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Economic Organization Forms beyond Investor Ownership

1. Introduction

As noted by Dow[2]: "Despite much attention (…) to the organization of firms, the question of why large firms are conventionally controlled by investors rather than workers has not been high on the economic research agenda, perhaps for the same reason that fish do not study water". That is a regrettable neglect, as study of non-investor enterprises may provide important insights, especially for scholars interested in economics of moderation. Other than worker-owned firms, also supplier-, consumer- and non-profit firms belong to this category. Not only do economists devote relatively less attention to them than to conventional firms, but they also rarely recognize their common characteristics. This article focuses on one common characteristic, which is defined as the owner's concern with qualitative aspects of her the firm's operation.

The workings of, an economic system are necessarily influenced by economic analysis that explains and rationalizes it. In my view the perceived superiority of inverstor ownership is linked to the overemphasis that economists put on efficient financial markets. This, in turn, is a result of economic analyses being dominated by mathematical modelling. This method requires a one-dimensional maximand, which I deem the main culprit. I will argue that this quantitative approach obscures a great deal of qualitative considerations that should be part of economic decisions. Consequently, inverstor ownership, especially when intermediated by financial markets, results in economic decisions oblivious to these qualitative considerations. Therefore, it is interesting to look at economic decisions made by non-investor-owned firms.

This paper is structured as follows: first I make an argument that excess is a consequence of subordination of economic activity to financial profit,

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[2] G. K. Dow, *Governing the firm: workers' control in theory and practice*, Cambridge University Press, New York 2003, p. 2.

sought by investor-owners. Second, I examine existing justifications for the investor ownership. Third, I conceptualize non-investor owned enterprise. Finally, I review evidence on non-investor owned enterprises that indicates their relevance for the economy of moderation.

2. Investor ownership as the cause of excess

The classic consumer theory treats all preferences as commensurable and substitutable. This is necessary for the exercise of preference aggregation and construction of utility functions. Yet, wellbeing is not a simple function of aggregated consumption. The standard assumptions underlying the utility function – independence of preferences, consistence of choice – are only applicable to a limited scope analysis, but being applied to the totality of human desires they trap economic analysis in the maximization paradigm.

Realizing that consumption maximization is not realistically the sole drive behind human actions, standard economic models consider "preference for leisure" as an element that may limit the relentless pursuit of more consumption. But this only applies to individual consumers-workers. Capital, on the other hand, knows no leisure and standard economic models do not consider constraints for relentless pursuit of return on investment. In the following section it will be argued that this is exacerbated by the current structure of financial markets and that putting ownership of economic organizations exclusively in the hands of investors hardwires the economy for excess.

Dating back to the work of Ronald Coase and still in the modern literature, a firm is a basic unit of economic organization and is conceptualized as a nexus of contracts, an entity that facilitates transactions between multiple parties. The parties involved may be defined more narrowly, as investors, managers and employees, somewhat more broadly, including suppliers and customers, or broadly including government and pressure groups.[3] Parties involved exchange various things – such as labor, financial capital, property rights to land and equipment, intermediate products, final products – most of which have a qualitative dimension. To perceive all these objects of exchange as qualitatively identical and analyze solely their monetary value makes the ecological and social impact of these transactions opaque. Each of these groups, has a stake in the firm (thus the term: stakeholders), which for most of the groups is not only pecuniary, but real. The real dimension of a stake could be, e.g. for employees – employment security or workplace relationships, for suppliers – preservation of traditional production techniques, for customers – health considerations, for the community – impact on the natural environment, etc. Such stakes, of qualitative nature,

[3] R. E. Freeman, J. McVea, *A Stakeholder Approach to Strategic Management*, Darden Business School Working Paper" 2001, no. 01–02.

are not subject to the maximization logic, as opposed to the pecuniary stake, of quantitative nature. Every transaction represents a particular mix of qualitative and quantitative stakes. Clearly, for the investors who are not involved in operation of the firm the pecuniary stake is a dominant motivation. Thus, putting investors in control of most of the firms, subordinates most of the economic activity to the motivation of financial profit, the only measure of a firm's performance that can be maximized infinitely. Unfortunately, its maximization often comes at the expense of other measures of qualitative nature.

