Extending the Constitutional Theory of the Firm by Introducing Conventions

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Abstract

In this paper, it will be argued that unanimous agreement as the ultimate criterion of goodness in constitutional political economy corresponds better with the analysis of the firm than it does with the analysis of much larger organisations, such as nation states. The aim of the paper is also to argue that conventions play a central role in the attainment of a social contract. Conventions enter the explanation in two ways. Firstly, they are logically prior to agreement, and secondly, as it is argued here, it is convention that carries behavioural influence through ongoing, collective interpretative effort, rather than the agreed explicit rule itself. A social contract upon a rule is here seen as the outcome of the process by which shared expectations emerge and change. Furthermore, as soon as a rule is agreed upon, it is the collective process by which the rule's meaning is reinterpreted in future unforeseen situations that explains behavioural constraints, not the rule as a principle itself. The paper also connects the present approach to other theories of the firm.

Introduction

This paper argues that contractarian reasoning can contribute to new institutional theories of the firm by emphasising the procedural justification of the constraints within which actors make choices among alternatives. Normative individualism as the methodology of constitutional economics brings along logical constraints to efficiency considerations that new institutional theories are largely silent about. A central difference between constitutional economics and the new institutional theories of the firm is that while the latter focus mainly on efficient *outcomes* within a given institutional framework, the former examines the criteria by which the institutional framework *itself* can be considered efficient.

The paper will maintain that taking *voluntary exchange* as the ultimate source of justification in constitutional economics is problematic. This is because the boundary between voluntariness and coercion depends on conventions of property and fairness which define how voluntary exchange is arrived in the first place. I will argue that by limiting efficiency consideration to voluntary exchange alone breaks with the constitutional procedural justification producing logical inconsistency. I will propose that cutting the infinite regress of the procedural justification of rules should not be done before conventions have been incorporated into the justification process.

The firm can be seen to be constituted by a group of self-interested people cooperating and competing within a set of multi-layered rules. Individual decisions and actions are interrelated and coordinated in ways that allow us to refer to *corporate* (Coleman 1990) or *concerted* (Vanberg 1992) action. The contribution of the constitutional approach is that it highlights the (explicit or implicit) constitutional agreement as an *exchange of commitments* (Vanberg 1994, 140). The

contracting parties benefit from constraining their future choices within the constitutional framework. The core argument of the constitutional theory the firm is that an organisational social contract results in relations among the parties that are different in kind from market relations (see an opposing view in Alchian and Demsetz 1972).

There are not many theorists who have analysed the firm from the contractarian perspective. Vanberg (1992) has provided a persuasive analysis on how the constitutional paradigm can provide a consistent individualist interpretation of organisations as acting units. His approach is linked with Coleman's (1990) analytical perspective on the procedural foundations of collective action. Gifford's (1991) constitutional analysis of the firm argues that the firm will benefit if relation-specific investments can be secured through the owner's attempt to purposefully design an efficient constitution. Wolff (1997) recognises that corporate culture, as in Kreps (1990), can be taken as an implicit part of the constitution of a firm. Langlois (1995) discusses the interplay between constructed and spontaneous elements in the emergence and perseverance of firms.

Figure 1 illustrates the goal of this paper. The contributions of Coleman, Vanberg and Gifford are depicted as the area A, providing a constitutional approach to the firm. My aim is to justify the introduction of conventions into the contractarian perspective (area B), and to propose that taking into account the interplay between evolution and design can aid our understanding of many aspects of the firm (area C).

