Contents

Figures	xiv
Tables	xvi
Preface	xvii
Preface to the first edition	xix
Preface to the second edition	xxiii
Acknowledgement	xxv
PART 1 BASIC CONCEPTS	
1. The gains from the trade	3
1. Production and the firm	3
2. Scarcity	4
3. The allocation problem	6
4. Recontracting and the allocation problem	11
5. Tatônnement	12
6. The equilibrium method	15
7. Institutions and information	16
8. Institutions and contract enforcement	18
8.1 The exchange game	18
8.2 Conventions and norms	20
8.3 Reputation	23
8.4 Monitoring and penalties	23
8.5 Moral leadership	24
9. Conclusion	25
2. Transactions costs	27
1. The process of exchange	27
2. Contracts and information	30
2.1 Adverse selection or 'hidden information'	30
2.2 Moral hazard or 'hidden action'	34
2.3 Bounded rationality	35
2.4 Asset specificity and 'hold-up'	36
3. Institutional responses to transactions costs	38
3.1 Money	39
3.2 Political institutions	42
3.3 The firm as a nexus of contracts	43

	4. Conclusion	49
	Appendix	51
		31
3.	The entrepreneur	53
	1. Introduction	53
	2. Contrasting views of the entrepreneur	54
	2.1 The classical tradition	54
	2.2 Knight	55
	2.3 Kirzner	58
	2.4 Schumpeter	65
	2.5 Shackle	69
	2.6 Casson	71
	3. The entrepreneur and the firm	76
	3.1 The small entrepreneurial firm	77
	3.2 The firm as a coalition of entrepreneurs	80
	Appendix	84
4	D	
4.	Property rights	86
	1. Introduction	86
	2. Types of property rights	88
	2.1 Private rights	88
	2.2 Communal rights	89
	2.3 Collective rights	89
	2.4 Exchangeable rights	90
	2.5 Alienable and inalienable rights	92
	2.6 Exclusion	92
	3. The development of property rights	92
	4. Team production and the classical capitalist firm	98
	5. Alternative structures of property rights	101
	5.1 The single proprietor	102
	5.2 The partnership	104
	5.3 The joint-stock company	108
	6. Property rights and managerial theories of the firm	111
	7. Property rights and transactions cost approaches to the firm 7.1 'Ownership' of the firm	113
	7.1 Ownership of the firm	113
	7.2 Hansmann and the costs of ownership	115
	7.3 Grossman, Hart and the property rights theory of the firm	
	8. Entrepreneurship and property rights	118
	8.1 'Ownership' and the entrepreneur	122
	8.2 The property rights approach to the finance of the	122
	entrepreneur	
	L	124

	9. Conclusion	125
	Appendix: The assignment of residual control rights	131
5.	Principal and agent	136
	1. Introduction	136
	2. Observability and the sharecropper	137
	3. Risk sharing	141
	4. Effort incentives	146
	5. Information	150
	6. Examples of incentive contracts	154
	6.1 Health and motor insurance	155
	6.2 Law enforcement	155
	6.3 Employment contracts	156
	7. Monitoring the effort of team members 8. Incentive contracts and the firm	158
	9. Conclusion	162 165
	Appendix: The Von Neumann–Morgenstern axioms of choice	103
	under uncertainty	167
6.	Hierarchies	171
0.	1. Introduction	171
	2. Piece-rates and time-rates	173
	2.1 Payment schedules, moral hazard and effort	173
	2.2 Payment schedules, adverse selection and worker	175
	sorting	177
	3. The role of the monitor	179
	3.1 Monitoring and moral hazard	179
	3.2 Monitoring and adverse selection	180
	4. Contracts and adverse selection: the screening	
	mechanism	182
	5. Moral hazard, penalties and wage payments	184
	5.1 The efficiency wage	185
	5.2 Deferred compensation and 'bond-posting'.	187
	6. The rank-order tournament	189
	6.1 Incentives and the structure of a tournament	189
	6.2 Further problems with high-powered incentives	195
	7. Idiosyncratic exchange	197
	8. Rent seeking, entrepreneurship and opportunism9. The firm as a governance structure	199 203
	9.1 The internal labour market	203
	7.1 The internal labour market	203

