THE CHOICE OF BUSINESS FIRMS: A SUGGESTION TO THE RULERS IN EASTERN EUROPE

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1. THE (IM) MORALITY OF THE TRANSITION INDUSTRY

The rejection of private property rights was the central premise of socialism from its earliest days, and the abolition of private property rights was the driving ideological force behind all socialist experiments in the twentieth century. The best examples of those institutional arrangements are the former Soviet Union and the former Yugoslavia. The Soviet type firm and the labor-managed firm were not ad hoc models; indeed, they were the consequence of the basic philosophical and economic premises of the socialist doctrine as it has evolved since the eighteenth century. And they have both failed.

The apologists of socialism argue that by pursuing their own ends, the political leaders in Eastern Europe and the former Soviet Union ruined the chance for socialism to prove itself as a viable alternative to the private-property, free-market economy. The argument is plain wrong. The leaders did exactly what all of us are doing. They pursued their private ends; the economic outcome being determined by the system of incentives that socialist institutions generate.

Today, the consequences of the socialist experiment, perhaps the costliest experiment in human history, are fading from our memories. For university students in the West, the socialist rule in the Soviet Union and Eastern Europe is fast becoming an ancient history; something that could not possibly happen again. Young men and women are busy with their careers in competitive markets. Baby boomers in the United States are focusing on the value of their retirement annuities. President Clinton has almost succeeded in socializing our health care. The European Community is creating a huge bureaucracy, which will eventually replace the freedom of choice in Western Europe with legislated outcomes. John Paul II has expressed some serious misgivings about the consequences of the free-market, private property economy.

Memories are in the short supply in the East as well. In Russia and many East European countries pro-collectivist parties (communists, socialists, nationalists, etc.) are gaining votes. In Serbia and Bosnia people are talking about good old days under Tito. They forget that Tito's "war of liberation" freed Yugoslavia from the German occupation not a day sooner than it would have happened anyhow. To seal his victory over the opponents of communism, Tito murdered in 1945 over 30,000 Croats, Serbs and Slovenes. In the early 1950s, Tito organized concentration camps that were as bad and probably worse than Stalin's gulags. As late as in the 1970s, Tito conducted a major purge that condemned thousand of people in Serbia and Croatia to unemployment and jail sentences.

The attitude of present-day socialists has been affected by two real world experiences: the failure of all socialist experiments to develop efficient enterprises, and the theoretical research and empirical evidence about the efficiency-enhancing consequences of the right of ownership. Those two real world experiences created strong (survival) incentives for socialists to rewrite the doctrine in a way that would make private property rights and socialism compatible. To accomplish that, they needed allies. And they found them in the West as well as in the East.

Western scholars associated with Russian Centers, East European Centers, associations for comparative systems, and various industrial policy institutes

discovered, practically overnight, that the demand for their “skills” was gone with the wind. To survive, they had to look for the ways to salvage their knowledge and training. In the East, universities were not de-communized (except in East Germany). After many decades of research and teaching about economic planning, East European professors had to do a complete turnaround and support free-market reforms. Leaving aside the morality of those people, the fact of life is that their human capital is not adeuate to help them understand and even less appreciate the economic forces at work in the private-property, free-market economy.

I conjecture that the transition process, as we knew it in 1989-92, is long gone. Today, we witness the birth of a new rent-seeking coalition: the transition industry. It consists of the latter-day socialists, social engineers, bureaucrats, economists from the West and the East who are looking for programs that would reward their old skills, reformed and non-reformed communists, and others. The survival trait for this diverse group of rent-seekers is to seek ever larger role for East European governments, to develop and impose legislated outcomes, and to deny that private property rights and individual liberty are superior to social engineering. To paraphrase Vaclav Klaus, “the muddle in the middle” is the quickest way to the third world. By failing to separate analysis from abstract valuations and beliefs (which occur in a cognitive limbo), the muddle in the middle offers no useful evidence for economic analysis.

The purpose of this paper is to remind the political-scientific elite in Eastern Europe that the strong positive relationship between the private-property, free-market economy and economic development is not accidental. The more property rights in a good the person has, the closer is his private cost to the social cost of using that good. This relationship between private and social costs creates strong incentives for individuals to engage in activities that promote economic development. As they exploit those incentives, risk-takers capture the rewards. Socialist institutions create incentives that cannot duplicate the contribution to economic development that profit seeking individuals such as Gates, Ford, and Dell have been making.

This paper will focus on two interrelated issues. First, it will discuss the economic advantages of privately owned firms. Next, the paper will emphasize the importance of keeping the state out of the process of choosing business organizations.