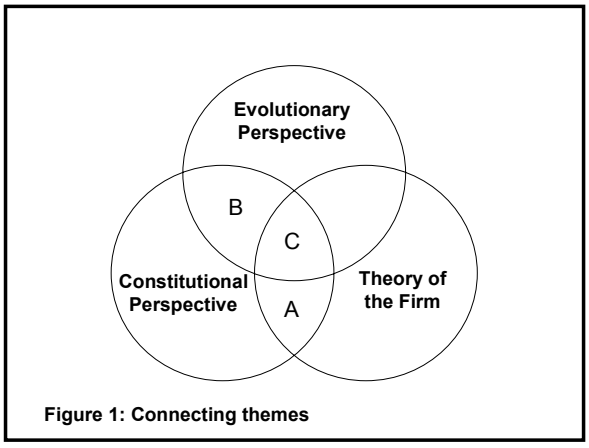

Figure 1: Connecting themes

The extended constitutional approach may have some interesting connections with other theories of the firm. I propose that it can be viewed as an overarching perspective that can encompass many existing insights into the theory of the firm. It can provide further explanations on the resolution of *coordination* and *motivation* problems within organisations, emphasised by the modern contract theory (cf. Milgrom and Roberts 1992). Matters such as the feasibility of incomplete contracting, or why participants are willing to constrain their rent-seeking and opportunistic tendencies in relations characterised by asset specificity and asymmetric information, receive explanation that complement transaction cost and other contract theories. Corporate culture has a close connection to the present theme and will be discussed in connection to constitutional reasoning.

The paper is organised as follows. Section 2 will provide some basic principles of constitutional economics. It will also initiate the rationale for directing constitutional analysis to the theory of the firm. Section 3 aims to explain the rationale for introducing conventions into contractarian reasoning. In section 4 I turn to examine the constitutional theory of the firm. The discussion is limited to the contributions that are closely related to the contractarian reasoning provided by Buchanan and other advocates of constitutional political economy. The reason for this limitation is based on the recognition that the term constitution may be used in various ways that do not have to correspond with contractarian philosophy. In section 5 I will examine the extended constitutional perspective further in relation to other theories of the firm. Finally, section 6 will provide some concluding remarks.

On the basic principles of constitutional economics

Constitutional economics is essentially about the examination and evaluation of the foundational rules of social order. It is an inquiry into the interrelation between what Hayek called the *order of rules* and the *order of actions* (Hayek 1973). The constitutional perspective suggests that in our pursuit for social improvement, changes in the order of rules ought to be the principal means (Vanberg 1994, 5). It directs our analytical attention toward the *choice among constraints* (Buchanan 1991, 5). This perspective implies the recognition that societies are complex systems where purposeful design directed to particular outcomes does not in many cases bring about what is desired. This results from the genuine uncertainty of outcomes. The source of uncertainty is our ignorance of the unintended consequences inherent in human (inter)action. Although an organisation can be viewed as being intentionally constructed to realise a certain purpose, the actions taken within the organisation have unintended consequences as well. This relates to Hayek's view on the relation between the origin of rules and their outcomes as he states that 'it is possible that an order which would still have to be described as spontaneous rests on rules which are entirely the result of deliberate design' (Hayek 1973, 46). What is meant by the notion of *purpose* becomes central. If by purpose it is referred to rather concrete ends, it is consistent to view the goal of an organisation as an outcome of purposeful design. This, however, leaves open the question to what extent the attainment of that goal can be viewed as a planned process. Alternatively, if one views purpose as being directed towards more abstract ends such as self-maintenance or survival (cf. Selznick 1948), the purpose seems to owe more to spontaneous elements.

The constitutional perspective directs the analytical interest from the goal-oriented discussion to the foundations of agreement on participatory and distributional rules. The firm is then not defined through its possible goals, but through the rules that constitute a system of productive relations among the participants. The constitution of an organisation specifies the terms of participation: (1) which resources participants are to contribute to the organisation, (2) how and by whom the decisions on the use of pooled resources are to be made, and (3) how

the resulting benefits from the joint endeavour are to be shared among participants (Vanberg 1985, 22).

Constitutional analysis is consistently individualistic. (1) The derivation of institutional constraints is based on a calculus of individual interests. (2) Collective choice is derived from the participatory behaviour of individual members. (3) Emphasis is directed to the selection of rules that will limit the behaviour of those who operate within them (Buchanan 1991, 8).