3. Existing arguments for investor ownership

The notion of ownership of an organization is related to the concept of incomplete contracts. It is never possible to contract for every possible instance, therefore in any firm some party must have authority to make decisions falling out of the scope of contracts. In other words, a firm is a hierarchy, essentially a power structure. The stakeholders of the firm are in different power positions within this structure. The holders of ultimate control, referred to as residual control in the literature, are deemed the owners of the firm.[4] Currently great majority of firms are investor-owned, even though non-investor enterprises, i.e. cooperatives and non-profit organizations, exist and persist.[5] There are different varieties of collective inverstor ownership, i.e. partnership, limited liability partnership, and most importantly corporation, private or publicly listed. As a rule, the largest firms are publicly listed. According to the ownership concept described above, in investor-owned companies' shareholders are owners, i.e. they exercise residual control, particularly to achieve appropriate residual profit.

The theory of property rights provides several arguments to explain the predominance of investor ownership. One of them refers to homogeneity of interests – Hansmann[6] suggests that ownership, i.e. exercising residual control, is costly in terms of resources engaged to reach decisions by a group of owners and in terms of inferior decisions resulting from collective choice problems. He assumes collective choice problems to be particularly severe if the owners have heterogeneous interests.[7] The interests of investors, especially those detached from the operations of an enterprise, are generally aligned at maximizing present net value of firm's earnings (leaving aside minor preference differences as to the liquidity and

[4] O. D., Hart, J. Moore, *Property Rights and the Nature of the Firm*, "The Journal of Political Economy" 1990, no. 98(6), p. 1119–1158.

[5] H. Hansmann, *The Ownership of Enterprise*, Harvard University Press 2000.

[6] *Ibidem.*

[7] This should be the main reason why ownership is almost always held by one distinct group of stakeholders; Hansmann posits that collective decision-making costs among parties with adversarial interests would be infinite.

risk). Such high homogeneity of interests among investors greatly reduces collective decision making costs for this group of stakeholders. The other important argument relates to the fact that together with residual control owners also bear the residual risk in the firm. The investors are a group well suited for risk bearing because they can diversify risk among many investments. Yet, this leads to the dispersion of ownership, which on the other hand results in agency problems.

Lazonick and Sullivan[8] explain how agency theorists, in the belief that market is, as a rule, more efficient than any organization, have built a strong normative argument that firms should focus on maximizing shareholder value. According to the authors parallel structural changes in financial markets, namely diminishing individual stock ownership and rise of institutional investors such as mutual funds and pension funds, enabled emergence of a competitive market for corporate management, which created strong incentives for managers to abandon the strategy of reinvesting profits in favor of short-term strategies based on downsizing and distribution of dividends. A current wave of company share buybacks is a pertinent example of this.[9]

The last three decades have seen expansion of the financial sector globally, increased financial intermediation ratio and growth of institutional investors such as pension funds, mutual funds and insurance companies.[10] Individual savers have many reasons to cede management over their capital to such institutions, which achieve great economies of scale and thus are able to employ highly qualified experts, operate on international markets, pay lower commission fees, make large indivisible investments, create highly diversified portfolio and engage in securitization. In such a system individual shareholders have no relation to the particular firm where their capital is invested or even no information about it, not to mention interest in its operations. Individuals only judge performance of the fund investing on their behalf. In other words, financial intermediation obscures most of qualitative aspects of the investments and reduces investor behavior to narrowly defined rationality. Consequently, institutional investors have to compete in offering possibly greatest rates of return. Even if institutional investors may be, for different reasons, induced to do sustainable investment, they are under pressure to be competitive with investors that do unsustainable investments. What is more, institutional investors behave

[8] Lazonick W., O'Sullivan M., *Maximizing shareholder value: a new ideology for corporate governance*, "Economy and Society" 2000, 29(1), p. 13–35.

