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The Costs of Contracting

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

Simple Market Power

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

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

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

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

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

Ex Post Market Power ("Lock-In")

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

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

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

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

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

The Risks of Long-Term Contracting

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

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

Asymmetric Information

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

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

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

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

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

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

Strategic Bargaining

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

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

Communication of Patron Preferences

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

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

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

Compromising among Diverse Patron Preferences

Often a firm must deal on the same terms with all patrons in a given class even though individuals within that class have differing preferences. The firm may be constrained to offer the same working conditions to all of its employees or the same quality of goods or services to all of its customers. In these circumstances, market contracting can lead the firm to choose an inefficient compromise among its patrons' differing preferences. This problem occurs because a firm contracting in a market has an incentive to accommodate the preferences of the marginal patron. Yet efficiency generally calls for choosing conditions that suit the preferences of the average patron, and these preferences may be quite different from those of the marginal patron.[9]

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

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

Alienation

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

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

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

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

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

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

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

Who Bears the Costs?

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

Who Owns Whom?

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

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

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

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

3

The Costs of Ownership

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

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

Costs of Controlling Managers

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