The methodology of *normative individualism* provides a normative point of departure for constitutional economics advocated by Buchanan and other contractarians. Normative individualism suggests that we should take the values and interests of the individuals involved as the relevant standard against which the goodness of rules and their outcomes is to be judged (Vanberg 1994, 1).

The constitutional perspective highlights voluntary exchange as the core motivator for the individual to limit her behaviour within constraints. The cost of limiting one's own behaviour is accepted insofar as it does not exceed the benefit resulted from reciprocal behaviour of others. This perspective emphasises the calculative rationality of the individual who actively chooses her own constraints. By definition, a voluntary exchange happens only when the participants expect to gain from the trade.

The subjectivist position of the constitutional perspective recognises that values and theories about the world vary across individuals. This limits efficiency considerations because it is believed that no supraindividual scalar of goodness exists. There is no reason to believe that the ordering of preferences would not vary in time and across individuals.

From the subjectivist position, an assessment of efficiency relies on revealed preferences of the individual. When the idea of voluntary exchange is transferred to the realm of collective choice, the strict criterion of revealed preferences through observed exchange needs to encompass all the parties. As the subjectivist position holds that the values of individuals are incommensurable, an exclusion of any one party from the exchange breaks down the possibility to verify that the observed exchange was in fact efficient.

Since individuals vary in their tastes and interests, it is likely that when a group of people get together in order to pursue something collectively, conflicts of interests arise and mutual agreement may thus be difficult to achieve. The members need to *compromise* before a mutually agreed solution can be reached. The solution may not match perfectly with anybody's immediate interests but provides a more desirable outcome than being without it. The question about how to facilitate a compromise thus becomes central. A compromise requires the parties, to some extent, to alienate their immediate self-interests and, through introspection, assess what would be considered fair by the other parties.

The constitutional bargaining process itself contains aspects that facilitate agreement (Brennan and Buchanan 1985, 29). Rules are by definition more general than the outcomes that result from action guided

by those rules. A constitutional choice among alternative rules contains the elements of generality as a chosen rule needs to be applicable in numerous contingencies. Another basic characteristic of a rule is its extended time dimension. A rule needs to be applied over time, otherwise it can hardly be considered a rule. Due to these considerations, the individual faces genuine uncertainty about how her position will be affected by the operation of a particular rule. Insofar as mutual agreement is the goal, the individual tends to agree on arrangements that can be considered fair in the sense that they are broadly acceptable (ibid., 30).

For a contractarian, the only justified criterion of goodness in collective choices is a unanimous agreement among the participants. Alternative constitutional arrangements can be analysed in a hypothetical initial state to discover what basic principles such rules should fulfil. This may help her to create new alternatives that may receive acceptance among the relevant group. But, as Buchanan has recurrently noted, the members of the group are the sovereign decision-makers whose individual values are the only justified source for efficiency considerations. What makes this central principle problematic is its consequence on innovative and creative aspects of social endeavour. It is obvious that many innovations are such that only few understand their potential value immediately. Changes in rules are especially difficult to negotiate because individuals generally value the *status quo* (Schlicht 1998). Another problem that Barry (1984) has pointed out arises as all the members are in a position to veto an alternative that would otherwise be desirable. From the contractarian position, there is of course no such a thing as 'otherwise desirable', but it is intuitive to think that somebody may want to veto whatever the rest of the group are suggesting. This connects to the pragmatic criteria of justifiable exclusion from decision-making (children, mentally challenged, etc.). Any agreement on the contents of such a list fails by necessity to meet the contractarian ideal, however. This is because the exclusion must occur before the list is agreed upon.

Contractarians have tried to resolve this problem by proposing that not all choices among rules need to satisfy the strict criterion of unanimity. It is entirely justifiable for any group to unanimously agree upon relaxing the criterion for post-constitutional rules that are specific to the extent that a complete agreement would be too costly to achieve (Buchanan and Tullock 1962). This makes the perspective more operational but also creates a logical problem. If post-constitutional rules may be placed in categories of various degrees of unanimity (simple majority, two-thirds, three-fifths, etc), then a choice of which category to use regarding a particular post-constitutional rule becomes central. If a choice about the proper category of a rule is *less* than unanimous, then the choice *itself* becomes unjustified on constitutional grounds. The participants know that the higher the degree of unanimity that is required, the less probable it is for a rule to become accepted. Thus, those who favour a certain post-constitutional rule try to get it into a category with a low degree of unanimity, whereas those who oppose it try to get it into the category of the highest level of unanimity.