[9] W. Lazonick, *Profits without prosperity*, "Harvard Business Review", September 2014, https://hbr.org/2014/09/profits-without-prosperity (18.04.2015); *The repurchase revolution*, "The Economist", 13th September 2014, http://www.economist.com/node/21616968/print (21.04.2015).

[10] E. P. Davis, B. Steil, *Institutional investors*, MIT Press, Cambridge, Massachusetts London 2004.

much differently than individual investors, e.g. they are less risk averse[11], which significantly alters the dynamics in the financial markets. Nominal owners have a share but do not have a stake in firm's operations, therefore are oblivious to all other variables than financial return on equity. Investor ownership intermediated by the financial markets in their current shape strips ownership of the "husbandry" approach and holistic view of the organization and its relations to the society and to the natural environment. Such a system inevitably renders the economic organizations hard-wired for relentless maximization of financial profit, which originally was only supposed to be the means, not end goal for human wellbeing and resource preservation.

In the two sections so far I have argued that while sustainable economy can only be based on concern for the qualitative dimensions of human life, work and environment, yet the standard economic theorizing employ maximization principle and focus on quantitative analysis. Prevalence of investor ownership should be seen as a product of economic theorizing based on maximization principle. Moreover, intermediation of financial markets eliminates qualitative considerations by investors. For this reason, putting control over economic organizations in the hands of investors, intermediated by financial markets in their current form, directs their operations inevitably towards profit maximization.

4. Non-investor-owned enterprises: cooperatives, non-profits

In this section I will present alternative forms of ownership and deliberate their relevance to the concept of economics of moderation.

An alternative to inverstor ownership is the assignment of residual control to a different group of stakeholders than investors. Such arrangement is not hypothetical – it can be observed in the worker-owned cooperatives, producer-owned cooperatives, consumer-owned cooperatives, as well as non-profit associations and foundations.[12] This typology, based on Hansmann[13], distinguishes organization type according to the stakeholders group that is in control.[14] It is consistent with the apparent regularity that ownership rarely or never occurs in mixed groups of different stakeholders. According to the author, the phenomenon is explained by heterogeneity of interests of different stakeholders. In other words, this typology is based on

[11] M. Aglietta, *Shareholder value and corporate governance: some tricky questions*, "Economy and Society" 2000, no. 29(1), p. 146–159.

[12] Non-profit organizations restrict the owner's right to appropriate residual profit. The owners of such organizations can enjoy various rights, yet the most important one characteristic of investor ownership – pursuit ofreturn on investment – is ruled out.

[13] H. Hansmann, *The Ownership of Enterprise*, Harvard University Press 2000.

[14] In fact, Hansmann argues that an investor-owned company is nothing more than an investor-owned cooperative.

the premise that the legal owners should have interests that are roughly aligned with the organization, otherwise it is impossible to sensibly control it.

It is worth noting, that there exists a parallel strand of theorizing, rooted in sociology and social psychology, namely the open systems theory of organization. Its foundations have been laid by Katz and Kahn.[15] This perspective sees organization as a social phenomenon and generally abstracts from power or control considerations; it is proposed that because an organization is dependent on the environment to get the inputs and sell the output, therefore it needs to balance all actions to maintain support of all the engaged groups. For this reason no single group is more important than another. In this view, either all stakeholders are owners or ownership doesn't matter.[16] The open systems theory was one of the main inspirations behind the stakeholder approach, as developed in the management literature. In the stakeholder approach the managers have fiduciary responsibility to all stakeholders.[17] However, the economic literature is dominated by the rationalist approach.

The first category of the typology by Hansmann[18] encompasses ownership by groups that contribute inputs other than capital, such as labor (worker-ownership) or intermediate goods (supplier cooperatives). Worker-ownership's main characteristic is that ownership is bound with employment contract, what eliminates the employer-employee power and information asymmetry. Consequently, the worker-owners are concerned with qualitative aspects of employment in the firm. A supplier- or producer-cooperative usually involves hired labor and its objective is shifting bargaining power or part of buyer's fees to the suppliers. It is not a given that the owners in this model are concerned with non-pecuniary production aspects.