2. WHY DO WE HAVE BUSINESS FIRMS?

The firm is a group of people in teamwork. It is a set of contracts involving separately owned inputs whose value as a team exceeds the sum of the market values each member of the team could produce by contracting the use of his inputs across markets. Business firms exist because teamwork is an efficient method for organizing production.

In a private-property, free-market society, we observe a number of different contractual agreements. We can think of those contractual agreements as approximating a random selection, from which successes and failures are chosen. With bounded rationality and positive transaction costs, all contractual agreements producing positive gains (that is, the value of output in excess of the sum of the market values each member of the team could produce contracting across markets) are eligible for imitation. By imitating

successful contracts, individuals create a selection process from which different types of privately owned business firms emerge.

The privately owned firm is a set of contracts between the owners of cooperating inputs with one party who is central to all contracts. While the terms of contractual agreements among team members differ in some specific details from one firm to another, and especially from one type of business firms to another (e.g., corporations, codetermining firms, partnerships, mutuals, not-for-profit, cooperatives etc.), all privately owned firms have the same bundle of property rights. Those rights create their own incentives affecting economic behavior in specific and predictable ways. Three major property rights that define the privately owned firm are:

The owner's right to appropriate the firm's residual. This right creates incentives for the owner to pursue efficiency-enhancing behaviors, and to incur the costs of technological and managerial innovations. The owner's right to hire and fire members of the team. This right is essential in order to enforce incentives specified under the right number one. If the owner had to satisfy criteria not related to the performance of members of the team, such as the affirmative action in the United States, the firm's costs of production would be higher and marginal enterprises would not survive. The right to sell the preceding two rights. The transferability of assets is the most important component of the right of ownership. It provides individuals with a choice to take the value of their assets in a lump sum or as a flow over the life of those assets.

The bundle of rights specified above has three behavioral consequences that set all the different types of privately owned firms apart from non-private enterprises. First, the owner's right to capitalize the expected future returns into their market prices eliminates the time horizon problem; the flow of future benefits over the expected life of the firm being available to the owner in one lump sum. Second, the right of ownership allows the owner to make adjustments for his/her risk preferences. If I were risk averse I would sell the flow of income from my oil-well for a lump sum of money, and invest proceeds into government bonds. My risk-taking colleague can do just the opposite. No other types of property rights give individuals this type of choice. Finally, the bundle of rights creates strong incentives for the owner to seek the best use for the team's resources. Those three consequences of private property rights explain why privately owned firms have outcompeted all other types of enterprises.

4. THE ECONOMIC AND LEGAL STRUCTURES OF BUSINESS FIRMS

Let us now turn to the question: what do academic research and empirical evidence have to say about governance structures and different types of privately owned firms?

4..1. The Choice of Governance Structures

We know that the survival of business firms depends on their success in producing the market value that exceeds the sum of the market values each member of the team could produce by contracting the use of his inputs across markets. The source of the gains from teamwork is incentives arising from the contents and terms of contractual agreements among members of the team. Thus the governance structure of business firms matter.

There is a tendency in Eastern Europe to pass laws specifying governance structures. The problem with that tendency is that fixed rules freeze governance structures into a rigid system. They substitute preferences of the ruling elite and social engineers for the agreements between equity owners, potential investors, senior executives, the employees, and all other members of the team who know their own preferences, bear the risk of their choices, and are directly affected by the firm's performance.

On the other hand, the freedom of contract allows members of the team to choose what kind of firm they want to have (corporation, partnership, mutuals, cooperatives, etc.); to decide whether they want a centralized or decentralized firm, inside or outside directors, a strong CEO or a strong board; to choose the method of rewarding performance (stock options, cash bonuses, premium over market wages, non-cash benefits such as long holidays, etc.); and to specify trade-offs between profit and other objectives (as the York Times and the Wall Street Journal have done).

For example, in a large manufacturing firm in Dallas, four out of thirteen members of the board are former employees ("inside" directors). Two members of the board are current employees (chairman of the board and the president) of the Company. Remaining seven members of the board are "outside" directors selected for their accomplishments in finance, business and academics. As a condition of their tenure on the board, "inside" directors must seek membership on the board of other firms.

All the different governing structures that we observe in the United States have emerged through voluntary contractual agreements and passed the market (survival) test. The survival of alternative governance structures is the best evidence that no two firms are alike. Professor Andrews wrote that some boards specialize in handling crises, others produce CEOs from among their members, some boards are minutely interested in day-by-day operations, while others prefer to remain more detached. But, no single model can specify the interrelation of functions.