Therefore, if such a choice itself is not unanimous, there is no guarantee that any post-constitutional rule is efficient.

These problems concerning the strict unanimity criterion can be attempted to be remedied by three ways. The first alternative is to relax the strict unanimity requirement and accept a more operational alternative that takes unanimity as an ideal. The goodness of a collective choice is then measured by its *degree* of unanimity. The problem with this alternative is that it opens the door for the Kaldor-Hicks type reasoning by which a change in rules would be acceptable insofar as the benefit would over-compensate the loss and those who win could hypothetically compensate those who lose. The contractarian position maintains that in such a situation the compensation should be observed, otherwise no guarantee of mutual benefit is provided. This argument is logically problematic, however. If the participants perceive and calculate the compensation, there is no reason for them *not* to agree. The result then would be unanimous agreement. If, on the other hand, the participants do not perceive the compensation as a part of their gain in exchange (perhaps due to ignorance), the normative individualistic principle of the contractarian position does not allow an agency to 'know better' what is good for the participants, and thus the change in rules would remain coercive. To be sure, the idea that a change in rules is justifiable in contractarian terms insofar losers are compensated is unhelpful as it directs attention to *outcomes* that are nonexistent at the moment of choice. After all, in contractarian reasoning, efficiency of a collective choice is not derived from *ex post* outcomes but, instead, from the exchange at the moment of collective choice.

The second alternative to remedy problems arising from the strict criterion of unanimity is to limit the applicability of the contractarian reasoning to rules that are general enough so as to facilitate agreement behind the veil of ignorance (Rawls 1971) or of uncertainty (Brennan and Buchanan 1985). It is likely that general *principles* of human rights, separate property, and government may be shared in a large group. The problem with general principles is that in order for them to carry behavioural influence, they need to be *interpreted* in dissimilar situations. Even though an agreement on general principles may be reached, unanimity on rules that define more accurately the scopes and limits of various (often conflicting) rights may remain unattainable, as the participants are able to foresee how a certain configuration will affect their relative positions.

The third alternative to remedy problems arising from the unanimity criterion is to direct contractarian reasoning to smaller groups whose members may share more coherent sets of values. This idea is based on the assumption that the more coherent the values among the participants are, the more detailed rules the participants can agree upon. Another central assumption is that in smaller groups the probability of more coherent values is higher than in larger groups. If these assumptions prove to be realistic, contractarian reasoning is perhaps more applicable in smaller organisations, such as business firms, than at the level of nation states.

The rest of this paper aims to examine this third alternative. However, even though agreement on more detailed rules may generally be better facilitated in smaller groups, I shall maintain that the exchange of commitments among the participants depends on the conventions of fairness and reciprocity in that group. This view is closely related to Sugden's interpretation of contractarianism in which 'the object is to evaluate possible changes in the institutions of an existing society, using a criterion of agreement that is defined relative to the knowledge and the *conventions* that prevail in that society' (1993, 421, emphasis added).

Enter conventions

In the approach proposed here, conventions enter the constitutional analysis in two distinguishable ways. First, it is maintained that from a structural perspective conventions logically precede a social contract. Second, it is argued that a social contract upon a rule does not *per se* produce coordination of actions and expectations. A rule needs to be continuously reinterpreted as the future is disclosed. It is the ongoing interpretative effort that produces shared expectations of appropriate courses of action.