The second category encompasses ownership by consumers of the outputs, e.g. retail, wholesale or housing cooperatives, as well as communal utilities. One may object that communal utilities are closer to the state-owned enterprises than consumer cooperatives. Indeed, this is the special case where the stakeholder group has means to coerce all its members to participate, which is not true for retail or housing cooperatives. However, this does not change the nature of the argument – the owners, whether voluntary or not – have interest in the qualitative dimension of the firm's production, not solely in its profit.

[15] D. Katz, R. L. Kahn, *The social psychology of organizations*, Wiley, New York 1978.

[16] J. A. Andersen, *Reintroducing the Owner: On Corporate Governance, Goals, Organization and Leadership Theories*, in: Proceedings of the 8th *European Conference on Management, Leadership and Governance*, J. Politis (eds.), Academic Conferences International Limited, 2012, p. 1–7.

[17] R. E. Freeman, J. McVea, *A Stakeholder Approach to Strategic Management*," Darden Business School Working Paper" 2001, no. 01–02.

[18] H. Hansmann, *The Ownership of Enterprise*, Harvard University Press 2000.

The last category encompasses all organizations, in which the owner's right to withdraw residual profits is limited, i.e. non-profit associations and foundations. However, the non-distribution criterion proposed by Hansmann turns out to be quite imprecise. Certainly, it is not a universal criterion, when one takes national legal particularities into account. The author considers organizations specified as tax exempt under US federal tax code, but there are certainly other organizations bound by non-distribution constraint and the delineation may differ across countries. As pointed out by e.g. Steinberg[19], labor unions, political parties, trade and civic associations, professional sports leagues, and governments themselves are all barred from distribution of profits. This only turns our attention to the fact that all organizations are "economical", in a sense that they partake in resource allocation process.

Similarly, once we accept that ownership belongs to only one particular group of stakeholders, there is no fundamental difference in the internal democratic mechanisms between investor- and non-investor-owned firms – the decisions are taken by some preference aggregation procedure among the owners. The key feature distinguishing broadly defined cooperatives and non-profit organizations and conventional firms is the engagement of owners in the operations of the firm. In all the above-mentioned organization types the owners have non-pecuniary stakes in their firms, i.e. other considerations regarding its operations besides financial profit or loss.

5. Advantages of non-investor owned enterprises with regard to curbing excess

This section provides a very brief account of stylized facts about non-investor owned enterprises supporting the claim that they pursue multidimensional goals instead of single maximand expressed in financial terms.

Both cooperatives and non-profit organizations can be and were indeed analyzed in the standard economics framework, i.e. with the assumption of a single maximand. In his much cited work, Ward[20] applied marginal analysis to develop a model of a worker-owned cooperative maximizing income-per-worker. The model results in 'perverse supply response'[21], which received much curiosity and prompted further elaboration on the model

[19] R. Steinberg, *Economic theories of nonprofit organizations*, in: *The study of the nonprofit enterprise*, H. K. Anheier, A. Ben-Ner, (eds.), Springer Science+Business Media New York 2003, p. 277–309.

[20] B. Ward, *The firm in Illyria: market syndicalism*, "The American Economic Review" 1958, vol. 48, no. 4, p. 566–589.

[21] I.e. in order to maximize income per worker, a cooperative should increase employment and output with the fall of demand and decrease employment and output with the rise of demand.

by Domar[22] and Vanek[23], who partly refuted Wards claims. Furubotn[24] and Pejovich[25] proposed a broader view on individual maximization within labor managed firm to suggest that one can expect the majority to strive to secure gains for labor, which leads to inefficiency, and that worker-owners fail to accumulate capital within enterprise or disregard maintenance of its capital assets.

Yet, the results of empirical research seem to be at odds with assertions of the theorists. Ward's sloped supply curve is not observed and the general assumption that the worker-owners' dividend should be considered as a maximand is rejected.[26] This shows how inappropriate the reductionist approach is to any organization with real social dynamics. Ward's mistake was to believe that cooperatives would flexibly adjust employment to maximize dividend; in reality, firing decisions are much more disruptive to a collective of co-workers than payroll adjustments. Various studies confirm that worker-owned enterprises adjust wages or working time instead of workforce size.[27] In other words, worker-owners consider qualitative dimensions of the firm operations, such as employment stability and workplace relations, more than investor-owners.

