to impotence", their "ownership" having become separated from "control". That is, they fail to exercise or lose control over "their" directors.

Why would founders/shareholders allow this to happen? My thesis is that this phenomenon involves much more than merely the loss of internal electoral control over directors, that there is a deeper structural

significance to these developments. In short, their explanation is to be sought in the question whether this association of founders/shareholders still exists in any meaningful sense, and whether it is still meaningful to think of "members" "electing" "officers", and thus of any loss of electoral control of the former over the latter. That is, whether it is not more correct, from a structural point of view, to regard this not just as the breakdown of the internal electoral- and control-process- a breakdown in "corporate democracy", presumably undesirable - but as the de facto if not de jure dissolution of the association itself (which obviously implies and is probably preceded by the former, but is not necessarily undesirable)?

9.4.2 Dissolution of the shareholder-association

The explanation for such a dissolution has to be sought in the typical nature of a shareholder-association or -union. Without having to go into a detailed analysis of the typical nature and characteristic structure of such an association or union, it can be stated that an essential (necessary) feature of such a union - and here it closely resembles a labour-union - is the *bond of solidarity* between the members. Without solidarity as a unifying bond between the founders or shareholders this *voluntary* association cannot be founded or must disintegrate, the latter reflected as such in shareholder dispersion and the breakdown of its internal electoral process. As long as they have solidarity, however, this is not likely to occur.

The difference between a breakdown in the electoral process only versus the whole association as such is important. If a loss in solidarity leads to formal (or de jure) dissolution (as such a voluntary act) we have two significant implications. Firstly, the managership- and control-contract between the founder-association and the firm/manager becomes null and void. Secondly, the current board of directors ceases to have any legitimacy - in fact, the office of director ceases to exist. The individual shareholders are left in individual shareholder-firm relationships which do not embody any control-contract nor, of course, authority. (Recall that share- ownership as such cannot imply control and, moreover, that it is the association and not the individual members which had the hiring-contract.) And if they subsequently get organised again, this will have to be a new association which will, as such, have no contract giving it any control over the firm, nor any other source of formal control or authority. (This does not necessarily leave them at the "mercy" of management, though- see section 9.5.)

A second important difference is between a formal and non-formal dissolution. If there is no formal dissolution - if the association is merely dormant, say - or if, as is the case in the U.S. experience, the legal system does not recognise the dissolution of the shareholder-association (because, for instance, it does not recognise, in the first place, the latter as separate from the firm, which continues to exist), the contract remains valid if unused. In this case it will happen

that the office of director is kept alive nominally, even though it would have no real legitimacy - electoral breakdown will be a symptom of this case. The individual shareholder is in more or less the same situation as in the previous case. However, were these founder- shareholders subsequently to get organised again due to a new solidarity, the law will see this not as a new association but as the revitalised original founders-association, with any original managership- and control-contract intact.

Against this background one can view the practice of proxy votes as keeping the association and board alive in name while actually acknowledging the de facto demise of the association - whence the breakdown in the electoral process and the dominance of insiders on the "board" which by now has become a shadow management and remains that until the shareholders get revived and organised again. Before such revival the board is but a remnant of an earlier period of shareholder-solidarity, even though legally it still has authority to exercise a managership- and control-contract (to the extent that it existed before), selecting and hiring the top manager. Hence one can view the "takeover" of such a "board" by management as the rendering harmless of the board during the loss of solidarity, thus preventing someone else - notably someone who has neither authorisation from the shareholders nor any separate control-contract with the firm - from taking it over and (mis-)using any original hiring-contract to suit their purpose. (This interpretation contrasts sharply with the orthodox

view of the managers nastily usurping the legitimate (property) rights of the "owners", reducing them to "voiceless orphans".) If the association is then revived by the founder-shareholders they can always use their newfound consensus to actively elect true representatives as their directors, thus ending the management-"takeover" of the board.

9.4.3 Sources of solidarity - a trigger mechanism?

There are various factors which can explain the absence or presence of shareholder-solidarity. The clue to the first and perhaps most basic of these lies in the origin of a voluntary founder-association. Since the founders of a voluntary association can be seen, in general, to found or join the association because they see it as a means towards an end, failure to have consensus on a common end (or set of ends) would preclude attainment of the necessary solidarity to found and/or sustain the voluntary association, as would absence of a common perception of the usefulness of this association in the achievement of the common end.

We argued that the founders of the firm see it as the means towards their common end - in the case of the private capitalist firm, for instance, this is likely to be profits or earnings on the capital they supplied to the firm. In order to found the firm they then found a founder-association as means to this (intermediate) end.

If this is the only purpose of constituting the founder-association the founders may see no further purpose in having this voluntary association once the firm has been constituted, and voluntary (de facto if not de jure) dissolution is bound to follow, leaving only the kind of relations (and protection) to be discussed in section 9.5. If, however, a secondary or derived purpose of the association is to ensure continued ultimate control over the firm via an appropriate managership- and control-contract, to ensure that it continues to serve, in its actual form, as suitable means to the original purpose, this could ensure continued solidarity in the association, and thus its continued existence. Further, presuming the founder-shareholders continue to share this common purpose, continued solidarity will depend on a continued consensus on the usefulness of and need for the association in this regard.

