UNDERSTANDING THE NATURE OF COMMERCIAL COMPANIES

Much of the thinking about commercial companies as organisations is inward looking. Companies are treated as organisms; personalities are ascribed to them; they are treated as though they were autonomous moral beings

Along with this perspective goes a highly normative view. Companies are viewed as having duties towards their employees, their customers and Society. At least in part, this view is the one which has informed the commissioning of the "Tomorrow's Company" Enquiry.

This paper suggests an alternative way of looking at the Company. It suggests that there is considerable value at looking at a non-normative, less value laden model. This model suggests alternative ways of thinking about issues such as ownership rights and the economic rent or "abnormal" levels of profit. It helps to explain why some companies do exhibit the characteristics of personality and why many companies discover that it is beneficial to behave in ways that appear generous and considerate towards the people with whom they deal. However, it also addresses the reasons why some companies may behave in ways that do not fit a normative paradigm. In these situations it suggests that it may be a very proper business of government to regulate if it feels that the conduct of such companies does not fit the demands expressed through political institutions.

Moving From Stakeholder Theory to a Transaction Based Model

Most conventional thinking about the company focuses on stake holders who have some sort of interest in an organisation which has identity of its very own. The transaction based model of the company turns this view on its head. Instead of the company enjoying an independent existence and having parties who hold some sort of stake in it, this model sees such parties (providers of capital, providers of labour, customers, the Community) as people with whom the Company conducts transactions within the market and to whom the Company actively has to market itself.

Two sets of ideas underpin this framework, which is applicable not only to commercial companies but to many other human organisations.

The first set of ideas are those developed by Oliver Williamson in the 1970's and best described in his book Markets and Hierarchies* . In this book, Williamson explains that markets and "hierarchical" structures (i.e. Companies) are alternative ways of organising economic activity. Markets are very effective as long as certain conditions prevail but problems arise when a number of conditions, which he characterises as "bounded rationality", "opportunism", and "small numbers" prevail.

* Williamson, Oliver E., *Markets and Hierarchies : Analysis and Anti-trust Implications,* New York : The Free Press 1975.

"Bounded Rationality" represents the fact that there are limits to the amount of information that are available to the parties to a transaction (or there are hefty costs in securing information). "Opportunism" describes the fact that the parties to a transaction do not necessarily share the same objectives but are out to get the best deal for themselves. The problems created by "Bounded Rationality" and "Opportunism" only become a problem if Williamson's third condition of "Small Numbers" prevails. If there are many alternative players within the market with whom someone can conduct transactions the competitive pressures will remove the risk of one sided transactions, but these arise when there are few players which whom to contract.

The problems of "Bounded Rationality", "Opportunism", and "Small Numbers" are particularly common for the conduct of specialised economic activity which is to be repeated over time. These types of transactions create a "first mover advantage" in which someone who is tendering for repeat business may have the inside track and consequently be better placed than other parties to secure business the second time around parties. Under such circumstances "Small Numbers" problems arise and the holders of the inside track stands to gain additional profit from the transaction. If conducted within a company setting as opposed to a market setting this additional profit might be shared or secured for the other party to the transaction. The Company can create a framework of objectives to contain and harness "Opportunism" to mutual benefit.

The second set of ideas relates to the symmetry within commercial transactions. It is helpful to consider both parties to a commercial transactions as sellers and both as buyers. The party generally viewed as the customer can often also be viewed as the seller of a service or opportunity to the party generally viewed as supplier. For example, a retail outlet purchasing product from a manufacturer can also be seen as a provider of a channel of distribution to the manufacturer. An employee is generally viewed as providing labour to his employer, but equally the employer can be seen as the provider of employment and of career opportunities. A tenant in commercial property purchases the right to the use of the property, but also can be seen as the provider of a secure flow of revenue equivalent to a financial instrument which, in the case of a tenant with a good covenant, is readily marketable.