The term 'convention' is here broadly defined as a social pattern of behaviour which is shared among the participants to the degree that it is common knowledge that most participants conform to the pattern and that most participants expect most of the others to conform as well. Conventions can be contractual and noncontractual. A noncontractual convention is one which does not require a covenant to enforce conformity because it is in the direct interests of everyone to conform; and there is no need for explicit agreement as it is obvious to all parties what the expectations of others are. A convention, such as on which side of the road to drive, is thus noncontractual in the sense that no contract needs to be established for its maintenance (Gauthier 1998). A convention is contractual if its maintenance requires an agreement and a covenant to enforce the agreement. For instance, a rule by which a firm's outcome is to be distributed among the participants is contractual.

As a first approximation, the term contractual convention might be used interchangeably with the term social contract. They both require agreement. The distinction between a social contract and a convention can be seen in their dissimilar relation to time and process. The constitutional position emphasises a two-step notion of rules: before a game can begin, rules must be agreed upon. In the second step, the game is carried out within the agreed rules (Buchanan 1991). This leaves open the question about how those rules are to be interpreted in disclosing future situations that are necessarily nonexistent at the moment of rule making, and also, how interpretation modifies the rules themselves. A social contract can, of course, be seen as conjectural in the sense that the disclosing future can be expected to provide feedback so as to motivate the participants to revise the contract to better correspond with changed circumstances (Vanberg 1986). However, the way participants come to recognise a decrease in the desirability of the present rule is argued here to be due to a recognised discrepancy between the *de facto* convention

that is adhered to and the rule that was agreed upon in the past. It is unrealistic to assume that the participants collectively and simultaneously suddenly realise the presence of a discrepancy that they had all failed to recognise earlier.

Thus, it is argued here, it is the shared interpretation of rules that influence behaviour, not the agreed rule itself. Such a collective interpretative effort has more to do with convention formation and change than with the rule as an outcome of collective choice. Even though this argument may sound somewhat strange, consider the following logic. The explicitly agreed rule itself is a *principle* that has been arrived at through collective interpretation. I argue that the interpretative process by which the principle is arrived at is more important than the principle itself. This is because what explains the agreement upon a rule is not the rule itself, but the collective interpretative effort that gives rise to agreement. Another reason for this argument is not derived from the process by which an agreement is arrived at, but from the process of interpretation that begins immediately *after* the rule is in place. After an agreement upon a rule, interpretation upon its meaning begins to have its influence. Viewed this way the explicitly agreed rule itself serves as a discontinuation point in the *processes* that both create it and interpret its meaning.

The first argument for the structural priority of conventions over a social contract, as presented in the beginning of this section, is derived from the logical problem that would result if no convention were assumed to exist at the moment of agreement. As Block and DiLorenzo put it:

> Constitutional economists try to derive a theory of human and property rights from their constitutional framework and they seek to do so on a consensual basis. But how can people give their consent to a contract before it is clear that they have any rights to do so? Where do these rights come from? How can a person agree to be bound by a constitution if it is this very document which can alone establish his rights? If rights are established only by constitutions, then before their advent individuals have no rights. But if they have no rights, what "right" do they have to participate in the construction of a constitution? (Block and DiLorenzo 2000, 571)

Taking an agreement as the starting point is logically problematic because if the initial state does not already include some mutual expectations, that is, a convention of reciprocity, a social contract remains unattainable. This refers to Hobbes' (1996) model of the initial state. In that model, the participants cannot resolve the first-mover paradox because in a genuine anarchy, reputation accumulation is impossible. In order for a protective agency to arise, the model must be extended to comprise at least bilateral reciprocity in a way presented by Nozick (1974). The reason why I use the term bilateral reciprocity rather than exchange is that although there is exchange, it is not temporally symmetric in the sense that all exchanging parties receive gains at the moment of exchange. They receive expectations of gains that require the keeping of promises and trust.

The contractarian position is maintained to be able to systematically extend the individualistic perspective of classical liberalism

into the realm of collective choice (Vanberg 1994, 204). The individualistic position maintains that voluntary exchange indicates agreement among the parties, and that such voluntary agreement is the ultimate criterion on which an exchange can be judged to be efficient (Buchanan 1977, 128). In direct analogy, the contractarian individualistic position maintains that a collective choice can only be judged efficient if it is based on voluntary agreement by all parties involved (Vanberg 1994, 204). This paper maintains that the way voluntariness is defined in particular situations depends on the relevant conventions among the participants.

