Chapter Six. Agency and Incentive Problems Within the Large Organization

Most of our discussion of information problems in the previous chapter assumed, for the sake of simplicity, the absence of opportunism (i.e., it neglected the possibility that individual subgoals might conflict with maximizing the organization's goals). We considered mainly the costs of transferring and aggregating information that result from human conceptual limitations, and not those that result from strategic concealment of information in order to derive rents from private knowledge.

In this chapter, we will examine the agency problems resulting from opportunism: the deliberate pursuit of private goals at the expense of the organization, self-dealing by management at the expense of productive efficiency, shirking by production workers, and similar problems. The problem of inefficiency resulting from knowledge problems is compounded when those engaged in productive work try to influence policy in a more rational direction, and find that it is blocked by the self-interest of management (but justified, of course, by reference to the organization's official values). And misalignment of incentives and open differences in legitimate self-interest are themselves a problem, even without opportunism. Before we go further, it might be a good idea to quote Oliver Williamson's definition of opportunism:

> By opportunism I mean self-interest seeking with guile. This includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit....
>
> More generally, opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse. It is responsible for real or contrived conditions of information asymmetry, which vastly complicate problems of economic organization.[1]

The basic agency problem, as stated by Paul Milgrom and John Roberts, results from the fact that the agent has "an informational advantage":

> ...only the agent knows what acton he has taken in pursuit of his or the principal's goals, or only the agent has access to the specialized knowledge on which his action is based. The principal's problem is to design a compensation and control (monitoring) system that attracts and retains good agents and motivates them to behave appropriately (in the principal's interest). The asymmetry of information prevents easy determination of whether a particular observed action or outcome corresponds to desirable behavior and thus renders the problem nontrivial.[2]

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[1] Oliver Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: Free Press; London: Collier Macmillan, 1985), pp. 47-48.
[2] Paul Milgrom and John Roberts, "An Economic Approach to Influence Activities in Organizations,"

The general subject matter and subtopics of the agency and incentive field was ably described, also, by Laffont and Martimort in their general introduction to agency theory:

> The starting point of incentive theory corresponds to the problem of delegating a task to an agent with private information. This private information can be of two types: either the agent can take an action unobserved by the principal, the case of *moral hazard* or *hidden action*; or the agent has some private knowledge about his cost or valuation that is ignored by the principal, the case of *adverse selection* or *hidden knowledge*. Incentive theory considers when this private information is a problem for the principal, and what is the optimal way for the principal to cope with it. Another type of information problem that has been raised in the literature is the case of *nonverifiability*, which occurs when the principal and the agent share ex post the same information but no third party and, in particular, no court of law can observe this information.[3]

The effect of incentive structures and the distribution of rewards on performance, and the agency problems attending the shift of part of the reward of labor to rentier classes, was a matter of common sense observation long before the rise of formal organization theory. Adam Smith compared the incentive effects of various systems of agricultural labor in Book Three, Chapter Two of *The Wealth of Nations*.

> It seldom happens... that a great proprietor is a great improver..... Compare the present condition of those estates with the possessions of the small proprietors in their neighbourhood, and you will require no other argument to convince you how unfavourable such extensive property is to improvement.
>
> If little improvement was to be expected from such great proprietors, still less was to be hoped for from those who occupied the land under them. In the ancient state of Europe, the occupiers of land were all tenants at will.... They were not... capable of acquiring property. Whatever they acquired was acquired to their master, and he could take it from them at pleasure....
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> But if great improvements are seldom to be expected from great proprietors, they are least of all to be expected when they employ slaves for their workmen. The experience of all ages and nations, I believe, demonstrates that the work done by slaves, though it appears to cost only their maintenance, is in the end the dearest of any. A person who can acquire no property, can have no other interest but to eat as much, and to labour as little as possible. Whatever work he does beyond what is

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American Journal of Sociology, supplement to vol. 94 (1988), p. S155.

[3] Jean-Jacques Laffont and David Martimort, *The Theory of Incentives: The Principal-Agent Model* (Princeton and Oxford: Princeton University Press, 2002), p. 3.

sufficient to purchase his own maintenance can be squeezed out of him by violence only, and not by any interest of his own....

To the slave cultivators of ancient times gradually succeeded a species of farmers known at present in France by the name of metayers.... The proprietor furnished them with the seed, cattle, and instruments of husbandry, the whole stock, in short, necessary for cultivating the farm. The produce was divided equally between the proprietor and the farmer, after setting aside what was judged necessary for keeping up the stock, which was restored to the proprietor when the farmer either quitted, or was turned out of the farm....

Land occupied by such tenants is properly cultivated at the expense of the proprietor as much as that occupied by slaves. There is, however, one very essential difference between them. Such tenants, being freemen, are capable of acquiring property, and having a certain proportion of the produce of the land, they have a plain interest that the whole produce should be as great as possible, in order that their own proportion may be so....

It could never, however, be the interest even of this last species of cultivators to lay out, in the further improvement of the land, any part of the little stock which they might save from their own share of the produce, because the lord, who laid out nothing, was to get one half of whatever it produced. The tithe, which is but a tenth of the produce, is found to be a very great hindrance to improvement. A tax, therefore, which amounted to one half must have been an effectual bar to it. It might be the interest of a metayer to make the land produce as much as could be brought out of it by means of the stock furnished by the proprietor; but it could never be his interest to mix any part of his own with it. In France, where five parts out of six of the whole kingdom are said to be still occupied by this species of cultivators, the proprietors complain that their metayers take every opportunity of employing the master's cattle rather in carriage than in cultivation; because in the one case they get the whole profits to themselves, in the other they share them with their landlord....

To this species of tenancy succeeded, though by very slow degrees, farmers properly so called, who cultivated the land with their own stock, paying a rent certain to the landlord. When such farmers have a lease for a term of years, they may sometimes find it for their interest to lay out part of their capital in the further improvement of the farm; because they may sometimes expect to recover it, with a large profit, before the expiration of the lease. The possession even of such farmers, however, was long extremely precarious, and still is so in many parts of Europe. They could before the expiration of their term be legally outed of their lease by a new purchaser; in England, even by the fictitious action of a common recovery.... Even in England, the country perhaps of Europe where the yeomanry has always been most respected, it was not till about the 14th of Henry VII that the action of ejectment was invented, by which the tenant recovers, not damages only but possession, and in which his claim is not necessarily concluded by the uncertain decision of a single

> assize. This action has been found so effectual a remedy that, in the modern practice, when the landlord has occasion to sue for the possession of the land, he seldom makes use of the actions which properly belong to him as landlord, the Writ of Right or the Writ of Entry, but sues in the name of his tenant by the Writ of Ejectment. In England, therefore, the security of the tenant is equal to that of the proprietor.... Those laws and customs so favourable to the yeomanry have perhaps contributed more to the present grandeur of England than all their boasted regulations of commerce taken together.[4]

Frank Knight's 1921 work *Risk, Uncertainty and Profit* treated the firm as a mechanism for assumption of risk by the entrepreneur. Knight contrasted the "handicraft stage," or "production for the market," with "free enterprise." Under the former, a large number of individuals were independent producers who bore uncertainty for themselves. Under the latter, the great majority of small producers become contractual suppliers of productive services to the entrepreneur, who in turn specializes in uncertainty-bearing and in return receives the residual income of the firm.[5]

Of course this is grossly misleading, since there is no reason risks cannot be pooled and spread among small producers as joint residual claimants of a larger producer-owned firm, through cooperative ventures in auxialliary services like marketing, and through mutual insurance. The location of the entrepreneurial function in a small handful of large-scale owners is a historical accident. In fact Knight himself admits as much shortly thereafter:

> It matters not at all whether the persons liable to a given contingency organize among themselves into a fraternal or mutual society or whether they separately contract with an outside party to bear their losses as they fall in. Under competitive conditions and assuming that the probabilities involved are accurately known, an outside insurer will make no clear profit and the premiums will under either system be equal to the administrative costs of carrying on the business.[6]

It seems that the actual causal relationship is just the reverse of Knight's portrayal: the particular form of uncertainty-bearing that Knight associates with "free enterprise"--large-scale absentee ownership--is the outcome of large-scale, concentrated absentee ownership in the first place, and the attendant necessity of mitigating the risk for absentee owners.

Knight's discussion of "free enterprise" is the source of the distinction, widely relied upon in organization theory, between contractual and residual claimancy. Contractual income is a defined rent for productive services, while residual income (or profit, in the

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[4] Adam Smith, *An Inquiry into the Nature and Causes of The Wealth of Nations.* Great Books edition (Chicago, London, Toronto: Encyclopedia Britannica, Inc., 1952), pp. 167-169

[5] Frank Knight, *Risk, Uncertainty, and Profit* (Boston and New York: Houghton Mifflin Company, 1921), p. 244.

[6] Ibid., p. 247.

accounting sense) is what goes to the firm owner when all contractual expenses are paid.[7]

But Knight treated the firm as a mechanism for *managing* risk, as well as assuming it. He argued that organization was substituted for markets, and higher forms of organization like the corporation for lower forms like the partnership, in order to minimize the form of risk he called "moral hazard" (a term he borrowed from the insurance industry to include the broader category of "assumption by one person of the consequences of another person's decisions").[8]

Unfortunately, as Knight himself recognized, these risk-managing benefits were offset to some extent by the generation of *new* risks--agency risks--*within* the firm:

> Those in control of the policies of a business are almost inevitably in a better position to foresee its future earnings than are outsiders, and it is difficult to prevent their taking advantage of this position to the detriment of their efficiency as managers of productive operations. The "corporation problem" arises largely out of this situation.
>
> Matters become still worse when the managers of productive property begin to manipulate their industrial and financial policies with a view to *producing* changes in capital values, of which they inevitably know in advance of outsiders and of which they take advantage with corresponding ease.... Perhaps as bad as manipulating policies for the sake of quick gains on the securities market is the corruption of sources of information for the same purpose.[9]

Chester Barnard, in *The Functions of the Executive*, distinguished between "effectiveness" and "efficiency," which was an early way of considering the ways in which individual pursuit of sub-goals may detract from the performance of the organization's goals.

> When the purpose of a system of cooperation is attained, we say that the cooperation was effective....
>
> ....Cooperative efficiency is the resultant of individual efficiencies, since cooperation is entered into only to satisfy individual motives.... The efficiency of the cooperative action is the deree to which these matters are satisfied.[10]
>
> Although effectiveness of cooperative effort relates to accomplishment of an objective of the system and is determined with a view to the system's requirements,

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[7] Ibid. p. 271.
[8] Ibid., pp. 252-253.
[9] Ibid., pp. 334-335.
[10] Barnard, *The Functions of the Executive* (Cambridge, Mass.: Harvard University Press, 1938, 1968), pp. 43-44.

efficiency relates to the satisfaction of individual motives.[11]

Of course the term "organization's goals" is misleading, since the organization is not a conscious entity with a will of its own. In fact, the goals of the organization are the goals of a particular group of individuals, whether it be the shareholders or the senior management. Policies, like cost-cutting, are often justified in the name of "organizational goals" like increased return on equity, when in fact they simply serve to fund management self-dealing of some sort. In the end, the "goals of the organization," or the "purpose" or "requirements" of the "system," are in fact the goals, purpose, and requirements of those who hold power within the organization or system.

The problem, therefore, is how to structure incentives so as to bring the individual's efforts in line with the needs of the organization.