9.2 Specific human capital	204
9.3 Behavioural norms and perceptions of fairness	207
9.4 Company unions and disputes procedures	208
10. The Japanese firm	208
11. Conclusion	210
Appendix	214
Integration and the visible hand	217
1. The variety of business enterprise	217
1.1 Vertical integration	217
1.2 Conglomerate diversification	218
1.3 International integration	219
2. Strategy and structure	220
3. Visible and invisible hands	226
3.1 The boundary of the firm	226
3.2 Arm's length and obligational transactional relations	227
3.3 The franchise chain	229
3.4 Quasi-vertical integration	230
4. Integration, complexity and environmental uncertainty	232
4.1 Integration, coordination and complexity	232
4.2 Integration, coordination and uncertainty	235
5. Integration, internalisation and market failure	238
5.1 Monitoring input quality	239
5.2 Internalisation and the multinational firm	241
5.3 Integration and market power	242
5.4 Transaction-specific investments and opportunistic	
recontracting	246
5.5 Enforcing intertemporal commitments	250
6. Integration and innovation	251
6.1 Research and development	252
6.2 Schumpeter's entrepreneur	255
7. Conclusion	258
Corporate governance 1: managerial incentives	261
1. Who controls the joint-stock firm?	261
2. Four views of corporate control	262
2.1 Control and the shareholder: the traditional view	262
2.2 The managerial interest and the Berle-Means critique	264
2.3 Entrepreneurship and the neo-Austrian critique	265
2.4 Contractual incompleteness, dependency and control	267
3. Corporate governance as a principal–agent problem	269
4. Managerial incentive contracts	271

7.

	4.1 Managerial incentives and the theory of principal and	
	agent	271
	4.2 Some early studies of managerial contracts	273
	4.3 Interpretative problems and more recent studies	275
	5. Monitoring managers	282
	5.1 Do shareholders monitor managers?	282
	5.2 The costs of monitoring	283
	5.3 The degree of shareholder control	284
	6. The managerial labour market	290
	7. The product market	293
	8. Conclusion	297
9.	Corporate governance 2: the takeover and capital structure	301
	1. The entrepreneur and the takeover	301
	2. The takeover and the free-rider problem	302
	3. Minority shareholders and the takeover	303
	4. Hold-up, breach of faith and the takeover	305
	5. Adverse selection, short-termism and the takeover	306
	6. Moral hazard, monitoring costs and the takeover	309
	7. The takeover and capital market efficiency	310
	8. Defences against hostile takeovers	313
	8.1 Supermajority amendments	313
	8.2 Dual-class recapitalisations	314
	8.3 Poison pills	314
	8.4 Greenmail	315
	8.5 Golden parachutes	316
	9. Do takeovers improve economic efficiency?	316
	9.1 The takeover wave of the 1980s	316
	9.2 Moral hazard and the free cash-flow theory	317
	9.3 The role of the 'junk bond'	318
	9.4 Gains to target and bidding companies	319
	10. Capital structure and corporate governance	321 321
	10.1 The Modigliani-Miller theorem	
	10.2 The agency costs theory of financial structure	323
	10.3 Agency problems, debt and the Hart-Moore theory	326
	of financial structure	331
	10.4 Bounded rationality and financial structure	332
	11. Corporate governance – bank versus market systems	332
	11.1 The United Kingdom and the United States	333
	11.2 Japan and Germany	335
	11.3 Differences in capital structures	337
	12. Conclusion	331