Some evidence suggests that cooperatives have a useful role in combating unemployment.[28] In adverse economic conditions, when conventional firms tend not to enter market, the cooperatives are formed. Interestingly, once formed, they have good survival rates – in fact, more cooperatives survive than conventional companies.[29] In all, they exhibit resilience and dynamics very much different to the volatility observed in an environment populated by investor-driven enterprises.

At the same time, counter to the suggestions that worker-owned cooperatives provide poor work incentives, researchers find them equally effi-

[22] E. D. Domar, *The Soviet collective farm as a producer cooperative*, "The American Economic Review" 1966, vol. 56, no. 4, part 1, p. 734–757.

[23] J. Vanek, *Decentralization under workers' management: A theoretical appraisal*, "The American Economic Review" 1969, vol. 59, issue 5, p. 1006–1014.

[24] E. G. Furubotn, *The long-run analysis of the labor-managed firm: An alternative interpretation*, "The American Economic Review" 1976, vol. 66, issue 1, p. 104–123.

[25] S. Pejovich, *Why has the labor-managed firm failed*, "Cato Journal" 1992, no. 12, p. 461.

[26] J. P. Bonin, D. C. Jones, L. Putterman, *Theoretical and empirical studies of producer cooperatives: will ever the twain meet?*, "Journal of Economic Literature" 1993, vol. 31, no. 3, p. 1290–1320.

[27] *Ibidem.*

[28] P. Kalmi, *Catching a wave: the formation of co-operatives in Finnish regions*, "Small Business Economics" 2013, no. 41(1), p. 295–313.

[29] A. Ben-Ner, *Comparative empirical observations on worker-owned and capitalist firms*, "International Journal of Industrial Organization" 1988, no. 6, p. 7–31; V. Pérotin, *Entry, exit, and the business cycle: Are cooperatives different?*, "Journal of Comparative Economics" 2004, no. 34(2), p. 295–316.

cient as conventional firms.[30] Shirking turns out not to be pervasive. This can be explained with psychological factors at play, such as identification with the firm, reputation among the peers, pride from work. This again underlines the importance of qualitative considerations.

At this point it should be mentioned that for many people the important feature of the cooperatives is that they prevent alienation of work.[31] Similarly, workplace democracy can be considered as a value of its own.[32] These statements sit well together with the argument proposed here that there is a number of values that people strive to realize simultaneously and that reduction of economic analysis to monetary value is unhelpful, if not counterproductive.

As mentioned before, worker-owned cooperatives are only one special case of this organization form. The consumer- and supplier-owned cooperatives, where the owners are not directly involved in firm's operations, but do benefit from it financially, may put the argument that non-investor ownership should be linked to qualitative considerations in question. Unfortunately, the literature often confounds different kinds of cooperatives. Otherwise, most research has been done on agricultural producer cooperatives, but its method and focus have little relevance for the argument proposed here. The dedicated research would be needed to make founded claims that consumer and supplier cooperatives pursue more than one-dimensional financial objective. Yet, there is some evidence on the behavior of another special form of cooperative enterprise – the cooperative bank, which cannot easily be categorized either as a consumer or supplier cooperative. Even though owner-members' interests are purely pecuniary, there is still a pronounced difference compared to investor-owned banks, namely that cooperative banks prove much more resilient in times of crisis.[33] In other words, cooperative banks are characterized by stability, a quality which can hardly be associated with investor-owned banks, which can be deemed main drivers of volatility in the contemporary financial sector.

Perhaps most interestingly, non-profit organizations have non-pecuniary objectives indicated in their statutory documents. It should be also noted that laws regulating this form of organization usually indicate the general public benefit purposes it may serve. And yet, there is also fair amount of literature on the question of "what do non-profits maximize"? In his ma-

[30] B. Craig, J. Pencavel, *A Participation and productivity : A comparison of worker cooperatives and conventional firms in the plywood industry*, "Brookings Papers on Economic Activity: Microeconomics" 1995, p. 121–174.