It is evident that such consensus will depend, for one, on the level of achievement of this purpose resulting from the activities of the firm (which is, for the private capitalist firm, the level of earnings accruing to shareholders, say). To the extent that such founder-shareholders receive at least their expected level of, say, earnings, the perceived need for a separate voluntary association to oversee and exercise control over the firm can be expected to decline. The resulting loss of solidarity within the association may eventually lead to its effective and voluntary dissolution (or at least dormancy}.reflected in the breakdown of its internal electoral process as observable symptom. On

the other hand, to the extent that the level of purpose-achievement is unsatisfactory the apparent need for control by the association is a potential source of continued or revived solidarity, and dispersed votes will maintain or regain their potency.

This suggests that the level of purpose-achievement may act as a *trigger* or *activator* in the shareholder-firm relationship by maintaining or reviving shareholder-solidarity. In the case of the private capitalist corporate firm this role is fulfilled by the level of earnings, or the profit rate, say.

This idea is reinforced when we consider, more generally, to what extent a shareholder-association and its directors can actually exercise contractual control over the internal operation of the firm. As we saw, the formal extent of control-rights is to be determined by the contracting parties, but in practice customarily reflects the view of the firm as property of the shareholder, and seems to give the founder-association full control over all aspects of the firm's activities (and indeed views the directors as the "managers" of the firm). On the other hand the control that can actually be exercised by the association and its directors is bound to be limited by the extent of their expertise and informedness concerning the activities of the firm. Indeed, one can argue that the only criterion they are competent (and perhaps entitled?)[102] to judge upon is the results in terms of their

102) See footnote 99, section 9.2.1, once again.

purpose, not *how* the firm attains those results. This constraint may be especially true for the run-of-the-mill shareholder whose only interest is, say, his earnings on the capital he supplied to the firm (i.e. his "payment") and, moreover, whose only ability to judge performance is the level of his earnings. Irrespective of the formal control-rights an association may have, its members may often not be competent to judge or control the internal activities of the firm - any control-part of the hiring-contract may be irrelevant - and are liable to e.g. authorise their directors to "do something" (e.g. replace top management) only when they observe too low a level of earnings, say. That is, only the managership-part of the contract may be relevant, and only against the norm of the level of earnings.

Thus both in terms of interest and competence the level of purpose-achievement, as such dependent on the way the firm's overall managing function is performed, seems to serve as an activator of shareholder-solidarity, unleashing firstly the voting process within the association and subsequently the exercise of any hiring-contract. Conversely a breakdown in shareholder-solidarity, the -association and thus "corporate democracy" - as apparently occurred in the historical development of the firm- can be explained by (sustained) sufficient levels of purpose-achievement via the activities of the firm:[103] As such these developments reflect the typical nature of the shareholder-firm relationship.

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103) Cf. Marris, R., *Economic Theory of Managerial Capitalism,* pp. 16/7 for a related discussion.

9.4.4 Other factors affecting solidarity: interlocking structures

Other factors can serve to strengthen the bond between founders/shareholders. An important source of this is when another more or less unrelated bond is superimposed upon the relationship between these individuals, i.e. a bond not deriving from their common founder- or shareholdership. A bond most notably present (especially in "earlier" forms in our spectrum of forms of the firm) is that of the *family.* If all the founders are members of the same family this produces a strong bond between them, as such implying unity in the implicit founder-association independent of levels of purpose-achievement. That is, when this other societal structure is superimposed upon or interwoven with the founder- association we have a second and very potent (if a-typical) source of unity in this association. Accordingly any managership- and control- contract with the firm is likely to be very much alive, often resulting in the founders and/or directors themselves occupying top management posts.

Of this the so-called entrepreneurial corporation is a prime example, where family-dominance of the founder-association enables (leading) family members to get themselves elected as directors and, moreover, authorised to "hire" themselves as top managers. (This ability is probably not quite unlimited - at some point continuously low purpose-achievement may strain the family tie.) As the degree of family-interwovenness diminishes, however - say when the firm has to go to the capital market for further

financing, i.e. outside the family circle- non-family shareholders and directors presumably come into play, as does the separation of directorship and managership, eventually leading to a clean structural picture with no interwoven or overlapping structures.[104)]

This is then the way in which the degree of family-interwovenness fits into the whole structural picture, thus explaining the preliminary proposition we derived in section 7.5, i.e. that historically "owners" had a role in management only insofar as the family was interwoven with "ownership" and consequently also with managership. (In the unincorporated forms of the firm it is still so dominated by the family that it is not yet constituted as a separate structure, with no real question of separate director- or managerships yet - founder, director and manager all coincide in the same person(s). In this more or less "collapsed" situation the analysis above still applies, if almost trivially.)

What was viewed, traditionally, as the dispersion of shareholders now appears to principally involve the disappearance of encompassment by another structure which provided an a-typical (family-)bond between the members of the shareholder-association, thus leaving only such solidarity as provided for by the typical nature of this association, as examined earlier. As such the traditional view was based on an as yet incompletely

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104) There remains, of course, a purely external or "differentiated" interlacement - each individual is a member of his respective family; recall section 7.3.

separated-out form which tended to obscure the typical nature of the various internal and external relationships, hence this view's depiction of the structurally "clean" situation, with complete separation, as an undesirable distortion.