> The net satisfactions which induce a man to contribute his efforts to an organization result from the positive advantages as against the disadvantages which are entailed....
>
> Hence, from the viewpoint of the organization requiring or seeking contributions from individuals, the problem of effective incentives may be either one of finding positive incentives or reducing or eliminating negative incentives or burdens. For example, employment may be made attractive either by reducing the work required... or by increasing positive inducement, such as wages....
>
> More important than this is the distinction between the objective and subjective aspects of incentives.... Given a man of a certain state of mind, of certain attitudes, or governed by certain motives, he can be induced to contribute to an organization by a given combination of... objective incentives, positive or negative. It often is the case, however, that the organization is unable [or unwilling--K.C.] to offer objective incentives that will serve as an inducement to that state of mind, or to those attitudes, or to one governed by those motives. The only alternative then available is to change the state of mind, or attitudes, or motives, so that the available objective incentives can become effective.[12]

(This is known in some circles as "getting one's mind right."[13] And since one of the best ways to get an employee's mind right and make a given set of incentives acceptable to him is the induced fear of prolonged unemployment, the macroeconomic policies of the state are useful in creating the appropriate atmosphere for attitude adjustment.) In Barnard's later elaboration of techniques for inducing the appropriate state of mind, this corresponds roughly with his first category of "coercive conditions":

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[11] Ibid., p. 56.
[12] Ibid., pp. 140-141.
[13] *Cool Hand Luke*.

> If an organization is unable to afford incentives adequate to the personal contributions it requires it will perish unless it can by persuasion so change the desires of enough men that the incentives it can offer will be adequate. Persuasion in the broad sense in which I am here using the word includes (a) the creation of coercive conditions; (b) the rationalization of opportunity; (c) the inculation of motives.
>
> (a) Coercion is employed both to exclude and to secure the contribution of individuals as an organization.... [F]orced exclusion is... employed as a means of persuasion by example, to create fear among those not directly affected, so that they will be disposed to render to an organization certain contributions. It presents realistically the alternative either of making these contributions or of foregoing the advantages of association....[14]

Barnard mentions slavery ("the creation of conditions by force under which bare subsistence and protection are made sufficient incentives to give certain contributions to the organization....") as one example of historic coercion.[15] Of course the available alternatives in the labor market do not constitute "coercion" to anywhere near the same degree as chattel slavery or serfdom. But to the extent that the state limits the competition of jobs for workers and the number of employment opportunities relative to the number of workers, and thereby reduces the bargaining power of labor, it thereby effectively shifts the supply curve for labor to the left--in operational terms, exactly what Barnard meant by changing individual motives so as to reduced the incentive necessary to secure a given level of effort.

The other methods of altering individual motivation fall under the general heading, in varying degrees of intensity, of persuasion:

> (b) The rationalization of opportunity is a method of persuasion of much greater importance in most modern activities....
>
> (c) The form of persuasion that is most important is the inculation of motives. In its formal aspects this is a process of deliberate education of the young, and propaganda for adults.

In the words of Butler Shaffer, "institutions are... anxious to have us identify with them."

> Because they have purposes of their own that transcend any conflicting personal interests, and because they can accomplish their purposes only through us, institutions have an incentive to promote those attitudes and conditions that will get us to subordinate our wants to theirs and submit to their authority...

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[14] Barnard, *The Functions of the Executive*, p. 149.
[15] Ibid., p. 150.

> In an effort to strengthen our attachments to them, institutions endeavor to persuade us that their interests and ours are entirely compatible...[16]

Much, if not most, of this function is carried out at the level of society as a whole, and the cost of much of it is underwritten by the state. Perhaps the single most important propaganda function, for shaping of the average employee's mindset, is carried out by the state schools. It's hardly coincidental that the first centralized state school systems were created, in the early middle decades of the nineteenth century, when the factory system needed a work force trained in the virtues of punctuality and obedience. Given the fact that the overwhelming majority of the population were self-employed, most of them independent farmers, the attitudes of the available labor force were hardly suited in most cases to the needs of the factory system. Employers in search of docile wage labor were in much the same predicament as that which motivated the Enclosures in Britain. The "public" school system churned out a product (since then appropriately renamed "human resources") which was trained to show up on time, line up on command, cheerfully accept direction from an authority figure behind a desk, and eat and piss at the sound of a bell.

The function of the state schools today is essentially the same. The main difference is that, with the increasing portion of the labor force engaged in white collar work, the schools have supplemented their curriculum with the specific training in bureaucratic toadyism needed in today's work environment.

On a broader societal level, the extent to which the state and the corporate media together act as a propaganda apparatus has been described by Edward Herman and Noam Chomsky in *Manufacturing Consent*.

One essential component of the prevailing belief system that's especially important in the workplace is the ideology of "professionalism" (which will be discussed at length in the chapter on managerialism).

Barnard was well aware of the dangers presented by the employee who was not successfully socialized by any of these methods--especially the disgruntled employee who quietly remained within the system:

> ...If a communication is believed to involve a burden that destroys the net advantage of connection with the organization, there no longer would remain a net inducement to the individual to contribute to it. The existence of a net inducement is the only reason for accepting *any* order as having authority. Hence, if such an order is received it must be disobeyed (evaded in the more usual cases) as utterly inconsistent with personal motives that are the basis of accepting any orders at all. Cases of voluntary resignation from all sorts of organizations are common for this sole reason. Malingering and intentional lack of dependability are the more usual methods....

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[16] Butler Shaffer, *Calculated Chaos: Institutional Threats to Peace and Human Survival* (San Francisco: Alchemy Books, 1985), pp. 40-41.

> ...[T]he determination of authority remains with the individual. Let these "positions" of authority in fact show ineptness, ignorance of conditions, failure to communicate what ought to be said, or let leadership fail... to recognize implicitly its dependence on the essential character of the relationship of the individual to the organization, and the authority if tested disappears.[17]

The "evasion" of orders, "malingering and intentional lack of dependability," all fall within the definition of sabotage as the "willful withdrawal of efficiency from the production process." Oliver Williamson described it as

> the possibility that disaffected members of the organization may, rather than quit the organization, choose to subvert it.... The disaffected employee whose estrangement is unknown may deliberately plant misinformation or disclose sensitive information to outsiders in ways that impair the performance of the firm.[18]

A large portion of the present-day workforce, having in fact seen corporate management demonstrate its "ineptness, ignorance of conditions, failure to communicate what ought to be said," or to show respect to the workforce commensurate with its dependence on them, is quietly engaged in just that sort of passive-aggressive rebellion. And as the official ideology fails to counteract the effects of what workers see with their own eyes, as more workers become disgruntled by stagnant wages, downsizings, and speedups, we can expect to see more and more such quiet rebellion driving up operating costs. As we shall see later, in the chapters on the agency problems of labor and on labor strugge as asymmetric warfare, corporate management is (despite large increases in authoritarianism and surveillance) mostly powerless against such resistance.

Philip Selznick, in a 1948 article, echoed Barnard's themes of the dependency of authority on consent, and the existence of private sub-goals at odds with the goals of the organiization:

> ...[I]t is recognized that control and consent cannot be divorced even within formally authoritarian structures....
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> Unfortunately for the adequacy of formal systems of coordination, the needs of individuals do not permit a single-minded attention to the stated goals of the system within which they have been assigned. The hazard inherent in the act of delegation derives essentially from this fact. Delegation is an organizational act, having to do with formal assignments of functions and powers. Theoretically, these assignments are made to roles or official positions, not to individuals as such. In fact, however, delegation necessarily involves concrete individuals who have interests and goals

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[17] Barnard, *Functions of the Executive*, pp. 166, 174.

[18] Oliver Williamson, *Markets and Hierarchies, Analysis and Antitrust Implications: A Study in the Economics of Internal Organization* (New York: Free Press, 1975),, pp. 122-123.

> which do not always coincide with the goals of the formal system. As a consequence, individual personalities may offer resistance to the demands made upon them by the official conditions of delegation. These resistances are not accounted for within the categories of coordination and delegation, so that when they occur they must be considered as unpredictable and accidental. Observations of this type of situation within formal structures are sufficiently commonplace. A familiar example is that of delegation to a subordinate who is also required to train his own replacement. The subordinate may resist this demand in order to maintain unique access to the "mysteries" of the job, and thus insure his indispensability to the organization.[19]

Kenneth Arrow was one of the first thinkers to raise the issue[20] of monitoring costs in measuring an employee's productive output, as well as in verifying obedience. He divided the problem of "organizational control" into two parts:

> the choice of operating rules instructing the members of the organization how to act, and and the choice of enforcement rules to persuade or compel them to act in accordance with the operating rules.[21]

Enforcement rules, in turn, raised problems of incentive and monitoring systems:

> There are (at least) two problems in devising incentive systems. (1) An effective incentive system creates new demands for information; the reward is a function of performance, so top management must have a way of measuring performance. This may be the objective function itself, or it may be some other, more easily measurable, index. If the index is something other than the objective itself, the manager's incentives may not be directed optimally from the viewpoint of the corporation; for example, if the index of the manager's performance is based primarily on output rather than profits, he will be tempted to be wasteful of inputs. However, an index which supplies better incentives may require more information; in organizational control, as in automobiles, cuisine, and every other commodity, the benefits of improve quality must always be compared with its costs. (2) Even if the index is thoroughly appropriate, the relation between the reward and the index remains to be determined. Suppose there is no difficulty in isolating the contributions of a manager to the net worth of the firm. The fullest incentive to the manager would be achieved by fixing a base salary and a target level of contribution to net worth or profits and then giving the manager as a bonus the difference between his contribution to profits and the target level. If his contribution fell below the target level, the difference would constitute a negative bonus, to be subtracted from his salary. Such an arrangement would clearly not be satisfactory in spite of its desirable effects; the corporation of course intends to share in the profits attributable to the skill of its

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[19] Philip Selznick, "Foundations of the Theory of Organization," *American Sociological Review*, Vol. 13, No. 1 (Feb. 1948), pp. 26-27.
[20] Arrow, "Control in Large Organizations," pp. 397-408.
[21] Ibid. p. 398.

managers and not to give them all away to him....[22]

Arrow fails to mention one method by which such high-powered incentives could be achieved: residual claimancy by those engaged in productive effort. Of course he assumes, as a given, the absentee owned corporation worked by wage-laborers. But this is precisely the reason for most of the agency and information problems in the corporate economy: it starts from the premise of absentee ownership, and then resorts to hierarchy and extrinsic incentives to simulate the kind of employee behavior that would arise naturally in an economy of producer cooperatives. The hierarchical corporation is a sort of Rube Goldberg contraption for carrying out tasks as efficiently as possible given an utterly irrational foundation.

(Metering, incidentally, is another case in which informational and agency problems overlap.)

Michael Reich and James Devine criticized Arrow for his assumption of "implicit contract" rather than conflictual power relations betwee labor and capital. He presumed the existence of a harmony of interests, with hierarchy as an instrument for joint utility maximization by labor and capital.[23] If this was a failing on Arrow's part, then Armen Alchian and Harold Demsetz were guilty of it in spades.

Alchian and Demsetz made the next major contribution to the literature on the effort metering problem.[24] Their article, "Production, Information Costs, and Economic Organization," includes some extremely useful analysis. Much of their concrete discussion of the incentives for shirking, and the relative cost of monitoring compared to the savings--mostly in the early part of the article--is very much on the mark. Unfortunately, it's embedded in a larger context with so many bizarro, Looking-Glass World ideological assumptions, that extracting the genuine insights and incorporating them into a more realistic general framework is a considerable operation.