The constitutional theory of the firm

Firms, like other organisations (clubs, associations, states, etc.), are constituted by their members. By entering into an organisation a member becomes subject to the authority system of that organisation. An individual voluntarily gives up some of her autonomy in return for the benefit she gains from participation. When entering an organisation the individual not only accepts the authority system, but is also willing to submit part of her resources to be pooled and subjected to unitary control. It is through the exercise of control over the pooled resources that an organisation can meaningfully be treated as an acting unit. The constitution of a business firm states the terms of membership as well as the member's rights of participation in controlling the combined resources. (Vanberg and Buchanan 1986, 216). Many desirable aspects in the firm dynamics depend on the success of coordinating efforts among the members and on the ways that rights are defined and justified. Capability accumulation, knowledge creation and dissemination, communication and coordination of plans and actions are examples of such aspects. It seems reasonable that we should direct our analytical interests toward the constitutional dynamics of firms when long-term developmental issues are studied.

The constitutional rules of an organisation can be described as solving two types of problems: those arising (1) in team use of pooled resources and those arising (2) when the social product of collective endeavour is distributed among the members (Vanberg 1994, 139). The former type of problems refer to *knowledge* problems of how to arrange and coordinate various tasks within the organisation. The latter type of problems seem to correspond better with the *conflictual* aspects of self-interested members. The central criterion for agreement is that a rule needs to be general enough to facilitate impartial judgement. Rules of distribution do not necessarily provide uncertainty to the extent that the members could not foresee how their positions would be affected. With regard to privately owned business firms, an equal-share rule is not more prominent than any other alternative. One solution to alleviate conflicts of interests in distribution is to examine how far property rights can be developed to provide prominent demarcation in collective endeavour.

It appears intuitively obvious that if the property rights within a firm are ill-defined or ill-protected, the members suffer through reduced incentives to put an effort and increased incentives to rent-seeking.

Gifford is in line with other asset specificity theorists when he recognises that the core problem arises when it would be in the interest of the firm to have the members making firm-specific investments (1991, 91). If property rights are ill-protected, members remain vulnerable to rent-seeking on the part of others and thus remain reluctant to make such investments. The constitution of a firm is then viewed as a remedy for this undesirable state of affairs. The constitution is seen as a set of interdependent long-term contracts among the members (ibid., 92).

The role of the constitution, for Gifford, is to 'set up a system of constraints, limiting the ability of individuals and coalitions to impose external costs on others' (1991, 92). A constitution is thus designed primarily for limiting opportunism within organisations. For Gifford, the remedy for rent-seeking tendencies is a constitution created by the owner (or her agent) 'to maximize the sum of the present values of all the assets used in the firm' (1991, 93). The central purpose for the owner to set up constitutional constraints is to provide incentives for the employees to make firm-specific investments. This is accomplished by protecting the property rights of the employees to their firm-specific investments. 'By creating an efficient constitution the owner of the firm maximises the value of his own assets in the firm and at the same time those of the other firm members' (ibid.). The positive externalities that the owner thus creates are internalised by other firm members. This can partly explain the motivation for an individual to join a firm. A member can gain access to the pool of knowledge and is at the same time protected by the constitutional rules against potential rent-seeking by other members.

Furubotn (1988) is in the same line of reasoning as Gifford. With *codetermination*, Furubotn means a provision of control rights that give those employees who make firm-specific investments part of the firms' control rights. The decisive criterion is whether or not representatives of labour take part in the firm's decision-making processes at board level (ibid., 166). The core idea of the article is to explain that the firm maximises its profits by giving those employees who make firm-specific investments their share of decision-making rights. Furubotn maintains that the firm is actually a 'joint investment' among capital and labour providers and therefore the employee-investors should be regarded as equity holders (ibid., 168). The sharing of control rights via codetermination is then maintained to provide some assurance that '*all* interests will be considered in decision making and that unfair allocation of quasi rents will be prevented' (ibid., 168-9, emphasis in original).