The notion of another structure or organisation being or becoming interwoven with the shareholder-association has quite general application. One can conceptualise this as a case of interlocking structures. In most cases this takes the form of another organisation (structure) owning a number (or all) of the shares of the firm, thus encompassing the corresponding member-votes within the association. A common example of this is founder- and stockholdership by financial institutions, which is a special case of one firm "owning" (part of) another and thus being interwoven or interlocked with the latter's shareholder-association (and involved in the election of its directors). This is what is essentially involved in so-called corporate take-overs, which as such involves sufficient if not complete overlapping to ensure electoral control over the directors and the concomitant power to replace top management. (See section 9.5.4, however.)

Furthermore, this analysis also applies to the State in the role of the overlapping structure, owning, as part-founder, shares in a firm - with as extreme case the pure government corporation where the State is the sole founder and owns all the "shares": it subsumes the association.

Its chosen "directors" can thus exercise any managership- and control-contract. This does not change the fundamental nature of the relevant relationships at all - it is still a separate institution, still a firm in all respects, and the overall picture is *structurally* unaffected. In this sense the "ownership" of the firm, who owns it, is irrelevant.

9.5 The role of a stock-market

In a corporate economy the existence of a stock-market, or more generally a capital market, affects the position of the shareholder as such and vis--vis the firm significantly. Since this is a well-known part of the literature we will only provide a short summary and then proceed to new insights that could be added from our structural analysis.

Noting the de facto separation of control from ownership, Marris states that "(w)e are forced inevitably to the conclusion that if shareholders in general possess countervailing power, it must be found mainly •• in the transferability of shares and in the existence of an organised stock-market".[105] "Surprisingly, textbook 'theories of the firm' have largely ignored this link between the institution and its vicarious owners. . . . the interest of general economists has been small by comparison with the enormous role of share ownership, transactions and

105) Marris, R., *Economic Theory of Managerial Capitalism,* p. 18.

speculation in the popular and more realistic picture of our institutions.[106)]

9.5.1 Constraints on managerial autonomy

Building on the observations of Berle & Means several authors, often those associated with so-called "managerial" theories of the firm, have focused on the effect of the stock-market on the relative positions of shareholder and firm/management,[107)] with as main conclusion that *potential or actual transactions in shares are the ultimate constraint on managerial autonomy* in the (private capitalist) firm. This works, simply, *via* the downward effect of selling activity on share prices,[108)] which in turn has at least two potential consequences.

Firstly, it may affect *supplies of finance,* both *via* new equity-issue and borrowing, thus inhibiting expansion: "if firms pursuing certain

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106) Marris, R., "An Introduction …" in Marris & Wood, *op. cit.,* p.3; Marris sees Keynes as a major influence: "Keynes argued that a typical stock exchange behaved so capriciously that its role in resource allocation was either insignificant, harmful, or in contemporary epithet perhaps, 'irrelevant'. In the light of his own speculative successes, his view was influential and *is* still widely accepted."

107) Cf. Marris, R., *Economic Theory of Managerial Capitalism,* chapter 1; Marris, R. & Wood, A., *op. cit.* and Marris, R. & Mueller, D.C., *op. cit.* for surveys of the relevant literature;
Lintner, J. "Optimum or Maximum Corporate Growth under Uncertainty" in Marris & Wood, *op. cit.,* p. 172, is particularly concerned with long-term share valuation.

108) Cf. Furubotn, E.G. & Pejovich, S., "Property Rights and Economic Theory: A Survey of Recent Literature", *Journal of Economic Literature,* December 1972, p. 1150.

policies are unable to expand, in the long run others will predominate: in other words, financial policies inimical to growth do not have survival value".[109] Secondly, depressed share prices increase the likelihood of a so-called *take-over raid.* "Some policies may depress prices so far that the aggregate market value of the equity becomes significantly less than the value, to a single outsider, of the assets behind the equity. The 'outsider' would be a person or organised group who could value the assets on the assumption that sufficient stock was obtained to guarantee easy dismissal of the present directors and a suitable change of policy ... Therefore potential raids are, and always have been, a real factor to any management wishing to stay in office."[110]

The firm can thus not ignore share-prices and can, accordingly, not be indifferent to the extent of selling activity, as such presumably dependent on the level of shareholder-earnings deriving from the firm's activities (and e.g. dividend policies). Selling of shares is thus a *channel of shareholder-power* (or "say") which acts as a major constraint on the ability of management to operate the firm in interests other than those of the shareholders, i.e. on the "power of management" vis- -vis the "corporate orphans".

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109) Marris, R., *The Economic Theory of Managerial Capitalism,* p. 19; also chapter 1.
110) *Ibid.,* pp. 19/20.

9.5.2 Implications from our structural theory

i) Even without a developed stock-market the supplier of finance may be affected by low levels of earnings, at least to the extent that potential shareholders are aware of it, so that the current stockholder is still protected insofar as such information can be communicated to prospective capital-suppliers. Share-price is but a signal to the latter, so that a stock-market can be seen to serve to facilitate such communication and thus to strengthen the protection of the current stockholder. The stock-market role is thus, in this sense, a particular case - dependent on institutional arrangements - of a more general channel of shareholder-"power" or -constraint on management, a channel which derives from the fact that (future) capital-supply is a *voluntary* act. (A take-over, however, does require trade in shares.)

ii) The existence of a stock-market enables the founder-shareholder to quit the capacity of shareholdership. This ensures that stockholding, which is voluntarily entered into, is a voluntary capacity in all respects - the shareholder also has a *selling* or *withdrawal right* (which as such implies withdrawal from any shareholder-association as well). This undercuts any depiction of the modern shareholder as being "oppressed" by "corporate dictators", for he can sever his connection with the "oppressors" at any time (possibly but not necessarily at a net loss in terms of share-price).