They go entirely too far, for example, in asserting the nature of the corporation as a nexus of voluntary contracts. They deny, in fact, that authority relations are involved any more in employment in a corporate hierarchy than in self-employment in the market; the employment relation is a mere contractual relationship between equals, exactly comparable to the relation between a grocer and his customer.[25] First of all, on an

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[22]Ibid., pp. 400-401.
[23]Michael Reich and James Devine, "The Microeconomics of Conflict and Hierarchy in Capitalist Production," *The Review of Radical Political Economics* vol. 12 no. 4 (Winter 1981), p. 28.
[24]Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *The American Economic Review*, pp. 777-795.
[25] Ibid., pp. 777-778. John McManus, writing not long afterward, argued in almost identical terms that "[p]rices (and bosses in firms) serve to constrain behavior in order to generate mutual gains.":

> ...[N]o individual has unilateral coercive power over any other individual in the analytical framework we are developing. All members of a voluntary organization participate in decision-making, either directly

existential level, it should be a matter of simple common sense to compare the sense of being "a man set under authority" when one's continued livelihood depends on not offending a single employer, as opposed to offending one out of a hundred regular customers. But even on a purely theoretical level, Alchian and Demsetz implicitly

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> or indirectly by virtue of their implicit bids and offers for alternatives. A centralized organization such as a firm has no coercive power over its members other than the enforcement prodcedures to which the members agree upon entering or forming the organization.
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> Similar enforcement procedures would be agreed to in a decentralized price system. It is impossible to imagine any kind of organization being established without an agreement on some means of enforcing behavior constraints. No coercion is implied by such enforcement efforts, and the methods of measurement by which enforcement is accomplished must be mutually satisfactory, subject to the costs of measurement, whatever the form of organization chosen.

He gave, as an example, the extreme case of a team of coolies who owned the right to draw boats upstream on a section of the Yangtze, and hired an overseer with instructions to lay the whip on hard to maximize their productivity. John McManus, "The Costs of Alternative Economic Organizations," *The Canadian Journal of Economics*, Vol. 8, No. 3 (Aug. 1975), pp. 335, 341-342, 341n.

Of course, the extent to which such arrangements are "voluntary" is precisely the point at issue, given the extent to which the range of "alternatives" reflects a larger legal framework which capitalist interests played the major part in shaping.

He also argued that the choice between hierarchy and markets reflected "the least inefficient method of allocation," when in fact what is be inefficient from the standpoint of maximizing productivity or shareholder returns might be quite "efficient" from management's on the job consumption. While the choice may be based on "maximization of the consumption possiblities of the relevant group," it does not follow that "therefore the least inefficient method of allocation will be chosen." It all depends on the identity of the "relevant group." Ibid., p. 334.

assume, and unwarrantedly so, that labor relations take place in the environment of a free market. In such a free market, there would indeed be a common interest among employees of an organization to structuring the rules so as to minimize shirking and maximize output, because any increase in output would be shared by employees according to their marginal contributions to production. In the real world of state capitalism, however, the employment relation exists in the broader environment of a rigged market. The employment relationship takes on a considerable zero-sum character, in which the worker is apt to keep little if any of any increase in output, and any increase in productivity is likely to result only in increased workloads. In the real world, the motives for what Taylor called "soldiering" are quite rational. In the real world, shirking and consumption on the job result not just from the prisoner dilemma created by imperfect metering, but from adversarial power relations within the corporation. Jeffrey Nielsen put it aptly:

> With rank-based logic, people see work as a burden and organization as a necessary evil. We only grudgingly join up with organizations and then find life within them to be nasty, boring, and deadening to the spirit.. When the organization encounters hardships, the assumption is that those below should be sacrificed to protect the privilege of those above. All too frequently we read in the financial section of the paper about this type of logic in action: another CEO who laid off hundreds of workers is awarded with a fat bonus at the end of the year.[26]

A good illustration is Charles Johnson's critique of the predominant anti-union position among libertarians, as stated by Karen DeCoster:

> De Coster, like lots of other anti-union libertarians, claims that unions are economically harmful because they're toxic to efficiency and flexibility. The idea is that organized workers will tend to use their organization to oppose advances like automation, technological upgrades, flexible job duties, and reorganization of processes for greater efficiency. Partly because union contracts tend to preserve old job descriptions in amber, to better mark off each worker's turf, and partly because organized workers will use their coordinated bargaining power to oppose anything that reduces organized workers' hours or introduces new, not-yet-unionized (or differently-unionized) jobs into the shop. I don't necessarily find this complaint very persuasive. But. hell, let's grant most of it, for the sake of argument. Suppose that a union like the UAW *does* tend to block upgrades for greater efficiency and flexibility. If that's true, why is it true? *Because the unionized workers don't own the means of production.*
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> It's no surprise that there would be conflicts between the interests of the workers and the interests of the boss and board when it comes to innovation in shop-floor technology or processes. For a wage laborer, sometimes new technology and new processes mean easier and better work to do; often they mean that your hours will be cut or you'll lose your job entirely. In any case they will be deployed and integrated into the flow of work according to

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[26] Jeffrey Nielsen, *The Myth of Leadership: Creating Leaderless Organizations* (Palo Alto Calif.: Davies-Black Publishing, 2004), p. 53.

> what the *boss* finds most useful; they may very well result in you, as a wage laborer, getting stuck with speed-ups or harder work.
>
> None of this is a decisive argument *against* innovations in shop-floor technology or processes; sometimes things have to change, and change can be hard. But it *is* a natural source of conflicts between labor and capital. When workers are organized — *and when the goals of the organized workers are limited* to eking out the highest hourly wages and benefits, the most reliable hours, and the easiest conditions, that they can get *within* the existing ownership structure and business model of the corporation, through stage-managed labor actions, back-room negotiations with the boss, and multiyear fixed contracts, while the boss and the board keep ahold of final control over conditions on the shop-floor and most or all of the residual profits from any efficiency improvements, what you'll tend to see is a perpetual collision between a small but powerful coterie of managers and owners, who have every reason to try to shove new processes and technologies down their employees' throats, to the extent that they can get away with it, and a consolidated mass of workers who have little reason to care about starving themselves lean in order to fatten profits that don't go to them. Why should workers *want* to do more work faster, or to take on more flexible job descriptions, if they only stand to lose hours or subjected to speed-ups for their trouble? Both workers' livelihoods and process efficiency get caught in the crossfire.[27]

Alchian's and Demsetz's analysis of metering problems begins with the very useful recognition that metering problems might be reduced significantly by relying on market relations between separate firms, instead of on internal hierarchies.

> Metering problems sometimes can be resolved well through the exchange of products across competitive markets, because in many situations markets yield a high correlation between rewards and productivity. If a farmer increases his output of wheat by 10 percent at the prevailing market price, his receipts also increase by 10 percent. This method of organizing economic activity meters the *output directly*, reveals the marginal product and apportions the *rewards* to resource owners in accord with that direct measurement of their outputs. The success of this decentralized, market exchange in promoting productive specialization requires that changes in market rewards fall on those responsible for changes in *output*.[28]

If anything, the authors don't go far enough in making this argument. If the ideal contract is MacNeil's sharp ins and outs, then the market contract between separate firms or individuals is the ideal way to achieve it. Market contracting has the benefit, compared to vertical integration, of making a virtue of treating the production process as a black box. When a firm decides to buy rather than make an input, all that matters is the contractually defined inputs and outputs; all questions of the efficiency with which inputs are used are "outsourced" to the firm. And a contracting firm with its functions limited to one or a few stages of the production process, will have most production decisions made

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[27] Charles Johnson, "King Ludd's throne," *Rad Geek People's Daily*, May 23, 2008 <http://radgeek.com/gt/2008/05/23/king_ludds/>.

[28] Alchian and Demsetz, p. 778.

close to the shop floor--thereby greatly reducing its internal agency and information problems. As for changes in rewards falling on those responsible for changes in output, this is not just a requirement--it's a virtue. From the standpoints of metering, internal efficiency, and high-powered rewards, the optimum is to integrate stages of production through market relations rather than hierarchy, and for each stage to be organized not merely as a firm, but as a worker cooperative in which those engaged in production, as residual claimaints, reap all the rewards of increased output.

In the case of large organizations, metering is complicated by the fact that most production is what Alchian and Demsetz call "team production," so that no individual's marginal productivity is clearly identifiable, and it is difficult to determine the individual's share of the joint output. The authors argue that team production increases, by an order of magnitude, the cost of measuring individual productivity. As a result, the prevention of shirking becomes a problem.

> Clues to each input's productivity can be secured by observing behavior of individual inputs. When lifting cargo into the truck, how rapidly does a man move to the next piece to be loaded, how many cigarette breaks does he take, does the item being lifted tilt downward toward his side?
>
> If detecting such behavior were costless, neither party would have an incentive to shirk, because neither could impose the cost of his shirking on the other (if their cooperation was agreed to voluntarily). But since costs must be incurred to monitor each other, each input owner will have more incentive to shirk when he works as part of a team, than if his performance could be monitored easily or if he did not work as a team. If there is a net increase in productivity available by team production, net of the metering cost associated with disciplining the team, then team production will be relied upon rather than a multitude of bilateral exchange [sic] of separate individual outputs.
>
> Both leisure and higher income enter a person's utility function. Hence each person should adjust his work and realized reward so as to equate the marginal rate of substitution between leisure and production of real output to his marginal rate of substitution in consumption. That is, he would adjust his rate of work to bring his demand prices of leisure and output to equality with their true costs. However, with detection, policing, monitoring, measuring or metering costs, each person will be induced to take more leisure, because the effect of relaxing on *his realized* (reward) rate of substitution between output and leisure will be less than the effect on his *true* rate of substitution. His realized cost of leisure will fall more than the true cost of leisure, so he "buys" more leisure....
>
> If his relaxation cannot be detected perfectly at zero cost, part of its effects will be

borne by others in the team....[29]

Alchian and Demsetz, for the sake of accuracy, point out that by "leisure" they refer to all "non-pecuniary income." In this they include, in addition to shirking, what McManus (below) calls "consumption on the job":

> In a university, the faculty use office telephones, paper, and mail for personal uses beyond strict university productivity. The university administrators could stop such practices by identifying *the* responsible person in each case, but they can do so only at higher costs than administrators are willing to incur. The extra costs of identifying each party (rather than merely identifying the presence of such activity) would exceed the savings....[30]

The authors, with their unwarranted assumption of a non-zero-sum situation, assert that such shirking and consumption on the job result in lower pecuniary income for the faculty.[31] This ignores the possibility that such "non-pecuniary income" on the job will come in fact at the expense of rents that would otherwise accrue to management or to the owners, as a result of unequal exchange on the labor market.