	Comeni

10.	Profit-sharing, cooperative and mutual enterprise	341
	1. Residual claims and enterprise governance	341
	2. Principal-Agent theory and profit sharing	344
	2.1 Type of firm classified by distribution of residual	
	claims	344
	2.2 Monitoring effort and the profit-sharing firm	348
	3. Profit sharing and contractual incompleteness	350
	3.1 Debt finance	350
	3.2 Hold-up	351
	3.3 Bargaining within the firm	352
	4. The problem of investment decisions	353
	5. The size of the team	355
	5.1 Employment in the labour-managed firm	356
	5.2 Employment and profit sharing	360
	6. The labour–capital partnership	361
	7. The role of peer pressure	364
	7.1 Internal pressure	364
	7.2 External pressure	365
	8. The retail cooperative	368
	8.1 Transactions costs and the retail cooperative	368
	8.2 Role of retail cooperatives in nineteenth-century	
	England	369
	9. Marketing and supply cooperatives	371
	9.1 Marketing and distribution	371
	9.2 Supply cooperatives and the utilities	373
	10. Mutual enterprise	374
	11. Stakeholding	377
	12. Conclusion	379
11.	Non-profit and charitable enterprise	383
	1. The non-profit enterprise	383
	2. Governance problems and the non-profit	
	enterprise	384
	3. The rationale of the non-profit enterprise	387
	3.1 Contract failure	387
	3.2 Government failure	389
	3.3 Tax advantages	390
	4. Examples of non-profit enterprise	391
	4.1 Hospitals	391
	4.2 The university	394
	4.3 The arts	395
	4.4 The club	397

	5. Bureaucracy	400
	6. Conclusion	403
12.	Evolution and economic organisation	406
	1. The variety of theoretical approaches	406
	1.1 Neoclassical analysis of organisations	407
	1.2 Radical approaches to organisations	408
	2. The resources of the firm	409
	3. Evolution in economics	411
	3.1 Biological Analogies	411
	3.2 The evolution of the firm	412
	3.3 Market relationships and evolution	413
	3.4 An ecology of institutions	415
	4. Evolution and efficiency	416
	5. Conclusion	418
PAI	RT 3 PUBLIC POLICY AND ECONOMIC ORGANISAT	ION
13.	Economic organisation and the role of the state	423
13.	1. Introduction	423
	2. The neoclassical tradition	424
	3. The new institutional economics and public policy	425
	3.1 Establishing external institutions	426
	3.2 The normative Hobbes and Coase theorems	427
	4. The public interest approach	433
	5. Criticisms of the public interest approach to policy	436
	5.1 The Austrian critique	437
	5.2 The 'public choice' critique	443
	5.3 Contracting and the property rights critique	445
	6. Conclusion	451
1.4	District Lands and the asymptotic of hyginese	453
14.	Private and public enterprise: the ownership of business	453
	1. Introduction	453
	2. Some historical background	453
	2.1 The growth of public enterprise in the UK to 1980	454
	2.2 Public enterprise in other mixed economies	455
	2.3 Reform after 1980	455
	3. Public versus private enterprise	455
	3.1 Empirical studies in the 1970s	457
	3.2 Reform of public enterprise	462
	3.3 The forces of competition4. The process of privatisation in the 'mixed economies'	466
	4. The process of privatisation in the mixed economics	400

	4.1 Stock market flotation	466
	4.2 The employee buy-out	467
	4.3 The private sale	468
	4.4 Voucher privatisation	468
	5. Privatisation – policy dilemmas	469
	5.1 The Austrian view	469
	5.2 The public choice view	469
	5.3 Privatisation and the normative Hobbes and Coase	
	theorems	471
	6. Mass privatisation	472
	6.1 The political economy of mass privatisation	473
	6.2 Vouchers and privatisation	475
	6.3 The governance of enterprise after mass privatisation	477
	7. The effects of privatisation	478
	7.1 Comparisons between firms of differing ownership	
	types	478
	7.2 Case studies of firms' performance before and after	
	privatisation	479
	7.3 Econometric studies of the effects of changes in	
	governance	480
	7.4 Use of multinational data	482
	8. Conclusion	482
5.	Economic regulation and the structure of business	485
	1. Introduction	485
	2. The 'natural' monopoly problem	486
	2.1 Definition of 'natural' monopoly	486
	2.2 Contestability	487
	2.3 Sustainability	490
	2.4 Intertemporal unsustainability	493
	3. Organisational structure and competition	498
	3.1 Vertical disintegration in the public utilities	498
	3.2 Competition policy	500
	4. Regulating utilities	509
	4.1 Regulation as a contract	509
	4.2 Regulation as rent seeking	512
	4.3 Rate of return regulation	514
	4.4 RPI minus X	516
	4.5 Sliding-scale profits tax	519
	5. Franchising	522
	5.1 Auctioning the right to serve the market	522
	5.2 The Chadwick-Demsetz auction	523