iii) It is thus this principle of voluntary capital-suppliership and voluntary shareholdership that lies at the basis of the above constraint on managerial autonomy: management cannot be indifferent to exercising of the withdrawal right. As such this voluntarism produces a channel of shareholder-power and "having a say" which does not directly involve a voting process and/or a hiring- or control-contract, but which (for the first time in this study) *derives from share-ownership as such.* Since a "share" is in the first instance the payment (or promise to pay) received by the capital-supplier, this channel is a "right" which derives from the capacity of capital-suppliership, and the first "right" that a capital-supplier proper has outside any association (which may have a control-contract, etc.). Indeed, it is the only "right" that latches onto share-ownership as such, deriving from its typical nature.

iv) This channel, like that of contractual control discussed earlier, is likely to be activated by the level of earnings, thus producing a norm for the firm: failure of the firm to live up to the standard of expected or average earnings may lead to extensive selling of shares. Management is thus responsible to the shareholder at least to the extent of the average or expected rate of return (which is dependent on capital market conditions, say). This norm is "natural" in the sense that it derives directly from the typical nature of the shareholder-firm relationship, and not from contracts or associations.

v) This channel of "natural" shareholder-"power" thus provides, together with the right to get away from corporate "oppressors" at any time by withdrawing, another explanation for any loss in shareholder- solidarity due to a lack of a commonly perceived need for a shareholder- association in order to achieve their original purpose (recall section 9.4.3 above). The potential need for direct control can be expected to decline insofar as there is a stock-market through which shareholders can exercise their withdrawal right ("voting by selling"). Accordingly the development of a stock-market is/was bound to bring about a changed relationship between shareholder and management, transforming the former from someone seeing himself as an "owner" to an investor and holder of a liquid asset. Without any stock-market the founder-shareholder cannot easily sell his "share" - his withdrawal right is not fully manifested yet - and he may want to use (via the association) the original hiring- contract; with a stock-market non-founder shareholders emerge, with a meaningful withdrawal right, and less if any need for direct control over the firm, less need for a shareholder-association, less incentive to sustain any such association, and thus less solidarity.

vi) On the other hand, if a solidary association does exist, the resulting ability of the shareholders to act in concert is bound to increase their relative power-position vis-a-vis the firm. This may indeed provide for a real bargaining process not unlike that between labour and management, where the association's threat to e.g. sell out to a (single) "raider" is a very real source of bargaining power

see footnote 101, section 9.3). "Investors value voting rights not so much because they expect to use them, but because they can be sold to someone who might."[111] Also note that such bargaining power also accrues to sub-groups of shareholders who could form a significant coalition within the larger shareholder-association (which may or may not be dormant).

vii) This channel of shareholder-power is "natural" in a more fundamental sense than noted above. That is, this channel is intimately linked to and indeed a manifestation of the fact that capital has a *foundational role* in the firm. Accordingly this channel can now be seen to derive from a typical, intrinsic feature of the nature of the firm, with its particular positive form being dependent on institutional and legal arrangements. A limited supply of finance is a constraint on expansion precisely because additional capital is required as foundation for the unfolding and expansion of the overall managing function.

We have noted, more generally, that this role requires of the firm to safeguard its capital foundation at all times (section 3.1). Does this also apply in a non-expansionary context? The capital that is supplied to the firm by the founder-shareholder can, due to the nature of an exchange-agreement, not be recovered from the firm at will. In this

111) Marris, R., *Economic Theory of Managerial Capitalism,* p. 20.

regard the existing capital stock of the firm, and thus the latter's existence at current levels, is not threatened by any decline in share-prices as such. (Low earnings, the probable cause of such a decline, does of course ultimately do that, e.g. if the firm's physical capital cannot be maintained or replaced.) The same is not true for borrowed capital, however, for creditors may demand return of their. capital or at least refuse renewal of a loan or bondholding if they regard low share-price as a sign of low expected earnings and/or increased riskiness of the enterprise (or of course if low earnings cause the firm to default on its interest payments). Thus, also in a current-level or non-expansionary context the firm cannot, to the extent that it has borrowed capital, ignore depressed share-prices (and low earnings). This, still, is due to the foundational role of capital in the firm.

viii) The other way this channel can operate, i.e. via the potential threat of a take-over, derives from the foundational role as well, but in a different way. This threat derives from a valid hiring- contract between the shareholder-association and (top) management. This was seen to originate in the original shareholders being the founders of the firm in addition to supplying its founding capital, and making a hiring-contract with a manager. (Traditionally this has been called "ownership", reflecting just how important his foundational capital is.)

ix) A take-over is a threat to management - and thus a channel of shareholder-power - only because and insofar as there is a valid managership- and control-contract between shareholder-association and (top) management which the "raider" can use. This may seem trivial – until we consider the phenomenon of non-founder shareholdership more closely.

9.5.3 Non-founder shareholders and control

Thus far we have spoken of founders and shareholders more or less interchangeably, and have not focused specifically on non-founder shareholdership, which comes about when a founder sells his "share" – in the first instance his "payment" for supplying founding capital - to a non-founder in a simple exchange-transaction. This introduces a complication with potentially far-reaching consequences (in terms of, note, how the situation *should* be viewed in terms of the nature of the shareholder-association, and not how it is currently regarded by positive law).

