## Introduction

For many years I have been frustrated by the poor quality of the debate about the governance of organisations, particularly of commercial firms, but also of non commercial bodies. This seems to reflect shortcomings in the way in which people think about the organisations they deal with. This is not just a problem for the man in the street. The confusion is equally prevalent among professionals, whether in business, in academic life, in public life, or in journalism.

Cutting my teeth as a would-be professional politician in the 1970s in a Britain that was divided about the proper balance between the public and private sector and then gaining an exposure to the latest thinking about the nature of the firm and business strategy while studying in the United States at the end of that decade, I found myself reaching different conclusions about the nature of the firm, its purposes, and how it operated from many of those around me. During the following twenty five years I have developed, tested and debated those conclusions in the course of a career that has involved working as a consultant, line manager and director in companies varying widely in size and industry sector, several years involvement in party politics developing policy and standing for parliament, and almost twenty years service in part time roles within Britain's National Health Service. All the while, I have scoured the work of economists, business academics and a variety of other commentators for insights that would add to my understanding. This book is the outcome of these experiences and explorations.

In the following pages I argue for a new way of looking at organisations. This new way builds on existing theories that argue that humans come together in organisations like the commercial firm because they generally provide a more effective and cost efficient way to get things done than to rely on a mass of separate market transactions. It takes these theories further by looking at all the sets of transactions that a firm undertakes: with customers, suppliers, employees, investors, and external parties such as government in which the transactions may be conducted in the exchange of influence rather than cash. The result is a new model of the firm that provides new insights into the role of the management of companies and of the relative place of those parties frequently described as stakeholders.

This model is further developed by examining the various “currencies” in which the parties that transact with organisations: not just cash, but also influence, and in some circumstances physical force. The model is also extended so that applies to organisations other than commercial firms, including public sector bodies and voluntary organisations, not just those that are described in the United States as non-profit organisations but also bodies like trade unions and professional associations.

The outcome can be applied to a wide range of organisations in a wide range of circumstances. It should help those at the heart of these organisations think about the strategies that the organisations adopt. It should also help the stakeholders – a description I use only as a shorthand for those that deal with organisations because, as I explain later, the word itself is generally very misleading – understand better where they stand in relation to the organisation and consequently the options that may be open to them. It also raises important questions about the place of the individual and his or her values in relation to the organisations that they work for or have dealings with. And the model sheds light on the issue that fired my own interest in the subject many years ago, the nature of the ownership of organisations, particular the relevance of public versus private.

The opening chapters provide a background to the development of the new model. I illustrate the shortcomings in the existing ways in which organisations in general and commercial firms in particular are described and analysed before going on to summarise the principal existing frameworks for understanding organisations. I then try to set this new model in context in relation to other models: notwithstanding my belief that this is an enormously valuable way of looking at organisations in general and commercial firms in particular, I see it as complementary to many existing alternative ways of understanding the world around us and only in certainly selected cases actually replacing existing framework – in short, I hope that it

enriches the debate and our general understanding, rather than sweeping away the alternatives.

The second section of the book provides a set of building blocks that will help the reader understand the model described in later chapters. The first of these building blocks consists of ways of describing how firms relate external markets, drawn both from theoretical economics and from the practical world of marketing strategy. The second building block is the theory of transactional economics and market failure, which helps explain why people operate within organisations for much of the time rather than conduct their lives entirely through independent transactions . The final building block describes the different sanctions available for conducting transactions, which helps understand how the model extends beyond the narrowly defined commercial firm in it its commercial dealings and is applicable to non-commercial organisations and to transactions that do not involve cash.

The middle section sets out the model that is at the heart of the book. The first chapter in this section sets out a new way of looking at the commercial firm, starting with a simple company with investors, customers, suppliers and employees. The following chapters extend the model by bringing in greater complexity and other relationships, and then extend the model further to demonstrate how it can be applied to other organisations.