To justify a set of fixed rules about governance structures by saying that they reflect the evolving trend is plain wrong. No firm needs the law in order to adapt to emerging practices. And many firms need to be free to deviate from the trend. Analysis and empirical observations suggest that the best way to go is to let members of the team develop governance structures in accordance with their judgment of their survival needs.

4.2. Industrial Democracy by Fiat Is a Wrong Choice

Industrial democracy is an umbrella for all the different forms of labor participation in the governance of business firms. Evidence shows that industrial democracy has not emerged voluntarily on any significant scale and has failed to perform successfully whenever and wherever imposed by fiat. Yet, the demand for labor participation in the governance of business firms continues to be relatively strong. The reason is quite simple: industrial democracy offers too many rent-seeking opportunities, and satisfies too many ideological preferences to be discarded on account of its poor performance.

Whatever the facade of words, terms such as industrial democracy, stakeholding, or labor participation are code words for wealth transfers. Involuntary labor participation in the governance of business firms restricts the freedom of individuals to negotiate mutually beneficial organizational

forms. An implication is that by increasing the risk borne by equity holders, involuntary labor participation in the governance of business firms raises the cost of equity capital. When the shareholders invest their wealth into an investment project that turns out to be successful, they share the gains with labor. When the investment decision is not successful, shareholders alone bear the losses. Employees experience no loss of wealth; their cost is limited to the cost of changing jobs.

All the different forms of involuntary industrial democracy have one common effect: Labor participation in the governance of enterprises attenuates the right of ownership and, consequently, increases the gap between private and social costs of using scarce goods. The fact that labor participation in governance has to be mandated by the government and protected from competition is the best evidence of its inefficiency.

If labor participation had positive effects on the firm's productivity, why don't we observe the labor participatory firm on a significant scale? Why don't shareholders negotiate with employees a contract that would make both groups better off? If labor participation has to be mandated by law, how can we assert that it is a superior method for organizing production? There is no law in the United States that says that there shall be no labor participation. Indeed, there are cases in which labor participation has emerged voluntarily, but it has not happened on any significant scale.

Germany is a good case for analysis of the consequences of involuntary labor participation in the governance of business enterprises. The Codetermination Act of 1976 in Germany—a capitalist version of the labor-managed firm--applies to all business firms that have more than 2,000 employees. The supervisory council (i.e., the board of directors) for such firms has twelve members, of whom six are representatives of the shareholders and six are representatives of the employees. The chairman of the supervisory council is elected by the shareholders and holds the deciding vote in case of a deadlock.

Empirical evidence is simply not consistent with the claim that codetermination bestows benefits on workers without any detrimental effects on other members of the team. Immediately after the passage of the Codetermination Act of 1976, many business firms tried to escape the parity representation on the supervisory board through mergers, reorganizations, moving their headquarters abroad, and other structural changes. In the late 1970s, codetermination applied to about 650 firms. By the early 1980s codetermination covered only about 480 firms. About 120 firms had reduced their labor force below the 2,000 limit, while about 50 firms had changed their corporate charters. Assuming that both the size and contractual forms of those 170 firms reflected efficient business decisions, the post-1976 adjustments are a social cost of codetermination.

Jensen and Meckling summarized the economic effects of involuntary constraints on the freedom of contract in the following passage:

Indeed, labor can start, and in rare cases has started firms of its own. Moreover, firms are free to write any kind of contracts they wish with their employees. If they choose to, they can offer no-dismissal no lay-off contracts (tenure at universities). If they choose to, they can establish worker councils and agree not to change production methods without worker approval.

Moreover, employers would [encourage] such practices if the benefits exceeded the costs. Furthermore, if laborers value the security and "self-realization" which such participatory arrangements afford them at more than their costs to the employer, they are in a position to offer voluntary changes, which it will pay the employer to take. ...Since those arrangements are [rarely] observed, we infer that workers do not value the security, management participation, etc. at more than the cost of providing them [emphasis mine].

4.3. The Corporate Firm Has Emerged Spontaneously

In the United States, we observe a large number of different types of business firms such as single proprietorships, partnerships, corporations, mutuals, not-for-profit firms, cooperatives, etc. All those firms have emerged through voluntary contractual agreements and survived competition from other types of firms; that is, law mandated none of those types of business firms. They reflect the freedom of individuals to write any kind of contract they wish with each other and bear the costs (risk) of their choice.

The corporate firm is a product of this competitive environment. It has emerged spontaneously and survived competition from other methods of organizing production. The corporate firm is the best example of the wealth-creating consequences of the private-property, free-market economy. The advantages of the corporate firm over other types of private ownership firms arise from: the rule of limited liability, the dispersion of shareholding, and the market for corporate control. Let us briefly describe each of them.