The question is: *should the new, non-founder shareholder be regarded as a member of the (original) association?* This is crucial for the control-relation, for we have shown that no formal control-"right" at all can derive from share-ownership (or foundership) per se, but only from a contract between a founder- or shareholder-association and top manager. Accordingly transfer of the share to a non-founder does not,

per se, imply transfer of any formal (contractual) control to the non-founder. All that is transferred automatically is the withdrawal- right and associated "power".

The clue to this question has to be found in the particular origin of the association which has the contract with the top manager (keeping in mind that a variety of arrangements can in principle come about). In the context of the (private capitalist) corporate firm the association is formed by the original founders of the firm when they get together to found the firm. Membership of this association thus depends on being a *founder* which is, as such, a non-transferable capacity, and also a capacity separate from that of capital-supplier. Although it is true that a founder will also, due to his likely capacity as capital-supplier, be an owner of "shares", it is evident that such ownership is at most a necessary but not sufficient condition for foundership and thus for membership of this association.

This implies that the new, non-founder shareholder (who is of course not an initial capital-supplier either) should, in terms of the inner nature of this association (i.e. irrespective of what positive law may say) indeed *not* be regarded as a member of the association and should have no derived control by vote. The "share" he owns is in principle a derivative of capital-suppliership, while the control-contract is a derivative of foundership. Thus, when the founders sell their stock

the original association should be regarded as dissolved, as should the contract between it and management, and, moreover, the non-founder shareholders should not be able to revitalise the association or the contract. They can form a new association, but it would not automatically have a managership- and control-contract.

This still leaves the effect on supplies of finance as a channel of shareholder-power. Only the take-over process would be radically affected. Absence of a contract does thus not leave management unconstrained or the shareholder at the mercy of management - the latter remains responsible to the shareholder, as noted above, at least to the extent of the expected/average level of purpose- achievement (e.g. earnings). But the shareholder is now purely an investor, an asset-holder, with no notion of direct control-rights over the firm. His only right - not an impotent one - is that attached to share-ownership per se, i.e. his withdrawal-right. (And as always his share-ownership is still voluntary.)[112)]

In practice this is of course not what happens, for almost all legal systems do not make the distinctions we have made. This, as we noted in section 9.3, derives from the erroneous view of share-ownership as ownership of the firm, with concomitant property rights, so that in

112) The shareholders can, of course, always use the threat of wholesale selling, causing severe depression of share prices, to bargain with management to have a say in e.g. the appointment of managers. This may even lead to a new contract of some form, etc.

reality the condition for membership of this association (which is in any case not recognised as separate from the firm, as we do) is taken to be shareholdership. Accordingly non-founders normally receive all the legal rights that the initial share-owner had to control the firm via elected directors.

In spite of this, however, remark (v) of section 9.5.2 can still be seen to apply. Even with legal control-rights the need to exercise such control (and the need for the shareholder-association) can be expected to decline insofar as there is a developed stock-market. In this way the non-founder shareholder is effectively still transformed - voluntarily - to the role of investor and liquid asset- holder, as in the previous case. In both cases this is the position of the shareholder that seems to prevail, a position that clearly reflects his original role of capital-supplier, and not of founder.[113)]

On the other hand this is when and why a take-over raid is so potent a danger, for as sole or majority owner of shares the raider can activate the contract to replace management - the economic equivalent of a coup d'etat, as we noted before.

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113) Cf. Berle, A.A. & Means, G.C., *op. cit.,* chapter VIII, for a rather alarmed description of this position, alarm based on the notion of the "ownership"-rights of the shareholder.

9.6 Summary

In chapter 8 we concluded that neither the concept of "ownership" of the firm, nor the capacity of capital-supplier, nor the historical and developmental interwovenness of "ownership" and managership provide any basis for an intrinsic right of the shareholder to have direct or formal control over the firm. In this chapter we considered the notion of "corporate democracy" and control through voting, concluding that the latter can only provide a voice within a separate shareholder-association. What matters is the inter-relationship between this association and the firm, and its typical nature provides no basis for intrinsic control either.

The only basis for formal control, we concluded, can be a *contract* to that effect between and agreed upon by the firm (top manager) and the shareholder-association, a contract that was seen to originate, like a shareholder-association itself, in the role of the founders or, especially, a founder-association. Continued existence of the latter, and thus continued validity and relevance of this contractual control- channel was shown to depend on the solidarity of the members, which in turns is affected by various factors: number of shareholders, levels of purpose-achievement, overlapping societal structures, and alternative channels of shareholder-power or -protection.

An alternative channel was then shown to exist in the constraint that the voluntarism of shareholdership, coupled with the foundational role of capital, places on management - with particular attention to the shareholder's withdrawal right, his right to sell his share in a stock-market. This channel, unlike all the others, attaches to shareholdership as such, outside of the existence of any association or contract, and does not rely on the (false) notion of "ownership" of the firm. It is "natural" in the sense that *it derives intrinsically from the typical nature of the firm and the shareholder-firm relationship.* As such it is a *manifestation of the position of the shareholder as capital-supplier, investor and asset-holder.*

This then concludes our study of the nature of the relationships between different (groups of) people in and around the firm, with particular attention to the so-called "owners" and management. Along the way we have seen that the source of much of the controversy about this is false conceptions of the nature of capacities and the relations between them. Having cleared this up we can now link this to our earlier analysis of the role of goals and purposes in the firm (section 6.1), which returns us to where we started out, the so-called "theory of the firm".