[31] M. J. Wells, *Alienation, work structure, and the quality of life: Can cooperatives make a difference*?, "Social Problems" 1981, no. 28(5), p. 548–562.

[32] J. Vanek, *Decentralization under workers' management: A theoretical appraisal*, "The American Economic Review" 1969, vol. 59, issue 5, p. 1006–1014.

[33] J. Birchall, L. H. Ketilson, Resilience of the cooperative business model in times of crisis, International Labour Organization, Geneva 2009.

jor contribution to the topic, Steinberg[34] hypothesized that non-profits fall either in "service maximization" or "budget maximization" category. Putting his hypothesis to the test, he found differences with regard to industry sector: arts, education and social welfare organizations maximized service, while health organizations maximized budget. Further studies result in more confusion: Horwitz and Nichols[35] find that non-profit hospitals maximize service, Deneffe and Masson[36] suggest that they regard service and 'profit' (payments to the agents in control) at the same time. Brooks[37] hints that non-profit organizations may maximize service quality or other qualitative aspect of their mission, but dismisses this notion in favor of Steinberg's proposition, even though his test of a model based on this proposition is inconclusive. The inconclusiveness of the debate, or the complexity of the issue, seems to be in line with the argument that a non-profit, being a non-investor owned enterprise, faces dilemmas between different objectives, which by definition excludes maximization of just one. The evidence cited, in fact, does not rule out that neither output nor size – the quantitative dimensions of organizational performance – are maximized. Whether the objectives of an organization are virtuous or not and whether the choices are made wisely is a different matter.

6. Conclusion

This paper explored the idea of non-investor owned firms. The main argument is that while investors, in particular portfolio investors, have little or no concern for qualitative aspects of a firm's performance, owners that are not investors do. Non-investor owned firms are conceptualized as organizations where the right to residual control is assigned to a group of stakeholders other than investors, such as workers, suppliers or consumers, or where the right to distribute residual profit is not present, as in non-profit organizations. The argument is supported by reference to a selection of relevant empirical studies.

[34] R. Steinberg, *The revealed objective functions of nonprofit firms*, "The RAND Journal of Economics" 1986, p. 508–526.

[35] J. R. Horwitz, Nichols A., *What do nonprofits maximize? Nonprofit hospital service provision and market ownership mix*, National Bureau of Economic Research Working Papers 2007, no. 13246.

[36] D. Deneffe, R. T. Masson, *What do not-for-profit hospitals maximize?,* "International Journal of Industrial Organization" 2002, no. 20(4), p. 461–492.

[37] A. C. Brooks, *What do nonprofit organizations seek? (And why should policymakers care?),* "Journal of Policy Analysis and Management", 2005, no. 24(3), p. 543–558.

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Economic Organization Forms Beyond Investor-Ownership

Abstract

It is argued that the maximization logic, on which classic economic analysis is based disregards the multidimensionality of human desires. Therefore, the arguments for superiority of inverstor ownership, which are based on the maximization logic, are misplaced. Indeed, promising features can be observed among the existing non-investor owned organizations.

Keywords: heterodox economics, ownership, firm objectives, cooperatives, non-profits

Formy organizacyjne przedsiębiorstw inne niż własność inwestorska

Streszczenie

Klasyczna analiza ekonomiczna ignoruje w swojej logice maksymalizacji wieloaspektowość ludzkich pragnień. Argumentacja na rzecz wyższości własności inwestorskiej, stanowiąca element klasycznej logiki maksymalizacji, pozostaje zatem zachwiana i niedoskonała. Obserwacja rzeczywistości gospodarczej pozwala na zidentyfikowanie szeregu cech organizacji nie należących do inwestorów, które ukrywają w sobie duży potencjał analityczny.

Słowa kluczowe: ekonomia heterodoksyjna, własność, cele firmy, współpracownicy, brak nastawienia na zysk