Recognising the symmetry of commercial transactions leads to a recognition of the importance of marketing within the conduct of commercial transactions irrespective of the "side" a company find itself on or the type of market. Marketing, in the sense of considering the various dimensions of customer needs, competition, and the re-configuring of the offer accordingly, is as applicable to a company's dealings with the markets for capital, labour and supply as it is to its dealings with its customers. Different types of investor looks for different patterns of risk and return. Differing types of deal may be struck with suppliers depending on service level, length of agreement and terms. In the employment field the range of variables includes the character of the company, the nature of the financial package, employment security, and career development possibilities. Successful companies, whether by accident or design, find themselves in each of the market places in which they operate, (labour, capital, supply and customer) strategically positioned to secure a competitive advantage (or at least avoid competitive disadvantage) and extract the best deal available to them.

Combining the two sets of frameworks, *Markets and Hierarchies* and the appreciation of the need for strategic marketing across or market places in which a company is involved leads to a view of the company as a form of economic organisation which is interposed between a number of market interfaces, arising because of the difficulties in managing complex contracting because of the limiting conditions described by Williamson.

A company is not so much a series of assets and processes in which there are various "stake holders" but a means of managing the interface between a number of markets, in which it is conducting a series of transactions. Capital is purchased from investors and lenders in return for a flow of income which may be traded as an asset in the form of a bond or share at the risk adjusted net present value of the income flows. Fixed assets and raw materials are purchased from suppliers who may sell on spot contracts or may have very long term relationships. Labour is purchased from employees according to a wide variety of implicit or explicit contractual arrangements, ranging from the casual to the life time commitment. Relationships with customers for a service or product may likewise have an ephemeral quality or may, either implicitly or explicitly, involve a lifetime commitment to service.

Economic Rent and Notional Space.

A company can be conceptualised as the intersection of a number of multidimensional "surfaces" representing a variety of market place relationships. However, for most companies a potential solution space exists which represents the freedom to adopt alternative positions on the "surfaces" which represent against the various market places in which it operates. This freedom exists as a result of the market imperfections or, in Williamson's terms "market failures" In the economist's "nirvana" of perfect competition, or of cost free information, the solution spaces would themselves be reduced to a point with the company operating at the clearing price at each one of the market interfaces. At this point no party to the transactions in which the company engaged would be extracting any "economic rent", or extraordinary profit above and beyond the clearing price.

However, market imperfections exist and economic rent of one sort or another is commonplace. Within the transactions based model of the company, the presence of economic rent could be thought of as the existence of "notional space" which arises because there is a potential gap between the gap interfaces in which the company operates. The presence of this "notional space" means that there is economic rent to be extracted from within the company operations.

The source of "notional space" is the superiority in terms of economic efficiency of "hierarchy" over "market" for the organisations of the economic activity in the company. Provided that the notional space does not expand as a result of a deterioration in the operation of the external market places (as might arise if the costs of contracting in the market places increased or if a "small numbers"condition was created by a company acquiring competitors), an increase in the size of the "notional space" would represent a welfare gain to Society as a whole reflecting the improved efficiency of the company.

The problem then reverts to the second question which is that of the allocation of the economic rent. Social welfare will be maximised by encouraging companies to find ways to expand the solution space available to them. However, simultaneously there seems to be a case for encouraging the development of markets to reduce the notional space, which would have the effect of reducing the economic rent which is being captured by individual parties within the system, providing them with levels of return above their market price, and above those which are commonly thought of as being "fair". In an ideal world, markets would develop sufficiently rapidly to remove, or allocate, the "economic rent" - but even the best of all possible worlds falls short of this ideal.

The Allocation of Economic Rent.

Who is capturing the economic rent within companies, and who should be entitled to it? The conventional model of a capitalist economy suggests that economic rent is captured by owners of capital and properly so. While "windfall profits" are captured by investors, it is by no means clear that the owners of capital are either regularly receiving economic rent or, within this model, are any more entitled to it than anybody else.

Economic rent may be captured by particular parties to the transactions in which the company engages, either by accident or because of the limitations on pricing in a particular market. For example, the limitations on differential pricing in consumer markets mean that many consumers pay less for individual items of merchandise than they would be prepared to pay in a market which offered a supplier a high degree of opportunity for differential pricing. In other cases, parties to the transactions in which a company engage are able to extract economic rent because of their own relative power in a market place, offering them monopoly benefits, or at least the benefit arising from the presence of Williamson's three conditions ("Bounded Rationality", "Opportunism", "Small Numbers").