Furubotn's analysis remains noncontractarian in its emphasis on the profit maximisation rationale for joint decision-making. To be sure, if profit maximisation is the rationale for joint decision-making, then we have to consider the trade-off between increased decision-making costs on the one side, and the increased coherence between the rules and the interests of the participants on the other side (Buchanan and Tullock 1962). Such an assessment is necessarily directed towards consequences that are nonexistent at the moment of choice, and therefore remains speculative.

Gifford's analysis recognises the central rationale for a constitution as constraining the self-interested behaviour of the firm members. However, his analysis remains somewhat distant to the normative individualist foundation of constitutional economics. The idea that a central agent should (be able to) design an efficient constitution for the members of the firm to follow seems to disregard core issues in the procedural justification of contractarian reasoning - as well as the epistemic limitations of human actors. The unanimity criterion in constitutional economics is established precisely because of the problem that we cannot know whether a collective choice is efficient or not in any other means than by assessing the degree to which it corresponds with the interests of the relevant parties.

Connections to other theories of the firm

A common denominator for theories of the firm is that they are characterised by their concern with the existence, the boundaries and the internal organisation of the firm. Another common theme is that explanations for these matters are based on outcome-oriented efficiency considerations. The goal of the present approach is different. It discusses some foundational principles of a constitutional order within the business firm. The constitutional approach advocated here corresponds with the principles of subjectivism which give limited scope to derive efficiency claims. The present paper is thus unable to assess to what extent constitutional rules of an economic organisation are efficient in some other sense than being desirable, judged by the members themselves.

The literature on the theory of the firm is expanding and it would be futile to try to discuss all various approaches in this context, especially in a way that would give any more light to the matters than has already been given by others (for a detailed discussion on various contributions see Foss, 1999). In this section, I will discuss some ideas from different approaches that are connected with the main theme of the paper.

The issues connected with the constitutional perspective that are of interest here concern the contractual arrangements within the firm. Interesting issues arise from coordination problems as well as incentive-conflicts among the members. Transaction-cost considerations correspond with our immediate intuition as well. An economising individual will prefer more goods to less and less bads to more. It is therefore expected that people will try to organise production in ways that minimise various types of costs that necessarily arise from action. It is another thing to what extent lists of different kinds of costs take into account all relevant costs, or whether all those costs that influence choice behaviour can even in principle be made operational (cf. Buchanan 1969). Be that as it may, various approaches contribute to our understanding about the dynamics of economic organisations, a subject which is continuously changing as new, hitherto unperceived organisational arrangements are being created.

A constitution of a nation state applies to every member of that nation, even the legal-political elite (this is at least the general ideal of it).

Things are not the same within business organisations, however. Power relations emerge not only through political processes within firms but are also part of the legal statuses of the members. Owners and managers have, in part, different sets of legal rights and obligations than employees. Therefore, constitutional considerations within economic organisations differ from those at the national level.

Coleman has introduced useful terms that recognise these important distinctions. A constitution is *conjoint* when the beneficiaries and the targets are the same persons (1990, 327). A constitution of a Western nation is a good example of this. Although not every member of the nation participates to the same degree in the process of establishing the constitution, those who are targets, i.e., those who are constrained by the constitutional rules, and those who benefit from having a constitution are the same persons. Every member faces both costs and benefits from constitutional constraints. Cost incurs as the individual has to constrain her own action within the limits of the shared rules. Beneficial impact comes from others' similarly constrained behaviour.

A constitution is *disjoint* when the beneficiaries and the targets are not the same persons. As an extreme, those who benefit from certain rules may be completely different individuals than those who are subjected to those rules. An owner-manager of a firm may design a set of rules that constrains the actions of her subordinates but which do not concern herself. It is sensible to argue that economic organisations represent constitutions that have more disjoint characteristics than what can be found at the national level. As a first approximation, this could imply that business firms are characterised by more arbitrary rules than nations, and that subordinates within firms are subject to more coercive rules than their superiors.