The Law of Limited Liability. Mass production of goods, production of durable goods, production of heavy machinery, the implementation of new technologies, innovations, and many other investments and commercial activities require pulling together large amounts of capital. Banks could not satisfy this huge demand for capital without driving interest rates to a level at which many opportunities for economic growth would fail to be exploited. We have enough research and empirical evidence to know that the state can neither raise voluntarily large amounts of capital nor be trusted with the allocation of investable funds. Except in frictionless blackboard models, state ownership provides strong incentives for the allocation of resources to by-pass the market test.

In response to economic pressures from within the system, numerous contractual agreements were tried in order to resolve the need for pulling together large amounts of capital. Eventually a new legal concept evolved: the rule of limited liability. This law limited each owner's (i.e., equity investor's) liability to the market value of his investment in the firm, which created incentives for equity investments to be divided into small shares and traded in financial markets. By breaking up equity interests into relatively small shares, corporate firms were able to attract funds from small savers. This advantage derives from the anonymous alienability of shares, which enables shareholders to sell their shares without requiring the approval of other shareholders. By contributing to a substantial reduction in the transaction costs of raising large amounts of investable funds, the rule of limited liability made the corporate firm the most effective method of voluntarily gathering large amounts of capital for long-lived ventures.

The Separation Thesis. Starting with the dispersion of shareholding, which is a fact of life, A. Berle and G. Means developed the separation of ownership

and control thesis. The separation thesis quickly acquired a strong following among the critics of capitalism, who routinely ignore the difference between one's desires and the reality of market processes. Branko Horvat xe "Horvat" from Croatia and Mihailo Markovich xe "Markovich" from Serbia, applied the separation thesis to their own vision of the world. Some decades ago they blamed private ownership for transforming humanity into a horde of profit-seeking beasts. Today, they argue that there is no need to encourage the development of private-ownership firms because the dispersion of shareholding has already socialized private property rights in business firms.

The separation thesis basically says the following: The dispersion of shareholding insulates the management from the owners. Thus, the right of ownership is empty because the shareholders have no control over the use of their resources. Managers control resources, make decisions affecting shareholders' wealth, and can easily protect themselves by soliciting proxies at the company's expense. The bottom line is that the dispersion of shareholding leads to (1) withering away of private property rights in the corporate firm, (2) the transfer of a part of the residual (i.e. shareholders' wealth) to managers, and (3) a reduced flow of capital into business firms with dispersed ownership.

Empirical observations are consistent with neither of these two outcomes. The fact is that millions of individuals continue to invest in common stock. Why do they not choose other investment opportunities that exist in the United States? Why is equity financing not being driven out by investments in fixed claims? Why do we not observe a lower bid price for stocks of corporations with dispersed ownership relative to those firms that have less dispersed ownership? Why do dispersed ownership corporations not have lower rates of growth of shareholders' wealth?

The Benefits of the Dispersion of Shareholding. The dispersion of shareholding is, in fact, an important source of the efficiency of corporate firms.

1. There is no law in the United States that says that people have to buy shares in corporate firms. It is their choice. And they have many other alternatives for their savings. Thus, when people buy shares they voluntarily separate themselves from controlling their property. And for a good reason. Those who buy shares in corporate firms choose to specialize in bearing the risks. Managers are individuals who specialize in managing the risk. The dispersion of shareholding is then fully consistent with the law of comparative advantage.

2. In the United States, even small savers can diversify their investment portfolios and avoid the firm-specific risks. The separation thesis then "leads to lower capital costs for firms in the economy, and to greeter innovation, as shareholders are capable of investing in riskier ventures due to their ability to mitigate such risk through diversification."

3. The fact that shareholders have incentives to include innovative ventures into their portfolios means that the dispersion of shareholding is a source of capital for small start-up companies.

4. The diffusion of ownership provides the funds required for economic growth without a concentration of economic power within a society. An alternative is a concentration of share ownership in the hands of the state or

state protected rent seeking coalitions, which means a concentration of economic and political power within a society.

5. The separation thesis contributes to the development of a large middle class with significant and diversifiable stakes in the economy. Highly competitive money managers who quickly punish non-performing firms by selling their shares in financial markets represent this group, which includes millions of retirees.

The Costs of the Dispersion of Shareholding. Berle and Means were right in saying that the dispersion of shareholding has its costs. But, the fact that the corporate firm has continued to prosper could only mean that the benefits of the dispersion of shareholding exceed its costs. Let us now identify those costs and the circumstances upon which they depend.