But leaving aside their apologetic bias, the importance of their example in the block quote above cannot be overstated. In the vast majority of cases, any management attempt, through internal surveillance and authoritarianism, to prevent shirking, consumption on the job, or deliberate imposition of increased production costs (i.e., sabotage) by disgruntled workers, can be circumvented at less cost and difficulty by workers. In the offensive-defensive arms race between workers and employers, the workers will always be several steps ahead. Oliver Williamson's commentary on the above example sheds additional light on this problem. Referring to Alchian's and Demsetz's assertion that if detection of such pilfering were costless, it would be eliminated, he responded:

> But is this really so? Does it assume, implicitly, that metering intensively, where this is easy (costless), has no effect on the attitudes of workers with regard to transactions that are costly to meter?
>
> The distinction between perfunctory and consumate [sic] cooperation... is relevant in this connection. It seems at least plausible that extending metering with respect to such peccadilloes as appear to be of concern to Alchian and Demsetz... will be regarded as picayune and will elicit resentment. Cooperative attitudes will be impaired with the result that tasks such as teaching effectiveness--which can be metered only with difficulty, because information is deeply impacted, but for which consummate cooperation is important--will be discharged in a more perfunctory

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[29] Ibid., p. 780.
[30] Ibid., p. 780.
[31] Ibid., p. 780.

way.[32]

A disgruntled work force is quite adept at shifting its non-compliance to areas in which accurate metering is impossible, and thereby raising overall costs for the employer. Williamson's distinction between perfunctory and consummate cooperation will figure prominently in our discussion, in a later chapter, of the agency problems of labor.

The effectiveness of hierarchical control depends on workers not knowing when they're being monitored and when they're not[33]--and workers have a pretty good sense for that sort of thing. Williamson argues that it's impossible, "for information impactedness reasons, [to] determine whether workers put their energies and inventiveness into the job in a way which permits task-specific cost-savings to be fully realized...." Workers are able to thwart management policy by "withholding effort."[34] (It's odd, given such admissions, that Williamson elsewhere argues that opportunism poses less of a problem in organizations than in markets ("because... the internal incentive and control machinery is much more extensive and refined than that which obtains in market exchanges").[35]

Alchian's and Demsetz's "team production" focus is at the heart of the ideological difficulties in their articles. Their first example involves an actual work team and the problem of team members shirking at the expense of their coworkers. But their use of the term "team production" blurs (perhaps deliberately) the distinction between the team in the sense of a primary production unit of actual workers, and a "team" consisting of the owners of all production inputs--capital owners alongside workers. And it's understandable, given their ideological assumptions; they deny that there *is* a difference. For them the one is a "team," a nexus of contracts between equals, in the same sense as the other.

Their ideological agenda emerges even more clearly as they propose solutions to metering problems. It becomes increasingly clear that the image of the team as actual work unit has outlived its usefulness, and that their hypothetical "team" refers henceforward to the capitalist firm.

Alchian and Demsetz propose that the residual claimant in the firm should be assigned the monitoring function, and reap the productivity gains of monitoring, as a way of maximizing incentives to monitor accurately. The monitor's functions include

> measuring output performance, apportioning rewards, observing the input behavior of inputs as means of detecting or estimating their marginal productivity and giving assignments or instructions in what to do and how to do it. (It also includes...

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[32] Oliver Williamson, *Markets and Hierarchies,* pp. 55-56.
[33] Guillermo A.R. Calvo and S. Wellisz, "Supervision, Loss of Control, and the Optimal Size of the Firm," *Journal of Political Economy* 86 (1978):943-952.
[34] Williamson, *Markets and Hierarchies*, p. 69.
[35] Ibid., p. 10.

authority to terminate or revise contracts.)[36]

They portray this as a joint, voluntary contractual arrangement between the members of the "team" to give the capital-owning "team member" residual claimancy, in order to promote their common interests as co-equal members of the "team." The authors' idea of a "team" is reminiscent of the kind of "democracy" in which the sheep and the wolf, as equals, vote on what to have for dinner. What emerges from this agreement of equals, they continue, is an

> entire bundle of rights: 1) to be a residual claimant; 2) to observe input behavior; 3) to be the central party common to all contracts with inputs; 4) to alter the membership of the team; and 5) to sell these rights, that defines the *ownership* (or the employer) of the *classical* (capitalist, free-enterprise) firm. The coalescing of these rights has arisen, our analysis asserts, because it resolves the shirking information problem of team production better than does the noncentralized contractual arrangement.[37]

So, it finally emerges, what started out promising to be an examination of the problem of monitoring costs arising within the conventional, hierarchically managed corporate form, and possible solutions for it, has at long last shown itself instead to be a paean to hierarchical management as a *solution* to the monitoring problem. It does not examine monitoring costs as a problem of the capitalist firm, but explains the capitalist firm as the *solution* to monitoring costs. It treats residual claimancy by the capitalist owner as a response to *team* needs, with workers relying on the helpful employer to provide some solution to their prisoner's dilemma problem of shirking. It is, more specifically, an edifying account of how, in a society of free and equal people, some small number of whom just happen to own most of the means of production, and some of whom just happen to have only their labor-power to sell, everyone jointly agrees--as a matter of common interest, of course--to organize production in absentee-owned, hierarchical, capitalist firms. It seems that we have a new companion fable to share an honored place beside Marx's "bourgeois nursery-tale" of primitive accumulation.

Unfortunately, it ignores the extent to which monitoring problems *arise* from the separation of ownership from labor, the divorce of decision-making power from knowledge, and the dissociation of effort from reward, in the hierarchical and absentee-owned firm. The truth is that hierarchy comes into existence only to "solve" problems *created* by structural barriers to the most efficient form of production: the worker-owned and worker-managed firm.

The system starts out with the historical legacy of primitive accumulation (the mass expropriation of the means of production from the majority of the population in early modern times) and structural barriers limiting present-day working class access to

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[36] Alchian and Demsetz, op. cit., p. 782.

[37] Ibid., p. 783.

investment capital for forming their own cooperative enterprises. Given the starting assumption of productive resources concentrated in the hands of a small number of absentee owners, who must hire labor, the hierarchical enterprise is the best way of securing output from producers who have no intrinsic motivation and no rational interest in maximizing their productivity.

In other words, to paraphrase a bumper sticker, if the hierarchical, absentee-owned, capitalist firm is the answer, it must be a real stupid question.

But on reflection, it is possible that much of Alchian's and Demsetz's overall argument can be salvaged. Their treatment of monitoring costs and shirking is quite useful, if one mentally translates their "team" perspective to a "hierachy" perspective. For example, their insight that efficiency requires a close correlation of productivity and rewards:

> If the economic organization meters poorly, with rewards and productivity only loosely correlated, then productivity will be smaller; but if the economic organization meters well productivity will be greater.[38]

Again, to take the commonsense implication of what they actually say, as opposed to their ideological assumptions about what it means, this principle can be taken as a fairly straightforward argument for the greatest possible amount of 1) worker equity in the firm; and 2) worker self-management.

Although Alchian and Demsetz clearly have capitalist ownership in mind, their explicit statements equating employer, firm owner, and residual claimant, and arguing for the assignment of the monitoring function to the residual claimant, do not *technically* require these roles to be filled by the owner of capital inputs. Their argument for a monitoring function of the residual claimant, conceivably, could be applied to a situation in which the workers possessed residual claimancy and hired capital from an absentee input-owner; certainly, at least, it is fully consistent with that possibility, however little they have it in mind and however hostile they may be to it.

Their argument for assigning the monitoring function to the residual claimant, in itself, makes perfect sense. Stripped of all their cultural biases and pro-capitalist apologetics, the essential core of the argument is that monitoring power should be vested in the residual claimant: a principle that makes sense in the case of any kind of ownership, including worker ownership.

What does not make sense is their assumption that residual claimancy will rest with the owners of capital inputs.[39] In fact, the efficiencies resulting from assigning the

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[38] Ibid. p. 779.

[39] In fact, at one point toward the end of their article, they further undermine the basis for this assumption by suggesting that stockholder "ownership" of the corporation might be a myth, and arguing that the difference

monitoring function to the residual claimant are maximized in the producer cooperative. Monitoring is more expensive for the capital-owning member of the "team" because it requires a paid specialist, like a foreman or other front-line supervisor. On the other hand, if the monitoring of effort is a good method for approximating the member's marginal contribution,[40] then production workers are ideally situated to monitor each other's efforts in the normal course of their work. Savings on monitoring costs are maximized when workers are monitoring themselves, because they are the most effective and cheapest monitors--when, that is, they have a rational interest in maximizing output. That's why producer cooperatives typically have about a quarter as many foremen as capitalist-owned firms in the same industry. However, in the adversarial employment relation it is primarily the capitalist who has a rational interest in monitoring for shirking, while the workers have an entirely rational interest in what Taylor called "soldiering." Only in the case of residual claimancy by workers, as in a producer's co-op, is it in their rational interest to monitor each other's effort. In fact, if effort expenditure is a satisfactory proxy for marginal output, then metering is a relatively minor problem in a worker co-op, even when it would be a major problem for the capitalist. Most of the inefficiencies of the capitalist firm result from the fact that the production workers, by nature the most efficient monitors, are not residual claimants, and therefore cannot be entrusted with their natural function.

Their blurring of the distinction between the capitalist firm with its managerial hierarchy, and the actual production team, is quite unfortunate. First, while the members of a production team may have a common interest in preventing one member from shirking at the expense of the others, they may also (in the real world of adversarial employment relations) have a common interest in reducing their effort as a group (i.e., the slowdown or "going canny"); there is, therefore, a real difference between shirking at the

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between ownership of equity and debt, and more specifically between preferred stock and other securities of all kinds, is at most a matter of degree. In so doing, intentionally or not, they abandon the idea that residual claimancy is vested in capital ownership, and instead put forth ownership of the firm itself rather than ownership of capital (a distinction that will be familiar to readers of David Ellerman) as the basis of residual claimancy.

In so doing, they abandon whatever moral basis they may have had for vesting residual claimancy in the managerial hierarchy as representatives of the "owners," and leave the choice between control by a self-perpetuating managerial oligarchy and control by production teams as an arbitrary choice, based in mere legal convention, between two groups of employees.

[40] "What is meant by performance? Input energy, initiative, work attitude, perspiration, rate of exhaustion? Or output? It is the latter that is sought--the *effect* or output. But performance is nicely ambiguous beause it suggests both input and output. It is *nicely* ambiguous because as we shall see, sometimes by inspecting a team member's input activity we can better judge his output effect, perhaps not with complete accuracy but better than by watching the output of the *team*." Ibid., pp. 781-782n.

expense of one's coworkers and shirking at the expense of the company. Second, the costs and difficulty of monitoring individual workers by higher levels of authority within a managerial hierarchy--to which Alchian and Demsetz devote little attention--are probably an order of magnitude greater than the costs and difficulty of mutual monitoring among members of a work team. The individual workers, as owners, have far more interest in maximizing the firm's income than do workers in a capitalist enterprise, and therefore far more interest in making sure that their coworkers are doing their fair share of work; at the same time, under conditions of self-management, they are far more empowered to act as comanagers on the shop floor and reprove shirking when they observe it (this will be developed at much greater length in the chapter on cooperatives in Part Four).

Alchian and Demsetz also manage to get things exactly backward in explaining the relative preponderance of the capitalist firm over the producer cooperative. They treat the worker cooperative and large-scale profit sharing as anomalies that occur mainly in niches of the economy where abnormal conditions prevail, and assume that the "capitalist firm" will predominate unless "political or tax or subsidy considerations induce profit-sharing techniques when these are not otherwise economically justified...." Sharing in residual income by "team members" other than the monitor results in reduced incentive for the monitor to prevent shirking, and thus lowers the overall efficiency of the enterprise.