However, in most cases, it would seem that the potential for securing economic rent is most likely to lie with those who organise the economic activity within the company: the managers. The economic rent need not be extracted in the form of cash but may be applied in other ways. The management of companies which enjoy a substantial "notional space" within which they may position themselves have an enormous variety of opportunities for exploiting the degrees of freedom created by their appropriation of economic rent : large bonuses; lavish corporate entertainment, golf days, donations to charities and political parties; the quest for public honours; prestigous corporate addresses, acquisitions (which have been widely demonstrated to rarely generate the returns for share holders which are promised) are all examples of the way in which the economic rent within the grasp of managements may be applied.

Economic rent may also be absorbed or destroyed, by management under performance. Failure to optimise the business internally and in terms of its positioning against its markets need not reduce the returns provided to investors, the income levels derived by employees or the provision to customers of goods and services at the market price, but may reduce the potential latitude available to managers.

The Place of Strategic Management.

A Company exists within an envelope of market interfaces which are constantly moving. The discussion above is addressed substantially to a company existing at a fixed point in time. It does not address itself to the strategic management of a company over time or the way in which a company needs to position itself differently against markets as they develop.

A Company needs to be able to anticipate how the market places in which it moves will develop it should prepare to move itself in relation to each of its market interfaces so that as they move the point is chooses to adopt remains feasible. For example, if the cost of a source of labour is expected to increase over time, a company may need to find consumer market segments which will pay a price to reflect this higher labour costs, or re-engineer its operation by the application of fixed assets or automation, or find an alternative source of labour. Otherwise, it will find itself in an "infeasible" position outside the notional space defined by the market interfaces.

Does such re-positioning represent a superior application of economic rent? Not all resources applied to changing the long term strategic positioning of a company reflect considerations about economic rent. Securing the long term pattern of earnings expected by shareholders represents no more than the execution of the strategy for achieving the market positioning selected for the market interface with providers of capital. However, it could be argued that the application of economic rent to strategic re-positioning which secures only the long term career futures and personal aggrandisement of the senior management of a company represents no more than a decision about the timing of the realisation of economic rent by that group.

Corporate Responsibility, Government and Society in the Transaction Based Model

The transaction based model of the company has been addressed so far in essentially a four dimensional world: in which the company deals across four market interfaces with the suppliers of capital, labour, and raw materials, and with the customers for its goods and services. It has not addressed the surrounding issues of the relationship of a Company to Society or to Government, nor a possible prescriptive view of its duty towards the parties with whom it has transactions. These two sets of issues are partially related and consequently worth examining in parallel.

The model of the company described above is essentially amoral and does not ascribe a sense of responsibility to companies in the conduct of their affairs. Instead, it suggests that the "moral" behaviour of companies arises from two sources, one internal and the other external.

The internal source is the ethical standards of the individuals who organise the activity of the company. The company itself may have no personality but personalities work within it and need to live by their own moral codes. The company is not an autonomous being but represents the sum of the actions of autonomous beings who can choose to operate the company according to certain ethical standards or to impose ethical standards within their transactions with the company.

The external pressures arise from decisions about positioning and from the demands from contracting. Companies operating in the Western World in the late twentieth century find that many of the parties with whom they conduct transactions include ethical issues along the dimensions on which they judge the company. Conversely, the company can choose to market itself on the basis of standards which are described as "duties" making trade offs against other commercial dimensions, particularly cash. Similarly the creation of a personality for a Company represent the sum of collection of initiatives which have the effect of fulfilling the strategic marketing needs of the company in relation to the various parties with whom it conducts its transactions.

So where do the interests of Government and Society lie in relation to the "amoral" company? What expectations can Government or the community at large have for the company and how should the Company respond? Companies may adopt certain standards of behaviour in response to the desires of those who organise their activity or as a piece of market positioning. However, they also need to recognise the need to satisfy other, not necessarily cash, market interfaces.