Major costs of the dispersion of shareholding are the transaction costs of monitoring managerial decisions that affect shareholders' wealth, and the costs of hiring and firing corporate managers. Given their estimate of transaction costs, corporate managers should then be able to transfer some wealth from shareholders to themselves. They can do that in a variety of ways such as liberal expense accounts, plush offices, company planes, large number of beautiful (but not necessarily efficient) secretaries and receptionists, pleasant co-workers, opportunities to contribute to the causes they believe in, and so on. The consumption of those goods increases managers' total income over and above their contractual pay, and is conveniently reported as the cost of doing business.

An observable implication of the separation thesis should then be a negative relationship between the dispersion of shareholding and the shareholders' gains in wealth; or--the same thing--a lower bid price for stocks of corporation with dispersed ownership. However, academic research and empirical evidence have demonstrated that no statistically significant relationship exists between the dispersion of shareholding and the shareholders' gains in wealth. An implication is that the private-property free-market economy creates incentives to reduce the costs of the dispersion of shareholding. How?

1. In competitive (i.e., non-regulated) financial markets, market valuation of the expected future consequences of current decisions by corporate managers raises their costs of making decisions that are contrary to the interests of shareholders. With bounded rationality and positive transaction costs, market evaluations of the future consequences of current decisions are often wrong and are continuously modified. However, the critical factor protecting shareholders is that the (top) manager knows that his decisions are immediately scrutinized in financial markets, and that market valuations of the expected effects of those decisions on the profitability of his firms are quickly incorporated into stock prices. That is, financial markets raise the manager's costs of pursuing activities that deviate from the profit-seeking behavior or--the same thing--guard the shareholders' wealth.

2. The opportunity costs of corporate managers depend on the profitability of business firms they manage. That is, the present value of a manager's future earnings depends on the current profitability of his firm. An implication is that the pursuits of objectives other than the shareholders' wealth are costly in terms of the manager's future marketability. The consumption of

nonpecuniary goods at the expense of potential profits has to appear to the manager as a choice between more utility now or more income tomorrow.

3. Hostile takeovers are the most effective mechanism by which the market for corporate control assures shareholders that their wealth is well guarded. By disciplining corporate managers, hostile takeovers have increased the operating efficiency of corporations, their employee productivity, and their shareholder value. Macey wrote: The threat of a takeover creates a positive externality as managers of all firms, even those that are not subject to an outside bid, have incentives to maximize share value in order to reduce the arbitrage possibility for outside bidders, and thereby retain their posts."

5. CONCLUSION

Credible and stable private property rights have to precede the choice of business firms. Then and only then the choice of business firms can make a difference. But it is naive at best and dangerous at worst to assume that changes in property rights could happen simply because it is obvious that the prevailing rules are bad or because some people come up with a better set of institutions or both. The transition industry and its rent-seeking cohorts derive benefits from the prevailing rules and will defend them whether those rules are good or bad. To change property rights, some people have to perceive that their benefits from institutional reforms are worth their costs of taking on the establishment.

The smugglers in Montenegro are a good example of the group of people who might help to create more efficient property rights. It is not necessary to defend the morality of smuggling in Montenegro. Smuggling is a predictable and desirable consequence of the prevailing property relations in Milosevich's Yugoslavia. It seems that president Djukanovich understands that. By refusing to enforce anti-smuggling measures, Djukanovich has reduced the transaction costs of smuggling, and made the benefits of black markets widely available to Montenegrins. Montenegrins are better off than they would have been if their president raised the transaction costs of black market activities. I conjecture that smuggling in Montenegro might have two consequences:

1. Smugglers are profit maximizers in a competitive environment (cartel–like agreements have a very short life expectancy in all markets where monitoring costs are high). It means that in order to survive, smugglers must seek contractual agreements that will pass the market test. Those agreements that prove viable will be imitated by other smugglers as well as non-smugglers, and eventually institutionalized into the rules of the game. In that sense, black market activities tend to reduce the transaction costs of making self-sustaining changes in property rights in Montenegro, or--the same thing--smugglers have a chance of privatizing the process of institutional reforms in Montenegro.
2. Pursuing its private ends, the ruling elite in Serbia (the same goes for Croatia and Bosnia) has exploited the old myths in order to create internal ethnic conflicts. Like all competitive markets, smuggling is color, ethnic, and religion blind; performance being the only discriminating (surviving) criterion. Evidence shows that smuggling in Montenegro has generated a degree of cooperation between ethnic groups that has not been observed in the former Yugoslavia since 1991.

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