> If this were not so, profit sharing with employees should have occurred more frequently in Western societies where such organizations are neither banned nor preferred politically.[41]

Thus Alchian and Demsetz make the enormous assumption that the preponderant role of the conventional capitalist firm results entirely from the forces of the free market, and that the only conceivable effect of any structural constraint or bias would be to privilege the cooperative at the expense of the capitalist firm. The possibility that capitalist ownership has already been privileged by a historical process "written in letters of fire and blood" never occurs to them.

John McManus also contributed greatly, in an article written not long afterward, to the literature on metering problems. He argued that the choice between the hierarchical firm and the price system reflected the comparative transaction costs of metering between one and the other.

> A centralized organization, such as a firm, can improve on the allocative results of a price system only by effecting changes in the behaviour of the individuals within the group we are considering, given the costs of enforcing constraints on the activities of the individuals. The establishment of a firm leads to changes in the behaviour of

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[41] Ibid., p. 787.

individuals by changing the nature of constraints on their activities. In the place of market prices are substituted the directives of a central authority.[42]

The problem is that McManus (and other leading New Institutionalist figures like Oliver Williamson) tend to exaggerate the transaction costs of markets compared to hierarchy. McManus, in particular, was so focused on countering the neoclassical assumption that market prices were "costlessly enforceable behavior,"[43] that he neglected the contrary case. Defining enforcement cost as "the resource cost incurred to detect violations of behavior constraints," he continued:

> When we count our change, weigh meat, punch time clocks, inspect a used car, or supervise labourers, we are incurring costs to enforce behaviour constraints by monitoring or measuring the activity of another individual.[44]

The difference is that when a butcher weighs meat and gives back change, verifying the weight of the meat and counting the change are quite straightforward, compared to the metering problems inside an organization--where there is often no easily quantifiable meat and no change to count. The time clock may verify when a warm body was present, but the level of effort expended is another matter entirely. In most normal conditions, it is less expensive to measure product outputs than process inputs, which makes market trading across firm boundaries preferable in achieving the clear ins and outs that MacNeil treated as the defining feature of the ideal contract.

One reason for the inferiority of hierarchies to markets is that administrative constraints are less powerful than the "pecuniary behaviour constraints" (or high-powered incentives) of the market. McManus is entirely correct that this substitution is necessary within a hierarchy.

> Although one never observes a firm in which pecuniary incentives are completely absent, because it is costly to enforce centralized control, it remains true that the firm "supercedes"... a price system.[45]

The substitution of administrative for high-powered market incentives does, in some cases, make the individual employee more indifferent between the alternative assignments he may receive, and hence more cooperative and more compliant to authority:

> Centralized organization normally make [sic] some efforts to prevent members from exchanging among themselves, often called bribery.... In a centralized organization some forms of exchange... would reduce the total output of the members of the

[42] McManus, "The Costs of Alternative Economic Organizations," op. cit., p. 342.
[43] Ibid., p. 337.
[44] Ibid., p. 336.
[45] Ibid., p. 342.

> organization by creating an incentive for an individual to impose damages on others and/or by making it more costly for the members to enforce the directives of the central authority.

The prohibited forms of internal trade include, among others, the sale or cherry-picking of assignments, and attempts to sabotage others, if high-powered rewards are tied to the value-added of the particular assignment.[46]

Oliver Williamson argues, on similar grounds that "hierarchy uses flat incentives because these elicit greater cooperation and because unwanted side effects are checked by added internal controls."

> Not only, therefore, will workers be more willing to accommodate because their compensation is the same whether they "do this" or "do that," but an unwillingness to accommodate is interpreted not as an excess of zeal but as a predilection to behave in a non-cooperative way.[47]

But it's questionable how effectively the side-effects are checked by internal controls. As we will see in a later chapter, the agency problems of the incomplete contract, coupled with imperfect monitoring and the tendency toward perfunctory compliance, probably make the internal transaction costs of hierarchy at least as high, *ceteris paribus*, as those of the market.

Williamson himself admits there is a tradeoff involved in "the bureaucratized reward structure in the large firm which relies on salary and promotion rather than direct participation in the earnings associated with successful innovation."[48] Such low-powered incentives (i.e., lacking a strong correlation between changes in effort and changes in reward)[49] do not elicit much in the way of enthusiastic contribution.

In fact, contrary to Williamson's assumption, low-powered incentives may actually make workers *less* indifferent between assignments. Paul Milgrom and John Roberts argue that low-powered incentives are themselves an incentive for gaming the system, or "influence activities," as they call it. Were the remuneration for each job closely tied to its pleasantness or unpleasantness, as is the case in a free labor market, compensation would adjust automatically "to insulate employees against any non-monetary effects of the organization's decisions." In that case, employees would be "indifferent among the various decisions the organization might take, and... would have no reason not to cooperate fully in promoting the organization's objectives."[50] But since the central

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[46] Ibid., pp. 342-343.
[47] Oliver Williamson, "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives," *Administrative Science Quarterly*, 36 (1991), p. 275.
[48] Williamson, *Markets and Hierarchies*, pp. 129-30.
[49] Williamson, "Comparative Economic Organization," p. 275.
[50] Milgrom and Roberts, "An Economic Approach to Influence Activities in Organizations," p. S158.

principle of hierarchy is the downward shifting of unpleasantness and the upward shifting of perks (or as Paul Fussell quotes a British infantryman in North Africa, "one class gets the sugar and the other class gets the shit"),[51] this correspondence of reward to disutility is ruled out by the nature of things.

Although the substitution of administrative for market incentives is necessary within an employment relationship, that is really only another reason for the greater overall efficiencies of market contracting compared to hierarchy. The hierarchy is more "efficient" only in cases when a market simply can't do the job (Williamson admitted as much, as we saw in Chapter One, treating markets as superior to hierarchies aside from the exceptional case of asset specificity). Even in a majority of the latter cases, the calculus takes place in an environment of artificially high asset specificity, so that state capitalism promotes higher levels of asset specificity (and hence of hierarchy) than would prevail in a free market. And in a much larger majority of cases, the choice of hierarchy reflects power considerations: the usefulness of the organization as a base for exercising power in the outside society, or as a machine for internal control of a labor-force largely devoid of intrinsic motivation, given the structural forces that promote absentee ownership and the wage system.

It's odd, therefore, that Williamson persists in treating hierarchy as a solution to the problem of opportunism under incomplete contracting.

> Not every transaction fits comfortably into the classical contracting scheme. In particular, for long-term contracts executed under conditions of uncertainty complete presentiation [i.e., anticipation of future contingencies] is apt to be prohibitively costly if not impossible. Problems of several kinds arise. First, not all future contingencies for which adaptations are required can be anticipated at the outset. Second, the appropriate adaptations will not be evident for many contingencies until the circumstances materialize. Third, except as changes in states of the world are unambiguous, hard contracting between autonomous parties may well give rise to veridical disputes when state-contingent claims are made. In a world where (at least some) parties are inclined to be opportunistic, whose representations are to be believed?
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> Faced with the prospective breakdown of classical contracting in such circumstances... [one alternative] would be to remove those transactions from the market and organize them internally instead. Adaptive, sequential decision-making would then be implemented under unified ownership and with the assistance of

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[51] Paul Fussell, *Class*. The quote is well worth repeating in its entirety: "Sir, this is a fine way for a man to send his fucking life, isn't it? Have you ever heard of class distinction, sir? I'll tell you what it means, it means Vickers-Armstrong booking a profit to look like a loss, and Churchill lighting a new cigar, and the Times explaining Liberty and Democracy and me sitting on my arse in Libya splashing a fainting man with water out of my steel helmet. It's a very fine thing if only you're in the right class--that's highly important, sir, because one class gets the sugar and the other class gets the shit."

hierarchical incentive and control systems.[52]

...Which would alter bounded rationality and opportunism *how*, exactly? The functioning of Williamson's "hierarchical incentive and control systems" depends on internal monitoring systems which are equally vulnerable, given information impactedness and opportunism, to "veridical disputes." The hierarchy does indeed gain increased authority, under a "general clause," to meet new contingencies on an ad hoc basis without having to renegotiate. But compliance with management policies is as subject to monitoring problems and opportunism under hierarchy as is compliance with the terms of a contract. In fact it is arguably *more* subject to such problems, because of the relative lack of Nielsen's "sharp ins and clear outs" compared to the state of affairs when inputs and outputs cross firm boundaries. Although hierarchy replaces the need for renegotiation with the formal authority of management under a general clause, the general clause is as unenforceable in practical terms under hierarchy as in the market. As Williamson's own treatment of "perfunctory cooperation" suggests, passive aggression can bring any managerial hierarchy to its knees.

McManus, like Williamson, tends to assume that hierarchy is substituted for market relations for some reason of greater overall efficiency, and that the substitution of administrative for market incentives is a necessary evil that is made up for by the greater net efficiencies. In fact, the truth is probably more often the reverse. The firm is unable to provide high-powered incentives to production workers, despite their greater efficiency, because it would violate the whole purpose of the organization: primarily management featherbedding, self-dealing, and consumption on the job, and (a distant second) returns to shareholders. The position of worker incentives on the list varies, depending on how many other items are on the list.[53]

McManus himself writes a great deal on the particular agency problems resulting from the adminstrative incentives of the corporate hierarchy:

> The establishment of a centralized organization weakens the relationship between an individual's income and his actions....
>
> The loss that results from the attenuation or elimination of pecuniary behaviour constraints is due to the cost of enforcing constraints against consumption "on the job" in a centralized organization. ...[T]here are always some opportunities in any

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[52] Williamson, *The Economic Institutions of Capitalism*, p. 70.

[53] Although there is necessarily some zero-sum relationship between production workers and capital owners, I would argue that the zero-sum character of the relation between workers and managers is far greater. To a considerable extent, both wages and profits could be increased considerably simply by replacing front-line supervisors with self-managed teams, radically streamlining the hierarchy and cutting its salaries, and shifting the overhead savings to higher wages and profit-sharing for production workers. Probably more than half of total management salaries and on the job perks are a dead loss to production, coming at the expense of both production workers and shareholders.

> organization to direct one's activities to such non-pecuniary forms of consumption. In watching pretty girls, the enjoyment of companions and good conversations, taking pride in one's workmanship, and in countless other ways individuals "produce" output for use while on the job. With a centralized organization such as a firm, there is no immediate, direct loss of pecuniary income from consumption on the job and individuals will, therefore, tend to damage other members of the firm by shirking, thus reducing the total output... generated within the firm.
>
> ...The external effects that will lower output within a price system will mainly be due to individuals' exploiting the opportunities for consumption on the job against which it is too expensive... to enforce constraints.[54]

Scott Adams discussed "consumption on the job," in humorous form, as "reverse telecommuting."

In a 1976 article, Michael Jensen and William Meckling built further on this work on self-dealing and other agency costs. They started with a summary of the agency relationship and its problems:

> We define an agency relationship as a contract under which one or more persons (the principals(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs..., and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar value of the reduction in welfare experienced by the principal as a result of this divergence is also a cost of the agency relationship, and we refer to this latter cost as the "residual loss." We define *agency costs* as the sum of:
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> 1. the monitoring expenditures by the principal,
> 2. the bonding expenditures by the agent,
> 3. the residual loss....

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[54] McManus, op. cit., pp. 344-345.