But a descriptive model is nothing more than a description. The following section asks “So What?”. It draws out the implications from the model for the way that we should look at organsiations, what goes on inside them, how we should relate to them if we are on the inside, and how they relate to us if we are dealing with them from the outside. These implications are discussed in four chapters which in turn address the ownership of companies and their duties towards those that deal with them, the purpose of organisations and their strategies for development and survival, what we should expect from organisations as outsiders, and finally what it means to be on the inside of a company particularly in relation to ones own personal values.

The final section poses further questions that are suggested by looking at organisations through this framework. These questions by no means exhaust those that may be thrown up by the model, but at this stage demonstrate how it may spur fresh insights. If the boundaries of all organisations are defined by their relationships with a series of external markets in the way that the model, what does this mean for the way in which managers within organisations should operate? If the size and scope of organisations is a function of the relative efficiency of their own internal processing of information compared to the ways in which information flows shape market transactions outside organisations, what does the apparently unstoppable progress of information technology have for the shape of organisations? If most organisations conform to this organisational model, does this mean that some of the suspicions created by different forms of ownership and governance can be removed? And if this model was to become accepted as a paradigm, how will it change the way the we look the organisations that we deal with and the people that manage them?

**Chapter 1: Deficiences of current theory**

My objective in this chapter is to demonstrate the shortcomings in current debates about the shape of organisations, their purpose, their governance. This is both at the level of the debate that takes place not only among the general public and in the popular press, but also among professionals. And when I say professionals I include business men, policy makers, specialist journalists and professional economists.

These shortcomings are best illustrated by taking specific examples drawn from a wide range of different circumstances. These examples should extend across celebrated cases of management malfeasance such as Enron, management bungling that has destroyed companies like GEC Marconi, ill-informed debate about the boundaries between public, private and mutual companies such as privatisation of the railways and Equitable Life, and an example that illustrates the fallacies or shortcomings of stakeholder theory.

The important thing to do is to make the case for turning the current arguments upside down, or rather inside out. One of the primary shortcomings in the common currency of debate is that they look at organisations from the outside in, missing the insights that are available from looking from the inside out. This is certainly the case with both stakeholder and agency theory, which look at firms and organisations from the perspective of players that believe, I believe wrongly, that they have some sort of ownership rights over the organisation.

Indeed, just about all organisational models and theories of the firm that are based on notions of ownership are flawed. These also extend to the legal frameworks concerning the ownership of firms, since ownership of the share equity in the company does not adequately describe the relationship. The owners of equity have certain rights and claims on the company but, certainly in the case of public companies, are only able to exercise these rights very bluntly and in extremis.

A number of business school academics (eg Ghoshal, Kay) have argued that businesses should focus on more than just the bottom line and the short term interests of shareholders. However, they do this with reference to long term survival of the company or to some sort of amorphous public interest. In doing so, they do effectively challenge the egotistical excesses of the managements and the feather-nesting, but they do so without providing an alternative logical structure to replace the shareholder wealth maximising paradigm. They know in their gut that something is wrong but have not far come up with an alternative model to replace the current business school orthodoxy.

This was spectacularly demonstrated in the examples of corporate excess in the first years of the 21st century in companies like Enron…………

These shortcomings are also evident in the case of state owned and mutual companies. There is a a considerable literature that documents the ways in which these entities are liable to be "captured" by either their managements or by the trade unions that represent employees. Or they may simply fail to deliver the best value to the public, that it in theory are both client of their services and, remotely, investors the provision of the service. Yet in the popular mind there is generally a sense that the publicly owned or mutually owned entity is in some way morally superior and more likely to deliver greater value than an entity that also distributes profits to private investors. Basic microeconomic theory points to the superiority of market based capitalist organisation as a means of responding to our various personal preferences both as customers and as suppliers of our own labour. But when the choice is presented, as to whether we would prefer goods and services to be provided to us by a mutual or a state (or community) owned enterprise, the knee-jerk response is that we would prefer a provider that is not beholden to private shareholders. Whether we are talking about the inefficiencies of state owned enterprises in communist regimes in the twentieth century or the shortcoming of mutually owned enterprises like Equitable Life, there is no shortage of evidence for the underlying fallacy.