10. CONCLUSION: PURPOSES AND THE "THEORY OF THE FIRM"

our point of departure in this study was the various so-called "theories of the firm" - neo-classical, managerial, behavioral - and the resulting controversies between proponents of the different viewpoints, both on positive and normative levels. We pointed out that these controversies ultimately concern (one's view of) certain prominent aspects of the firm - capacities (those of shareholders, owners, directors, managers, workers, customers, suppliers), relationships between them, power and authority, goals and purposes, etc. - and that their resolution lies in a clear view of the underlying nature of these aspects.

Such a clear view was the main purpose of this study, as formulated in three questions: the typical nature of the firm as such, the typical nature of the capacities and the relationships between them, and the role of goals and purposes, notably whether they determine the typical nature of the firm. To this end we derived, from the historical development of the firm, its *characteristic structure,* capturing therein the broad typicalness displayed by this institution. We also characterised the firm as an *organised* institution (an organisation) and as a *voluntary association.* We then showed that from the concept of a characteristic structure one can derive a general, coherent and consistent conceptual framework for analysis of the relevant questions and issues: the difference and distinction between the firm's internal and external relations, the

nature of the employment relation, transactions costs and vertical integration, the contractual aspect of these relations, the question of authority in the firm vis-a-vis in the market, the role of purposes and goals in the firm, the role of "ownership" in the firm, the nature of the relation between "owners" and management, the question of "corporate democracy" and shareholder-voting, the role of the board of directors, the role of the stock-market, etc. At the same time we gained new insights into the contributions and shortcomings of other approaches, as well as into the historical development of the firm (a secondary purpose of this study). The main body of this study is thus now complete.

In conclusion we will now return, briefly, to the theories of the firm, not to present any new such theory - that is not the focus of this study - but to contribute certain insights from this study that are particularly relevant. That is, we want to consider the relation between these "theories of the firm" and what we have seen to be the typical nature of the firm and related relationships.

10.1 A reconsideration of the "theories of the firm"

Consider once again the two basic approaches - traditional versus managerial. In the *traditional* (or neo-classical) theory the firm is regarded, implicitly or explicitly, as a profit-maximising institution (as in the dichotomy of firm versus non-profit institution) - that is,

profit-maximising is viewed as an integral part of the firm - and as a (single-owner or "inflated") owner-controlled entrepreneurship. This fits in to a larger view of the perfectly competitive market which also forces the firm to do nothing but maximise profits, with zero-profits being seen as "normal". It is clear that this view is based, first of all, on a very ununfolded, "closed" or even "primitive" form of the firm, a polar case in the spectrum of developmental forms we have considered. The narrowness of this accounts for the inability of this approach to accommodate more unfolded forms of the firm like the corporation without trying to compress it to fit a "closed" mold.

Moreover, this theory attempts to define the firm in terms of its external environment, i.e. the nature of the firm is seen as being determined by external conditions - again a polar case, the perfectly competitive market - which, together with entrepreneurial motivation, cause the firm to profit-maximise - in this view perhaps its most typical and identifying feature - and to have zero-profits, thus being "normal", i.e. typical or natural. From our analysis it is clear that this view errs in several places. For it links the typical elements of the firm to external relations, while we have seen that a typical element, as such part of the typical nature of the firm (i.e. of its inner nature), is per se separate and quite independent of external conditions. This mistake is due to its failure to distinguish between the constant typical nature of the firm and the positive form of firms, the variability of which is transcended by the former. The positive form

of any firm will be affected by external conditions, yes, but its typical nature, as manifested in its characteristic structure, remains unaffected - it is still a *firm.* The typicalness of the firm, *what* it is, can thus not be determined by external conditions.

Neither can it, secondly, determine or be determined by the goals pursued by the firm, whether it is profit-maximisation or whatever. Baumol wanted to convince the economics profession that the goals of the firm cannot be determined by a priori considerations by showing that sales-maximisation as a goal makes eminent sense and is consistent with his experience with real firms; others attempted likewise. The power of our approach is that it goes much further, for it enables us to derive this result from the typical, inner nature of the firm. As we have shown in section 6.1, any particular goal pursued by the firm or its founders can never explain or determine the inner nature of the firm, nor can it be an inherent part of the typical nature of the firm. It is transcended by the latter. (Here insight into the distinction and relation between the constant inner nature of all firms and particular, actual features of positive firms is, again, essential - the positive form of the firm is what will not be independent of goals and purposes.)

On the other side of the debate we find the so-called *managerial* theories of the firm. These theories also build on certain market-conditions, but these are not polar and include the whole spectrum

imperfect competition (which allows the making of so-called "abnormal" or super-normal profits). On the other hand they do require the separation of ownership and control, which more or less limits their applicability to the large (modern) corporation with dispersed shareholders. It is thus still a view of the firm bound to certain external conditions, although these are not seen as determinants, but rather as factors *allowing* non-traditional ("abnormal") behaviour, notably the pursuit of objectives other than profit-maximisation – sales, size, rate of growth, etc. The pursuit of these goals is, however, regarded as subject to certain minimum profit (or minimum stock-market valuation) constraints - profits thus becomes a constraint, a minimum performance requirement, rather than the dominant goal of the firm (except when the constraint is binding, of which the perfectly competitive model is an example).