....The problem of inducing an "agent" to behave as if he were maximizing the "principal's" welfare is quite general.[55]

And these agency problems, they add in a footnote, are not limited to management collectively against the shareholders or production workers collectively against management. They exist at each separate rung of the hierarchy:

> ...the existence of positive monitoring and bonding costs will result in the manager of a corporation possessing control over some resources which he can allocate (within certain constraints) to satisfy his own preferences. However, to the extent that he must obtain the cooperation of others in order to carry out his tasks (such as divisional vice presidents) and to the extent that he cannot control their behavior perfectly and costlessly they will be able to appropriate some of these resources for their own ends. In short, there are agency costs generated at every level of the organization.[56]

Of course, they become more prevalent as an organization becomes more hierarchical.

In the rest of the article they argue that the less equity an owner-manager owns in the firm, the greater his incentive toward self-dealing; the resulting reduction in overall organizational income is diluted among numerous owners, while the gain accrues entirely to him.[57] But in fact this argument applies to all agency relationships, and is an excellent argument for vesting residual claimancy in production workers, as a way of reducing monitoring costs to a minimum and securing maximum effort.

Although the agency conflict between outside shareholders and management involves, as a considerable portion, the manager's tendency to engage in personal consumption out of the firm's resources, Jensen and Meckling consider this arguably less important than another side-effect of the agency conflict: the manager's reduced incentive, as his ownership stake is reduced,

> to devote significant effort to creative activities such as searching out profitable new ventures.... He may in fact avoid such ventures simply because it requires too much

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[55] Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial* Economics, vol. 3 no. 4 (October 1976), pp. 5-6.
[56] Ibid., p. 6n.
[57] Kenneth Arrow took a more nuanced view. It was not enough to reward a manager *proportionally* to his marginal profitability, if the absolute amount of the reward was too small a fraction of his actual marginal contribution. Nevertheless, he said, productivity rewards may still achieve a maximum return at a relatively modest level well below the value of the manager's marginal contribution. "Research in Management Controls: A Critical Synthesis," in C. Bonini, R. Jaediche, and H. Wagner, eds., *Management Controls: New Directions in Basic Research* (New York: McGraw-Hill, Inc., 1964), pp. 325-326. Of course Arrow, writing in 1964, had little idea of the sheer magnitude of today's potential for managerial self-dealing within the corporation, or the comparative opportunities for feathering one's own nest at the expense of profit-maximization.

trouble or effort on his part to manage or to learn about new technologies.[58]

But the two are actually related. As the cost of self-dealing declines, the personal reward for profit-maximization also declines. And the lack of stress and unnecessary effort is itself a form of consumption on the job.

We have already seen, in the previous chapter, that considerable transaction costs result from the distribution of idiosyncratic information among the members of an organization, and the difficulties involved in getting it to the right people. All this is true even without opportunism. When opportunism is thrown in, costs and information problems are further increased by the fact that those in possession of idiosyncratic information deliberately use it as a source of rents. Agents do their best to maintain a monopoly on information to which they are presently in sole possession, at the expense of the principal, in order to continue collecting such rents.

Hayek observed that the private information distributed among the members of an organization is vital to the successful operation of the organization. But as R. Preston McAffee and John McMillan point out,[59] those in possession of such information often see the organization's need for it as a source of bargaining power for themselves, and "[make] strategic use... of any special knowledge they have acquired.":

> Individual incentives... create a fundamental impediment to efficiency in hierarchies. Dispersed information within a hierarchy makes conflicts of interest inevitable. Information becomes distorted in our model--there is, in effect, a cost of communication--not because of limits to people's ability to transmit and receive information, but because of people's incentives to exploit any informational advantages they have.[60] This distortion increases cumulatively as the information moves up the hierarchy, so longer hierarchies have greater informational inefficiencies.
>
> The experience of large European firms exemplifies the bargaining advantages of privately-held information.... "People are reluctant to share their information," observed the head of a French company. "Managers in particular seem to think it gives them extra power." Resistance by middle-ranking managers, according to *The Economist*, has prevented most large European companies from establishing management information systems across their subsidiaries in the various countries in which they operate. "Those further down the management hierarchy... have an

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[58] Ibid, p. 12.

[59] R. Preston McAffee and John McMillan, "Organizational Diseconomies of Scale," *Journal of Economics & Management Strategy*, Vol. 4, No. 3 (Fall 1995): 399-426.

[60] McAffee and McMillan do not , as they mention shortly thereafter, see their analysis as negating "other sources of hierarchy inefficiencies, such as the limits to people's ability to process information" (which we examined in the previous chapter). They simply ignore it for the purpose of simplicity, preferring to concentrate entirely on the agency effects of private information. p. 401.

interest in husbanding information--and the power that goes with it.... The types of information which these companies have found it most difficult to standardize and collect is that on customers, pricing, product specifications, and local personnel.... This is precisely the information which would be most helpful in lowering the costs or responding quickly to changes in the market."[61]

Milgrom and Roberts, likewise, refer to the perceived benefits of "suppressing or distorting information" in order to influence decisions. The cost of bureaucratic politics is one of the diseconomies of the M-form corporation, as opposed to contracting across independent firm boundaries: "The boundaries between independent firms reduce the possibilities for influence. Consequently, those boundaries reduce influence costs."[62]

Oliver Williamson saw the small-numbers exchange relations in a hierarchy, and the information rents extracted under such circumstances, as quite similar to their counterparts in the outside market economy:

> Shifting a transaction from the market to the firm is significant not because a small-numbers exchange relation is eliminated but rather because the incentives of the parties are transformed. Indeed, the typical internal transaction is really a small-numbers exchange relation writ large. Investment by a firm in fixed plant and organizational infrastructure serves to insulate internal transactions from competition in the product market--with the result that, in the short run at least, there may be no credible alternative source of supply whatsoever. Functional managers, naturally, are not unaware of this condition. Coupled with the information impactedness advantage that they enjoy, a nontrivial degree of managerial discretion obtains.
>
> Internal opportunism takes the form of subgoal pursuit where by subgoal pursuit is meant an effort to manipulate the system to promote the individual and collective interests of the affected managers. Such efforts generally involve distorting communications in a strategic manner.[63]

The rents extracted from such control of information within the organization are directly analogous to the rents on control of information (through so-called "intellectual property" laws) in the outside economy. One reason mid-level managers are so resistant to networked organization models like "Enterprise 2.0" is that they enable ordinary production workers who generate useful knowledge to bypass the manager's informational gatekeeping function. Likewise, the corporate economy's hostility to peer-production and open-source information models in the outside economy is a response to a perceived (and very real) threat to the gatekeeping role of companies that have lost the

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[61] pp. 400-401.
[62] Paul Milgrom and John Roberts, "Bargaining Costs, Influence Costs, and the Organization of Economic Activity," in James E. Alt and Kenneth A Shepsis, eds., *Perspectives in Positive Political Economy* (New York: Cambridge University Press, 1990), pp. 482-485.
[63] Williamson, *Markets and Hierarchies*, pp. 124-125.

technological basis they had for that role in the old days of broadcast culture, and today depend entirely on the so-called "intellectual property" that they own. But digital technology and the networked world of the Internet render the old legal regime of "intellectual property" and the economic models based on it as obsolete as the brontosaurus. And, as we shall see in our chapters on the special agency problems of labor and on labor struggle as asymmetric warfare, such technological change has likewise doomed the internal role of management.

Corporate management also extracts rents from the production workers at lower levels of the hierarchy, when enabled by non-competitive markets, in a manner parallel to their rent extraction from the outside society.

> In a firm, according to our model, (a) production efficiency falls as the hierarchy lengthens; (b) production efficiency may rise or fall, depending on the form of the cost function, when the firm's output market becomes more competitive; (c) the longer the hierarchy, the smaller the marginal rate of payment with respect to output of the workers at the bottom of the hierarchy (so small firms will pay their workers piece rates, large firms will pay closer to fixed wages); (d) the more competitive the firm's output market, the more sensitive pay is to performance (so competitive firms will pay their workers piece rates, monopolists will pay closer to fixed wages); (e) the higher an individual is up the hierarchy, the more sensitive are marginal payments to performance (so bonuses will be a bigger fraction of income for executives than for production-line workers); and (f) a firm with a long hierarchy may not be viable in a competitive industry (so a large firm might respond to an increase in competition by shortening its hierarchy).[64]

Bengt Homstrom and Paul Milgrom attempt to defend the hierarchy as the least-bad alternative emerging from market selection, but fail to present any reason for doubting McAffee's and McMillan's contention that hierarchy is a net inefficiency that can survive only by parasitizing on the rents from a monopoly market:

> Like low-powered incentives, bureaucratic constraints have frequently come under attack as being costly and inefficient. It is notable that the specific criticisms we hear today--that bureaucracy impedes innovation, that it is hopelessly slow, that it prevents personal growth, and so on--are all problems that have been with bureaucracy from its inception. But we are hardly the first generation to recognize how costly bureaucracy can be. The natural economic hypothesis is that bureaucratic constraints can serve a purpose.[65]

True, true. Any form of inefficiency likely exists because it serves *somebody's* purpose, and any form of "irrationality" is likewise perfectly rational from the perspective

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[64] McAfee and McMillan, op. cit., p. 401.
[65] Bengt Holmstrom and Paul Milgrom, "The Firm as Incentive System," *The American Economic Review*, Vol. 84, No. 4 (Sept. 1994), p. 989.

of those whose interests it serves. It is only irrational and inefficient in terms of the net cost to society; it is rational and efficient for the parasites because they get the benefits, while the costs are paid by others--all of which is just another way of saying that that managerialist bureaucracies feed off of monopoly rents.

McAffee's and McMillan's argument is, obviously, a considerable departure from Oliver Williamson's approach. Williamson considers monopoly explanations of hierarchy to be overblown, and prefers to stress the increased governance efficiencies of hierarchy over market in cases of asset specificity.

Information rents are, in large part, the basis for the phenomena we will be examining in Chapters Eight and Nine, on agency problems associated with management and labor. Because of information rents, complete contracts--even when theoretically possible--are largely unenforceable. Open-ended promises by workers to accept direction from superiors, by management to pursue the interests of shareholders in preference to their own, or by the management of an acquiring firm to intervene in the affairs of the newly integrated division only in the case of clearly specified justifications--all these things are unenforceable, because the verification of compliance depends on information to which the promising party alone is privy. Williamson gives the example of Odysseus and the Sirens:

> Recall that Odysseus, with foreknowledge that the call of the Sirens was irresistible, commanded that he be bound to the mast when the ship came within range of the Sirens. Suppose further that Odysseus instructed the crew to "tighten and add to my bonds" should he ask for release. Should it be the case that the ship comes under attack or is otherwise in serious jeopardy, the bonds are to be relaxed if not released at his command so that he can direct the crew to tke appropriate adaptive action.
>
> The difficulty, plainly, is that the circumstances that qualify as an exception are not unproblematic. To be sure, the crew will refuse him if Odysseus signals, "Release my bonds, I must accede to the Sirens." But they are presented with a dilemma if Odysseus, whose knowledge of the seas and their perils is unsurpassed, should signal, "I perceive great danger; loosen my bonds a little so that I may instruct the recovery." When is the latter signal to be believed and when not?[66]

We have already seen hints of a recurring theme in the preceeding material: the need to internalize effort and reward in the same actor for incentives to operate with maximum efficiency. This was a matter of special importance for Alchian and Demsetz, although in their formulation it required the counter-intuitive mechanism of vesting the monitoring function in the managerial hierarchy as residual claimants, in order to maximize the

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[66] Oliver Williamson, "The Logic of Economic Organization," *Journal of Law, Economics, and Organization* IV:1 (1988), pp. 80-81.

incentive of the monitor to extract maximum effort from workers through administrative incentives. They took the rather perverse stance that sharing profits with those actually engaged in production would reduce the incentive to produce, by reducing the incentive of the overseer to wield the whip effectively over the producers.