These examples include the confusion among the shareholders and senior management of large companies about the proper purpose of business. Why are shareholders so surprised that the managements of the companies that they believe they own do not appear to behave in the interest of investors? Instead they are seduced into trying to grow their companies in ways that dilute shareholders' returns. Marrying for a second time may have been described as the triumph of hope

over experience but it is nothing to the appetite of company directors to acquire other businesses despite the wealth of research that demonstrates that most acquisitions reduce the wealth of the investors in the acquiring business. But chief executives and their immediate colleagues have every incentive for increasing the size of their company, since by custom and practice the pay and other rewards to senior executives is closely tied to the size of the enterprise that they manage.

Some of the problems can be explained by agency theory, which focuses on the differences in the incentives of the "principal" (the owner of a business or the commissioner of a service) and the "agent" or "steward" who actually takes responsibility for running the business or delivering the service. How does the principal ensure that the agent, who ends up in possession of the detailed knowledge about the enterprise in question, acts in the best interest of the principal? The drawback of agency theory in relation to the firm or the wider organisation is that it is one dimensional, seeing the agent as servant of the principal alone. But virtually all organisations, and by implication the people that manage them, are servants not only of an "owner" (whether private shareholder or representatives of taxpayers or customers) but also or the consumers of the goods or services, and have contractual obligations to other parties as well for delivery of what might loosely be described as services. These other parties include employees, who are being provided with employment opportunities in a place of workplace that means certain standards, and suppliers for whom the organisation providing an outlet and a consequent income stream subject to agreed terms of conditions applying to each party to the transaction. The underfunding of company pension schemes by companies in recent years is an example of a failure of the company as "agent" in relation to the employee as "principal". Similarly, the warranty conditions under which goods are supplied to a customer try to prevent the customer abusing the product and then making an unfair claim on the supplier are closely equivalent. These operate in a similar way to the contract between a principal trying to enforce an agent working for him to operate in a way that meets the objectives of the principal.

A further problem arises in that an articificial distinction is made between the publicly owned entity and the private company. Yes, at one level there is a difference between different sorts of investment that may be made in a company, whether it is share equity, bank debt, or money provided by government. But in all cases, some sort of return is required to compensate those who have provided the money for the riskiness of the project and for the consumption that is forgone by the providers of the cash. In most developed economies, public investment is required to show a return, even if ultimately a subsidy may be provided from current taxation to fund a public business that fails to make such a return. So, for example, a new hospital built by the National Health Service has to pay capital charges to the Treasury to reflect the money that is tied up in the facilities. These reflect the borrowing that the Treasury may be undertaking to pay for building the hospital. Those responsible for commissioning the services from the hospital will be deciding spending taxpayer's money to fund these capital charges. But this enforces the discipline when determining how best to spend public money and also to help those making decisions on the ground choose between investing in new capital projects or continuing with existing assets or less capital intensive solutions. And even where investment decisions are not involved, public bodies have to operate within a budget, within the limits of the cash that Parliament or a borough or county council have determined reasonable to raise from the public in the light of commitments made at the most recent election.

The popular debate suggests that there is something fundamentally different about enterprises according the nature of their ownership. But tap into any pressure group and you will find them railing against the iniquitous policies of the public entities they deal with. And, notwithstanding some hideous exceptions, most private businesses are run by principled people, maintain high ethical standards, deliver decent value for money products and services to customers, provide safe, comfortable and reasonably rewarding employment, and are at least as responsible towards to the wider community and the environment as public and voluntary sector organisations. The public debate does not reflect this, at least in part because the background mental models do not reflect the way that the world is.

Stakeholder theory is one of the responses to the shareholder primacy model. It resonates with many management teams, who know that they have to pay attention to their customers, their suppliers, their employees, and their neighbouring communities, and need to a word to describe them collectively. But the language of stakeholding implies that stakeholders have rights over the organisation in which they have stake, and are the beneficiaries of ownership rights or something close to rights,