In order to help understand the relationship between companies and Government and the community, it is worth stepping briefly into a wider framework of ideas about the currency of non-commercial transactions. In effect, there are three different levels of currency available in political economy: the currency of cash; the currency of political influence; and the currency of direct action. They represent progressively blunter instruments: the money economy represents a highly efficient medium for balancing a wide variety of complex and often small demand and supply considerations. The world of politics is a great deal less precise but is brought into play where the conditions for the money economy falls short of the objectives which populations expressing the views in a democracy demand. The political economy of direct action is less precise still, typically being the resort only of those for whom the money economy and the political system have failed. These other currencies - of political influence and direct action - are the currencies of the market place for regulation and licence in which Government and the Community operate.

Governments may surround companies with regulations, and groups in Society at large may impose pressures on businesses with whom they have no personal cash based transactions. The branch of economics known as "Welfare economics" analyses the business of externalities, examples of market failure where the full social costs of economic activity are not captured by the immediate parties to the money based transactions.

Recognising these conditions, even the least interventionist of Governments have recognised the need for a certain forms of intervention by Government. Other examples of regulation may be initiated by Governments more inclined to regulation, placed in power by populations who feel that they are insufficiently satisfied by the outcome of the money economy. Recognising these pressures, company need to position themselves against those markets denominated by political influence and clout in the same way that they position themselves against their cash based customers and suppliers. The winning of favours, of contracts, of licences, and of the right to trade in particular ways may be won by playing the political game or behaving in certain ways towards other parties. For example, a company behaving demonstrably responsibly towards its employees may as a result be better placed to win Government contracts or to have legislation amended in its favour. To take a current issue : the price of deregulation of shopping hours is undoubtedly bound up with the way in which employees in the retail world are treated by multiple chains.

The relationship of companies to Society at large is broadly similar, although the way in which the community is able to influence the company may be less clear or may be mediated through a third party, such as Government or even groups of employees or customers. Local communities and pressure groups are capable of reducing the solution space available to a company or rendering it "infeasible", with the result that a company can go out of business or withdraw from an activity. Planning consents, pollution and advertising standards are examples of areas where wider social interests come into play.

The debate over the appropriation of economic rent and the conditions that determine the size of the "notional space" available to a company are ones in which Government and Society may have a particular interest. They are ones in which markets themselves are not necessarily able to address satisfactorily. Consequently they are properly the business of Government in so far as Governments are able to provide conditions for the encouragement of management to seek to expand "notional space" but simultaneously to create the conditions through improvements in markets for a constantly countervailing pressure for the contraction of "notional space" into a finite point in which there is no economic rent and a fair and efficient distribution of the proceeds of enterprise.

Commercial Companies, Voluntary Organisations and the Public Sector : A Shared Framework and Common Concerns?

When considering "Tomorrow's Company" and the basis for understanding the core nature of business, it is worth considering whether there is anything unique about the commercial enterprise.

The transaction based framework for looking at the company seems substantially applicable also to other forms of organisations which operate outside the purely commercial market place. The boundaries between the public sector, voluntary sector, and commercial sector are much less than generally recognised. All represent alternatives in one form or another to market organisation.

Each organisation, whether company, voluntary organisation or public sector body, has to position itself against a variety of market interfaces, although the nature of the transactions may be different. Some of the currency of the transactions are unique to certain sectors: voluntary organisations receive some cash from donors and some input of labour from unpaid individuals. However, the same issues of positioning arise as for private companies seeking capital or labour inputs, only the available dimensions for the positioning of the organisation against the suppliers are different.

Increasingly, the organisation traditionally in the public sector and in the voluntary sector find their operational boundaries closer to the private sector. Locally managed schools, National Health Service Trusts and the income generating and service delivery businesses in a variety of charities are facing a great many very similar issues in terms of governance, operations, and relationships with third parties as private sector companies.

Recognition of the characteristic common to all the forms of organisation may yield insights into their operation and purposes. It may also provide a way of improving the understanding of those working in one sector of the work of those in others, and of lessons to be transferred from sector to sector. Importantly, it may also help break down the lack of public understanding of companies and business.