Holmstrom and Milgrom showed some awareness of the principle, arguing for asset ownership as the source of high-powered incentives: "When an agent owns a set of productive assets, she maintains those assets more effectively. She also reaps the many implicit returns that accrue through such ownership, notably those stemming from an enhanced bargaining position."[67] The implication in favor of producer cooperatives would seem fairly obvious, but perhaps not in this crowd.

In fact, it's remarkable just how little the question of internalizing rewards among production workers enters into the mainstream discussion of agency and incentives. Workers are often presented as the only participants in the firm whose main motivation is, as a matter of course, the fear of detection and punishment rather than the hope of reward for greater output.

A good example is the disconnect between Michael Jensen's perception of motivational issues for senior corporate management, and his perception of motivational issues for production workers. In the 1970s and '80s, Jensen was the apostle of the "entrepreneurial corporation." The central focus of his thought was how to structure incentives, through stock options and bonuses, to tighten the shareholder reins on management. Meanwhile, he decried the obstacles to economic progress posed by "striking Eastern Air Lines pilots, Pittston Coal miners, [and] New York Telephone employees, who seem perfectly content to destroy or damage their employer's organization while attempting to serve their own interests." The idea that his principles of management motivation might be applied to workers, attempting to align their interests with those of the firm by transforming them into stakeholders with some degree of residual claimancy, apparently never occurred to him.[68]

More generally, the corporate culture's view of how to structure incentives to overcome agency problems is completely different for management than it is for the productive work force. The corporate CEO's drive to loot the company, it seems, is so overwhelming and fundamental that he must be given a salary and stock options, each worth tens of millions of dollars, to dissuade him from taking off for Costa Rica with several suitcases full of embezzled cash--and even then, it often doesn't work. In the case of the production worker, on the other hand, the threat of termination and a bit of Fish! Philosophy are enough to elicit maximum effort and get him to view the employer's interests as identical to his own.

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[67] Holmstrom and Milgrom, p. 972.

[68] Michael C. Jensen, "The Evidence Speaks Loud and Clear," *Harvard Business* Review 89 (November-December), pp. 12-14. Quoted in Doug Henwood, *Wall Street: How it Works and for Whom* (London and New York: Verso, 1997), p. 272.

The issue of worker motivation does figure prominently, however, in the work of more radical thinkers. In the chapter on cooperatives in Part Four, for example, we will exmine a wide range of radical and new institutionalist literature on the effects of residual claimancy and self-management on worker output. For a critical analysis of worker incentives within a hierarchy, the focus of this chapter, Paul Goodman and Ursula LeGuin are two of the most insightful thinkers.

A key part of Paul Goodman's theory of incentives was the distinction between intrinsic and extrinsic motivation: "subordinates are restricted in both initiative and self-expression and their motivation is likely to be merely extrinsic, rise in status and salary."[69]

Extrinsic motivation comes into play in exploitative situations, where the work process is subjected to control from above and the expenditure of effort is for goals imposed from outside. Extrinsic is substituted for intrinsic motivation as a matter of necessity, when the institutional structure (absentee ownership or an administrative hierarchy) precludes production workers from internalizing the fruits of their labor:

> The conqueror is originally a pirate; he and his band do not share in the commonwealth, they have interests apart from the community preyed on. Subsequently, however, piracy becomes government, the process of getting people to perform by extrinsic motivators, of penalty and blackmail, and later bribery and training. But it is only the semblance of a commonwealth, for activity is not voluntary. Necessarily, such directed and extrinsically motivated performance is not so strong, efficient, spontaneous, inventive, well-structured, or lovely as the normal functioning of a free community of interests. Very soon society becomes lifeless. The means of community action, initiative, decision, have been preempted by the powerful.... Inevitably, as people become stupider and more careless, administration increases in size and power; and conversely.[70]

In such cases, the goals of the owners or the administrators are substituted for the intrinsic motivation of those directly engaged in work, and enforced with administrative penalties. In the case of higher education,

> it makes an enormous difference if it is directly society that uses the schools to train youth for its needs, or if it is directly the scholars that use the schools to learn or teach what they practically want to know or profess. When seminaries are founded to train ministers or our present universities are heavily subsidized to train military engineers, the social needs exist in the school as "goals of the administration" and this adds many complications: the scholars must be motivated, disciplined, evaluated. But

[69] Paul Goodman, *People or Personnel*, p. 81.
[70] Ibid., pp. 182-183.

> when students who want to be lawyers or doctors find themselves a faculty, or masters with something important to profess attract disciples, the case is simpler: the goals are implicit and there is no problem of motivation.[71]

One does not have to equate pecuniary motivation, as such, to extrinsic motivation, to appreciate the usefulness of Goodman's distinction. To use the language of mainstream organization theory, the substitution of administrative incentives for the "high-powered incentives" of the market is a substitution of extrinsic for intrinsic motivation: effort is divorced from reward, so that the two are no longer internalized in the same actor. But the substitution of entirely pecuniary motivation as a compensation for loss of control of one's work (the Taylorist bargain) is also a substitution of extrinsic for intrinsic motivation. One of the defining features of extrinsically motivated work is the loss of control over the pace and organization of one's own work, and the satisfaction that come from it, as well as the stress that comes from such loss of control:

> It is not so much that the pace is fast... but that it is someone else's pace or schedule. One is continually interrupted. And the tension cannot be normally discharged by decisive action and doing things one's own way. There is competitive pressure to act a role, yet paradoxically one is rarely allowed to do one's best or use one's best judgment. Proofs of success or failure are not tangibly given in the task, but always in some superior's judgment.[72]

Indeed, as we saw in Chapter Four, one of the central purposes of the state's school system is to train people from early childhood to understand that the tasks assigned by others, by authority figures, and motivated extrinsically, are the important ones. Self-selected tasks done for intrinsic motivation are trivialized as "play" or "hobbies." The school is almost diabolically designed to make children identify "learning" with the execution of tasks imposed by authority, and thus to inculate utter loathing of the very concept of learning. As a result, like Huxley's Deltas who as infants learned to associate books with painful electrical shocks, the majority of people can be safely trusted not to engage in any form of learning not directly associated with service to the corporate state. The school perverts and destroys all joy in learning in exactly the same way that the job perverts and destroys all joy in productive labor. The school, finally, is designed to habituate the young person to a life in which, for eight hour chunks of the day, five days a week, he walks through the doors of an institutional building into a life that is not his own and accepts tasks that are not his own; the relevance as a preparation for working life should be obvious.

In the typical large corporation, a major part of the work of Human Resources cheerleaders is devoted to the pretense that workers' main motivation is intrinsic. This is especially true in my field, healthcare. The HR cheerleaders pretend that the mission,

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[71] Goodman, *The Community of Scholars*, pp. 212-213.
[72] Goodman, *Like a Conquered Province*, p. 351.

vision, and values statements actually mean something to the worker--or to anybody, for that matter. But why should they, when senior management cares only about career advancement, white collar featherbedding, and bureaucratic empire building? Workers who really *are* dedicated to patient care are cynically manipulated and squeezed dry of every drop of compassion, their every minute at work a hell of short-staffing and stress. The typical hospital's management manufactures burnouts like Carter manufactures liver pills.

Goodman's contrast of extrinsic to intrinsic motivation was illustrated, in a fictional venue, by Ursula LeGuin in *The Dispossessed*. Her protagonist Shevek, a traveller from the libertarian communist world of Anarres, recalls his conversation with an elderly conservative (Atro) on the authoritarian and capitalist world of Urras. Shevek looks back on the conversation from his later perspective, hiding out in a warehouse after the suppression of a workers' insurrection in the leading imperialist state on Urras:

> Atro had once explained to him how this was managed, how the sergeants could give the privates orders, how the lieutenants could give the privates and the sergeants orders, how the captains... and so on and so on up to the generals, who could give everyone else orders and need take them from none, except the commander in chief. Shevek had listened with incredulous disgust. "You call that organization?" he had inquired. "You even call it discipline? But it is neither. It is a coercive mechanism of extraordinary inefficiency--a kind of seventh-millennium steam engine! With such a rigid and fragile structure what could be done that was worth doing?" This had given Atro a chance to argue the worth of warfare as the breeder of courage and manliness and weeder-out of the unfit, but the very line of his argument had forced him to concede the effectiveness of guerrillas, organized from below, self-disciplined. "But that only works when the people think they're fighting for something of their own--you know, their homes, or some notion or other," the old man had said. Shevek had dropped the argument. He now continued it, in the darkening basement among the stacked crates of unlabeled chemicals. He explained to Atro that he now understood why the Army was organized as it was. It was indeed quite necessary. No rational form of organization would serve the purpose. He simply had not understood that the purpose was to enable men with machine guns to kill unarmed men and women easily and in great quantities when told to do so.[73]

The hierarchical corporation, likewise, is a clumsy Rube Goldberg device for eliciting effort from people with absolutely no rational cause to be willing to expend unnecessary effort or increase output or productivity. Given the fact that worker ownership of the enterprise and worker control of production are ruled out by the fundamental goals of the system and the structural rules set up to promote those goals, it is impossible to provide either intrinsic motivation in work or the high-powered market incentives of sharing the returns on increased productivity. The only alternative is more and more hierarchy and

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[73] Ursula LeGuin, *The Dispossessed*, pp. 305-306.

authoritarianism, along with demeaning, manipulative gimmicks like Fish! Philosophy to manufacture enthusiasm without spending any money on incentives.

But such efforts will be fruitless, because most workers can see through them. When workers perceive that management is cynically trying to manipulate more work out of fewer people for less money, they will do the bare minimum. They will avoid any extra effort because there's nothing in it for them, and it will only serve to benefit their enemy. For example, before a Range Rover factory made a lifetime employment pledge in the early '90s, only 11% of employees entered the annual employee suggestions competition, "because they were worried that increased efficiency might cost them their jobs; afterward the proportion rose to 84 percent." And a single one of those proposals saved the company 100 million pounds.[74]

Douglas McGregor, the father of "Theory Y" management, made a similar observation about work incentives:

> Theory Y assumes that people will exercise self-direction and self-control in the achievement of organizational objectives *to the degree that they are committed to those objectives*. If that commitment is small, only a slight degree of self-direction and self-control will be likely, and a substantial amount of external influence will be necessary. If it is large, many conventional external controls will be relatively superfluous, and to some extent self-defeating. Managerial policies and practices materially affect this degree of commitment.[75]

Management policy affects commitment by creating (or most likely *not* creating) an environment "in which the individual can achieve his goals *best* by directing his efforts toward the success of the organization."

> ...["Best"] means that he will continuously be encouraged to develop and utilize voluntarily his capacities, his knowledge, his skill, his ingenuity in ways which contribute to the success of the enterprise.[76]

Of course this seldom happens. Wage labor (and most salaried work) is defined by the substitution of the organization's alien goals for one's own during the time one has alienated to the organization. As C. Wright Mills wrote,

> Alienation in work means that the most alert hours of one's life are sacrificed to the making of money with which to "live".... It means that while men must seek all values that matter to them outside of work, they must be serious during work.... In

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[74] John Micklethwait and Adrian Wooldridge, *The Witch Doctors: Making Sense of the Management Gurus* (New York: Times Books, 1996), p. 209.
[75] Douglas McGregor, *The Human Side of Enterprise* (New Work, London, Toronto: McGraw-Hill Book Company, Inc., 1960), p. 56.
[76] Ibid., p. 55.