 Control of natural monopoly networks – a summary of organisational models 	525
6.1 Government ownership and operation of the network	525
6.2 Government ownership with assets leased to a private	
operator	526
6.3 Network assets owned and operated by a franchisee	526
6.4 Network assets owned and operated by a regulated	
public company	527
6.5 Network assets owned by a network user but leased to	
a separate company	527
6.6 Network assets owned and operated by an	
unregulated public company	528
7. Deregulation	529
7.1 Production and supply in the public utilities	529
7.2 Deregulation outside the public utilities	531
8. Conclusion	532
Bibliography	537

Figures

1.1	Production possibilities in a four-person community	
1.2	Person C and person D together can produce 4 units of x and 4 units of y	
1.3	How person A gains from specialisation and exchange	1.
2.1	A central contractual agent economises on contractual links	44
2.2	Probability distribution of quality	52
3.1	Casson's theory of entrepreneurship	74
4.1	External effects result in overfishing	97
4.2	The team with a single monitor	104
4.3	The team with two monitors	105
4.4	Two 'managerial' models of the firm	112
5.1	State-contingent claims: a line of constant expected outcome	142
5.2	Risk-averse people have convex indifference curves	143
5.3	Optimal risk sharing but with a risk-neutral party. The	17.
	risk-averse person takes no risk	145
5.4	Contracts on rr' will just induce effort level e	147
5.5	All contracts in set xwy will induce effort level e and are	147
	Pareto preferred to a contract at θ	148
5.6	With a risk-neutral agent, a 'first-best' outcome is achievable	140
	at φ	150
5.7	With an informative signal, costless monitoring can save on	150
	risk-bearing costs	154
5.8	Effort costs, risk-bearing costs and monitoring gambles	161
6.1	Alternative contractual arrangements	174
6.2	Time-rates and piece-rates	175
6.3	Adverse selection in recruitment	181
6.4	Education as a screening device	183
6.5	The tournament	192
6.6	Distribution of observational errors	215
6.7	Cumulative distribution function of $\theta_k - \theta_i$	216
7.1	The unitary form	221
7.2	The multidivisional structure	222
7.3	A hybrid form	223
7.4	Price discrimination is required if a monopoly supplier is to	
	prevent substitution away from input m by downstream buyers	245

	List of figures	AV
8.1	Shareholder and manager as principal and agent	272
8.2	Management shareholdings and firm size	277
8.3	Managerial incentives: the case of the stable bonus	289
8.4	Leibenstein's X-efficiency theory of costs	294
9.1	The agency cost of outside equity	324
9.2	Financial structure: the agency cost approach	326
10.1	Firm type and the distributable surplus	345
10.2	Investor ownership with profit-related pay	347
10.3	Worker ownership with debt and outside equity	347
10.4	The size of the labour-managed firm	359
10.5	Mutual monitoring in a partnership	366
11.1	Newhouse's model of the non-profit hospital	392

Donation as a method of voluntary price discrimination

Niskanen's model of the budget-maximising bureau

Migué and Bélanger's bureaucrat discretion model

An optimal contract for public enterprise managers

Government contracting: fixed price versus cost-plus

Economies of scale and marginal cost pricing

396

398

401

402

429 435

461 495

515

521

The optimal club: Buchanan's analysis

The Coase theorem

Intertemporal unsustainability

A profit-sharing regulatory contract

11.2 11.3

11.4

11.5

13.1

13.2

14.1

15.1 15.2

15.3

Tables

1.1	Consumption levels with no trade	
1.2	A possible allocation that is outside the 'core'	8
1.3	Joint payoff to every possible coalition	10
1.4	An allocation of consumption that is in the 'core'	10
1.5	A second allocation of consumption that is in the 'core'	10
1.6 1.7	The structure of payoffs in a game of exchange	19
1./	Expected payoffs in the exchange game when the probability	
3.1	of repetition is 3/4 The gains to entrepreneurial activity	21
4.1	The fishery – an illustrative table	60
4.2	The Hawk – Dove game	93
15.1	The present value of the cost of satisfying the demands of	95
	each possible 'coalition'	496
		., 0