The first thing to note is that these managerial theories are based on a more unfolded conception of the firm in which the different capacities have become separated out, and are distinguished as such. Secondly, there seems to be a correspondence between the two major elements in the managerial utility function and the two characteristic functions that we have distinguished. In section 9.5 we showed that from the fact that capital has a foundational role in the firm derives a channel of shareholder-power which acts as a general constraint on the operation of the firm: management is responsible to the shareholder at least to the extent of the average or expected rate of earnings. It

is now evident that the recurring profit-constraint in the managerial theories is but a manifestation of these implications of the foundational role of capital: the foundational function implies a minimum condition for continued interference-free execution of the leading function, i.e. the overall managing of the production and/or distribution process.

The latter function then finds expression, roughly, in the other element in the managerial utility function, e.g. the size and/or rate of growth in the extent of the managing function. But it should be noted that size and growth are here seen as but proxies for managerial goals like prestige, power, salary, etc. Size or growth is thus a derived objective, disguising the fact that the managerial goals are regarded as the ultimate determinants. In this regard, by focusing on (managerial) goals only in purporting to study or explain the firm the managerial theory is as narrow as the traditional theory of the firm, and it still does not recognise the goals-issue as separate from the nature of the firm.

In spite of this, and even though these theories are formulated individualistically in terms of managerial utility functions - they do not consider the role and responsibility of the manager within the firm as a "whole", for one- this is the closest any "theory of the firm" has come to acknowledging and displaying elements of the typical nature or characteristic structure of the firm. (Especially the lexicographic form, which has a minimum profit-level as the first priority, with other goals as second priority, captures the foundational role of capital very closely.)

As Marris & Mueller have noted (see section 1.2), in the traditional view of the firm the (corporate) firm's prime objective can be seen to be to maximise shareholder welfare by maximising stock-market value, which then represents any profit-maximising element. (In the unincorporated firm the latter affects the wealth of the so-called "owner" directly.) We have also seen, above, that the fact that the stock-market value is a concern for the firm stems from the foundational role of capital in the firm. From this the view of the firm as an owner-controlled singular profit-maximiser appears, firstly, as a distortive overemphasis of the foundational function of the firm, at the cost of a narrow and restricted scope for the leading/managing function. In this sense the result of "perfect" competition is a not-so-perfect form of the firm, notwithstanding perfect competition's allocative properties.

Secondly, it implies a singular devotion of a whole societal institution, the firm, to the interests of what we have seen to be only its founding (or even non-founding) capital-suppliers, again with disregard for the potentially distortive and restrictive effects on the unfolding of the firm as a whole. The traditional view reflects only the viewpoint of the so-called "owner" and his property rights, and has no concern for the firm as such.

Thirdly, the concurrent allocation of the power to control the firm (for their benefit) to these (external) founding capital-suppliers implies the same submission of the whole societal institution to (outside) individuals, as captured most pregnantly in the view of the firm-as-property. (In this respect there is an approximate parallel between this "owner"-control and a State with a military government. This is especially so for the unincorporated firm, where the (personal) owner and controller of the capital(-power) also manages/governs the firm. Upon incorporation the correspondence is more complex, but the parallel still holds.)

10.2 The controversies reconsidered

In section 1.3 we mentioned major points of disagreement and controversy between the two broad approaches, positive as well as normative. The first question is whether the so-called "separation of ownership and control" has occurred or does occur at all. This is, of course, an empirical question which is not our concern here. However, with respect to the *terms* in which the factual developments are interpreted it has *not* occurred, for we have shown that whatever happened should not be described in terms of the concept of "ownership" of the firm, but in terms of the capacities of foundership, capital-suppliership and managership. Secondly, whether the directors of a company *will* attempt to maximise shareholder-welfare, i.e. whether profit-maximisation is an integral part of the firm, as propounded by the traditional view,

has been discussed above, and the contrary was derived from the typical nature of the firm.

Thirdly, *should* maximum shareholder-welfare be pursued by the firm? We have shown that neither from the inner nature of the firm nor from any notion of "ownership" can one derive such a prescription. From the viewpoint of the firm as societal institution the shareholders/"owners" are only the founding capital-suppliers or their successors/ heirs, which implies a responsibility only up to at least the expected rate of return on the capital they supplied to the firm (their "payment"). Above that there is no *automatic* or *intrinsic* obligation upon the firm, and its task is to operate (interference-free) as a self-dependent institution. Continued subjection of the firm to shareholder-interests, as we noted above, potentially threatens the integrity and unfolding of the firm, as shareholder-control (implicit or explicit) potentially compromises the managing authority of the management. (Also see p. 119 above.)

Fourthly, should the "managerial revolution" be reversed? Our analysis and developmental perspective have shown that alarm at this "revolution" and its effects on the behaviour of the firm sterns from false views regarding "ownership", control, etc. - the concept of "ownership" of the firm is simply not useful nor relevant in judging whether developments in the form of the firm, or the behaviour of the firm, is "right" or "wrong". Moreover, we saw that these developments have

resulted in the separation or differentiation of previously overlapping but different capacities, leading to a more opened and unfolded form of the firm and of the relationships. It is but *a manifestation of the typical nature of the relationships between these capacities.* Accordingly from the viewpoint of the typical nature of the firm and of these relationships there is no reason for alarm at or reversal of the process. (On the other hand the term ununfolded or "primitive" was not meant to denote undesirability per se of the simple forms of the firm- it is simply a matter of developmental order.) And fifthly, the modern corporation is of course not a new societal institution to be judged with criteria other than for other firms - it is still and always a firm, only an *unfolded* firm, and the apparent inapplicability of earlier concepts springs from their erroneous use with respect to the firm as such in the first place.