> short, they must be serious and steady about something that does not mean anything to them....
>
> Each day men sell little pieces of themselves, in order to try to buy them back each night and week end with the coin of "fun."[77]

In short, what McGregor called "Theory X" assumptions about human nature are an accurate description of the subordinate in a hierarchy. So long as the organization exists for purposes other than those of the people doing the work, and operates under leadership unaccountable to them, there's a *need* for LeGuin's "steam engine."

Although Oliver Williamson is hardly a radical of the same order as Goodman or LeGuin, his discussion of the "atmospheric consequences" of large size echoes their treatment of incentives. The "atmospheric advantages" of a firm, as opposed to market contracting, include "associational relations that may be valued," and "involvements of a continuing sort in which members are more sensitive to part-whole relations." But increasing organizational size negates these advantages, and promotes instead directly contrary atmospheric *dis*advantages:

> ...large size and hierarchical structure favor impersonality among the parties, which is more characteristic of a calculative orientation. This is partly attributable to the specialization of information gathering and the more limited disclosure of information... as firm size and hierarchical structure are extended... The corresponding assignment of decision-making to what are perceived by lower-level participants to be remote parts of the enterprise also contributes to this result.... To the extent that nonknowledgeability and nonparticipation impair involvement and larger-size results in role incompatibility, ...a more calculative orientation is to be expected.... Put differently, attitudes of voluntary cooperation are supplanted by a *quid pro quo* orientation. Since, moreover, each individual in the large organization is small in relation to the whole, so that the percentage effects of individual behavior are perceived to be insubstantial, the large organization may be thought to be better able to tolerate perfunctory performance or even deviant conduct.
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> A reduction in group disciplinary pressures... thus obtains.... Indeed, should alienation from the enterprise develop among individual components of the firm, small-group powers may even be turned against the enterprise in subtle but significant respects. The disaffected group may allocate rewards and sanctions in a perverse fashion. Industrial sabotage is an extreme manifestation of this condition.[78]

It's also important to bear in mind that perfunctory compliance and passivity do not occur just in special cases, when workers react to especially authoritarian hierarchies or abusive superiors. To a large extent, they are inculated by hierarchy and the superior-subordinate relationship themselves.

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[77] C. Wright Mills, *White Collar: The American Middle Classes* (London, Oxford, New York: Oxford University Press, 1951), pp. 236-237.
[78] Williamson, *Markets and Hierarchies*, pp. 128-129.

> We all know what it feels like to be told how to do something by someone else, particularly when that person does not do it every day. This is not a problem of ineffective individuals but of management as a system. Whenever someone in a superior position gives us orders, our natural responses are either:
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> - Blind, robotic obedience, not caring whether it is done well
> - Unspoken, passive-aggressive resistance, or what employees sometimes call "public compliance and private defiance"
> - Hostility, opposition, and rebellion
>
> Through years of experience, employees learn that it is safer to suppress their innate capacity to solve problems and wait instead for commands from above.[79]

In the same book, a historical digression tracing the profession of management back to slavery includes this gem:

> Managers became increasingly indispensable as slave plantations grew in size, empires expanded, and captured peoples were pressed into military and domestic service. They encouraged the expansion of slavery by disciplining and controlling the workforce, often on behalf of absentee owners, and were needed to combat the slaves' lack of motivation to work hard, take responsibility for safeguarding the owner's property, or protect the power and status of slave owners against their far more numerous slaves. Owners had to hire managers because without their vigilant oversight, no one would have chosen to remain a slave or voluntarily submit to arduous labor simply in order to magnify their owner's profit.[80]

Sound familiar?

Still another important consideration about perfunctory cooperation to bear in mind: it operates as a positive feedback system. As we shall see in Chapter Nine, the internal "crisis of governability" of the hierarchical organization is subject to the same kind of exponential growth and escalation we saw on a systemic level in Chapter Four. Authoritarianism breeds passive resistance and active hostility, which necessitates still harsher authoritarianism and surveillance, which inspires still more resentment and makes the workforce even harder to govern, which forces management to devote even more resources to internal control, etc., etc. In Chapter Nine we will consider, among other things, David M. Gordon's account of the parallel and mutually supporting growth of increasing internal authoritarianism and employee disgruntlement in the large corporation. For now, here's another good observation from Cloke and Goldsmith:

> The intrinsic emphasis in hierarchies on unquestioning conformity and strict

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[79] Kenneth Cloke and Joan Goldsmith, *The End of Management and the Rise of Organizational Democracy* (New York: John Wiley & Sons, 2002), p. 10.
[80] Ibid., pp. 21-22.

enforcement of rules encourages managers to coerce and manipulate employees into obedience. It equally encourages employees to obey rules blindly, resist responsibility for outcomes, and shelve their creativity, reinforcing the need for managers to watch over them. This makes the system self-reinforcing, turning it in a circle. Because bureaucracy mandates conformity to a single standard, it produces apathy, cynicism and iresponsibility at the bottom and autocracy, privilege, and unilateral action at the top. These dynamics make management even more immune to change, thereby reinforcing the need for bureaucracy.[81]

In addition to all the foregoing agency and incentive problems, finally, additional agency problems are created by incomplete contracting.[82] This is especially true of the incomplete nature of the labor contract, which will be the topic of a separate chapter. But it is true of other internal contracting within the firm, as well:

> The problem is that none of the following is costlessly enforceable: promises by division managers to utilize assets with "due care"; promises by owners to reset transfer prices and exercise accounting discretion "responsibly"; promises to reward innovation in "full measure"; promises to preserve promotion prospects "without change"; and agreements by managers to "eschew politics."[83]

In theory, the advantage of an incomplete contract is that it provides the management of the firm with a "general clause" allowing them to adjust the terms by fiat as the situation changes: "One advantage of hierarchy... with respect to bilateral adaptation is that internal contracts can be more incomplete."[84] In practice, however, the terms emerging from the "general clause" result from the de facto bargaining power of the different interest groups within the firm. Enforcement of the management prerogative is limited by agents' rents from impacted information, and the difficulty of monitoring compliance.

> ...[P]arties that bear a long-term bilateral dependency relation to one another must recognize that incomplete contracts require gapfilling and sometimes get out of alignment. Although it is always in the collective interest of autonomous parties to fill gaps, correct errors, and effect efficient realignments, it is also the case that the distribution of the resulting gains is indeterminate. Self-interested bargaining predictably obtains. Such bargaining is itself costly.[85]

There is a major difference in the contractual enforcement tools available in markets and hierarchies. Exogenous enforcement through official legal action in the courts is far

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[81] Ibid., p. 94.
[82] Williamson, *The Economic Institutions of Capitalism*, p. 29
[83] Williamson, *The Economic Institutions of Capitalism*, p. 161.
[84] Williamson, "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives," p. 280.
[85] Oliver Williamson, "Comparative Economic Organization," p. 278.

more feasible in markets; courts are more likely to refuse to intervene in the internal disputes of a firm, and leave it to resolution by endogenous enforcement mechanisms.

> There is a logic to classical market contracting and there is a logic for forbearance law, and the choice of one regime precludes the other. Whether a transaction is organized as make or buy--internal procurement or market procurement, respectively--thus matters greatly in dispute-resolution respects: the courts will hear disputes of the one kind and will refuse to be drawn into the resolution of disputes of the other. Internal disputes between one division and another regarding the appropriate transfer prices, the damages to be ascribed to delays, failures of quality, and the like, are thus denied a court hearing...
>
> The underlying rationale for forbearance law is twofold: (1) parties to an internal dispute have deep knowledge--both about the circumstances surrounding a dispute as well as the efficiency properties of alternative solutions--that can be communicated to the court only at great cost, and (2) permitting internal disputes to be appealed to the court would undermine the efficacy and integrity of hierarchy.[86]

Summary. Individual human beings make optimal decisions only when they internalize the costs and benefits of their own decisions. The larger the organization, the more the authority to make decisions is separated both from the negative consequences, and from direct knowledge of the results. And in a hierarchy, the consequences of the irrational and misinformed decisions of those at the top are borne by the people who are actually doing the work. The direct producers, who know what's going on and experience directly the consequences of the decisions, have no direct control over those decisions.

An institution, according to Butler Shaffer described it, is by definition an organization which is unaccountable to those making it up.

> By "institution," I mean to refer to *any permanent social organization with purposes of its own, having formalized and structured machinery for pursuing those purposes, and making and enforcing rules of conduct in order to control those within it.* An institution is an independent, self-justifying, self-perpetuating organization that is, for all practical purposes, no longer accountable to nor under the control of its members.[87]

Conflict of interest is built into a hierarchy. The relationship between any two adjacent levels in a hierarchy is, by definition, zero-sum. Those in authority benefit by shifting work downward while appropriating rewards for themselves. Since they do not appropriate the fruits of increased effort, subordinates benefit by perfunctory cooperation, and exploiting information impactedness to reduce effort.

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[86] Oliver Williamson, "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives," p. 275-276.

[87] Butler Shaffer, *Calculated Chaos: Institutional Threats to Peace and Human Survival* (San Francisco: Alchemy Books, 1985), p. 9.

Appendix 6A: Toilet Paper as Paradigm

I like to use toilet paper dispensers as a paradigm for the systematic stupidity of organizations. One thing that large institutions seem to have in common is public restrooms with completely unusable toilet paper dispensers. The typical public restroom in a large organization of any kind has one of those Georgia Pacific monstrosities (or something similar), encased in a plastic housing that makes the toilet paper roll difficult to reach and often almost impossible to turn. The housing is locked, so that an empty roll can be changed only by a housekeeper with a key, and it's impossible to just take the roll out for easy use. The worst part of it is, these toilet paper dispensers probably cost $20 or more each. I wouldn't be surprised, in the case of some government institutions, if their paper dispensers were custom designed (at great expense) to an elaborate set of specs, worked out in painstaking detail, for the individual institution. And what's really sickening is that you can probably go to Home Depot and get a toilet paper spool that actually works for less than a dollar.

I'm at an utter loss to understand what rational purpose this serves. Maybe they're afraid vandals will piss all over the toilet paper if it isn't properly shielded. Or maybe someone will try to make a fortune selling it on the black market. But you'd probably break your back stealing enough gross of cheap scratch-ass paper to equal the money wasted on a single one of those over-designed dispensers (not to mention the labor wasted in getting a housekeeper to make a special trip to the supply closet and unlock the dispenser every time the roll is empty).

So why do we find so many examples of this sort of thing? Why does just about any large institutional building have toilet paper dispensers that seem deliberately designed, at enormous cost, to perform their function as badly as possible? The answer lies in the nature of large organizations.

For one thing, the dispenser is produced for a "customer" who is not the actual user of the toilet paper, but some government or corporate procurement officer. And the procurement officer himself probably doesn't even set the product specifications. There are so many layers of bureaucracy between the producer of the crappy dispensers, and the ultimate user, that a company can specialize in producing such hardware for institutional customers without ever worrying that anybody will ever refuse to accept it on grounds of quality. Matthew Parris, by the way, announced his "new theory"

> that the free market doesn't work properly when the real customers are those who commission a product rather than those who use it. It is, for example, businesses, not the householder, that choose the courier service that makes you stay in all day in case it calls; it