10.3 Structural interlacements and the goals pursued by the firm

We noted in the Introduction (section 1.3) that one of the weaknesses of the other approaches, traditional as well as "managerial", is their inability to clarify issues among the overwhelming array of different forms, shapes and sizes the firm comes in and has come in historically. Most of the theories apply only in a more or less limited economic, legal or historical situation. This is precisely where one of the main strengths of our structural approach lies, for by identifying the characteristic structure as embodiment of the typical nature of the firm,

it penetrates to the underlying constancy in the diversity, to the inner typicalness that transcends all these variable forms, identifying them all as *firms.*

Only because of this ability can it provide, firstly, a consistent explanation of all the historical and developmental forms of the firm, from single-ownership to modern corporation, thus attaining full generality in this respect. Secondly, this ability to see the constancy within the diversity also applies in another important context, namely the multiplicity of societal organisations or structures - firms, shareholder-associations, families, States, labour unions, etc. As we have seen, part of the diversity among the positive forms of the firm is due to differing (degrees of) interlacements between such structures: firm and family, firm and shareholder-association, firm and labour-union, State and shareholder-association, financial institution (or another firm) and shareholder-association, or firm, shareholder-association *and* family, etc. Different interlacements and different degrees of it imply different positive forms of the firm - and these may obviously change over the course of a firm's life - and only insight into the constant inner nature and characteristic structure of the firm, and more generally the recognition and identification of different societal structures enables one to make sense out of this intricate (and changing) system of interlacements, to identify and "isolate" the firm throughout. As such this approach proves a quite general method for

analysing any potential interlacement the firm may become involved in, identifying its observed form as the result of the particular interlacement and *not* as some "new" societal institution.

The variability of the positive form of the firm can thus be understood in several (related) contexts: firstly, as the result of a certain phase of development or unfoldedness, and secondly as the result of a certain set of structural interlacements. A third relevant context is the external relations with shareholders, shareholder-associations, other suppliers, consumers, consumer-groups, other firms, government, etc., where relative (power-)positions is the important factor. (These contexts are not independent: family-domination may determine the stage of unfoldedness, or family-interlacement with the shareholder-association may affect the latter's solidarity and thereby its relative power-position vis- -vis the firm.)

My thesis is then that the *purposes* or *goals pursued by the firm* must also be understood within these contexts, i.e. as being dependent on circumstances in all three these contexts. The theories of the firm that we considered do this, partially, with respect to the third context, mainly with respect to market conditions. What we want to point out is that *the goal pursued is very likely to be a trait of a particular developmental phase and/or particular structural interlacement,* in addition to external conditions.

So, for example, as long as the founder-association is interwoven with the firm, or more precisely, as long as the former's board of directors overlaps (more than 50% say) with management - so that the control-relation between board and management *is* automatic - the goal of the founders *is* likely to be pursued, e.g. profits in the case of a private capitalist firm. Note that this interlacement, in turn, can be (and historically has often been) the result of the encompassing interlacement of the family first with the shareholder- association and consequently also with management.

When the so-called "managerial revolution" has occurred, i.e. when board and management do not overlap significantly (or at all}, the relevant question becomes the external power- and control-relation between the founder-association and management. As we saw above, in this case a factor like the solidarity of the association is crucial, as *is* the fact that the firm/management may be free to pursue other objectives as long as it fulfills its first responsibility towards the capital-suppliers (by attaining the minimum required profit-level).

On a different level relative power-positions vis-à-vis e.g. labour unions or consumer groups may imply other constraints on the goals pursued by the firm, as does, of course, the existence of competing firms, i.e. market conditions. (An extreme example of this is then where a so-called perfectly competitive market cause the minimum

profit-constraint to become binding and profits the main goal of the firm – the traditional or neo-classical firm, that is.)

If another firm (or a financial institution) becomes significantly overlapped with the shareholder-association, it may utilise a valid hiring-contract and install a management which will pursue *its* goals - the usual result of a take-over. Or, if the government is significantly or totally interwoven with the founder-association, it can ensure the hiring of managers that will pursue objectives like, say, job-creation or development of an infrastructure. And so forth.

(All of this is of course bound to the characteristic structure of the firm - the positive form of the firm that results from whatever goal is pursued must be consistent with the unchanging typical nature of the firm, otherwise the existence of the firm itself may be threatened. Crucial here, of course, is the capital foundation of the firm - its safeguarding implies a structural constraint on the positive from the overall managing function may be given in pursuit of any goal.)

Generally we can conclude that different external conditions, developmental phases and structural interlacements are likely to be the main determinants of the goals pursued by a firm. The specific contribution of our structural approach in this regard is, firstly,

that different stages of development may imply different goals and, secondly, that the *nature and strength of structural interlacements* - which may vary over time, for particular firms as well as in terms of general trends - may be especially important in determining the goal pursued by the firm. This conclusion, it must be noted, lies outside the grasp of the "theories of the firm", for they lack the structural insight necessary to identify such interlacements or (corresponding) developmental phases. Such insight, we have seen, derives only from the ability to distinguish the firm and other societal structures, even and especially when they are interwoven. This requires, in turn, insight into what is the typical nature of the firm, something which our characteristic structure approach provides most eminently.

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