Exit and efficiency

Markets in which business firms are embedded provide prominent resolution mechanisms to the potential coercion of firms' constitutional arrangements. It is reasonable to argue that employees have better opportunities to vote by their feet, that is, to withdraw from a firm that enforces unjust rules, compared to emigrating from a nation state (Hirshman 1970, Wolff 1997). This fact alleviates the potential coercion within disjoint constitutions. Also, an employee's ongoing participation in a firm is taken as an *implicit consent* to the firm's constitution. Although exit is more operational when examining economic organisations, than when discussing entire societies, it is not entirely unspeculative regarding economic organisations.

Exit indicates that the participant is not satisfied with the present constitutional order, or, that a better alternative has been found. This may lead to a logical problem in the constitutional approach. Continued participation is assumed to reveal interest to accept the organisational constitution. On the other hand, the normative individualistic foundation does not permit efficiency considerations other than those based on observed exchange. This means that when we observe two

consecutive exchanges by the same actor, we cannot assess their comparative goodness based on procedural justification. This is because an observed exchange does not contain information about its relative efficiency regarding other observed exchanges (cf. Buchanan 1969, Lachmann 1976). What this implies in the context where a member of a firm decides to change the employer is that both having stayed in the present company and entering into the new one enjoy equal procedural efficiency. An attempt to argue that the exit is due to unsatisfactory constitutional order is inconsistent with the procedural criterion of goodness of constitutional economics.

Constitutional economists probably accept the idea that each agreement is conjectural in the sense that it may become changed as circumstances call for it. Although one can argue that the change occurs because the old rule has become inefficient in the sense that the members do not perceive it advantageous any more, one cannot argue that one somehow knows the comparative efficiency of the new rule over the old rule *when it was chosen*. This issue is central to how we perceive the change in rules and thus cultural evolution. What I am arguing here is that, based on our limited reason and imperfect knowledge, insofar as two consecutive choices are based on voluntary exchange there is no secure way for us to measure their comparative efficiency. Consider two consecutive choices made by a single chooser, the first choice is about which car to buy and the second choice is over a range of shoes. We cannot claim to know which one of these choices was more efficient solely based on the observation of exchange. To be sure, the chooser does not know it either - in the consequential sense, that is. The beautiful car she just bought may turn out to be a catastrophe while the shoes she bought in the sales may serve her well for years to come.

Properly understood, the constitutional criterion of goodness is only concerned with the realisation of the members' interests *at the moment of choice*. The constitutional perspective does not pretend to have foresight into the degree of consistency between expectations and outcomes that eventually unfold. That is why entering a firm at t_0 point in time and entering into another at t_1 point in time deserve equal procedural efficiency. As soon as the agent enters the new firm at t_1 it may become clear that the previous firm was the better alternative. But to know this requires accumulation of knowledge that was not there before t_1.

Incomplete contracting

Incomplete contracting theories break with the Arrow-Debreu assumption of complete contracting. It strikes one as being rather realistic to assume that individuals do not know all the future contingencies which may affect the carrying out of a contract of any complexity or time span. Despite this, both the nexus of contract approach and the formal principal-agent theory are largely based on the assumption of complete contracting (Foss 1999).

Coordination is one of the themes around which the incomplete contracting approach rotates, beginning already with Coase's (1937) seminal contribution. Wernerfelt (1997), for example, argues that the firm exists because of its advantage in minimising *communication costs* in intrafirm relations. Herbert Simon (1951) emphasises the distinction between the employment contract and the market contract. This perspective contradicts another contractual idea, developed by Alchian and Demsetz (1972), that intrafirm contracts cannot be distinguished from market contracts. Their analysis implies that the firm is reduced to a fictitious legal entity. The constitutional perspective is founded on the recognition that intrafirm relations are essentially different from market relations. They are different enough to make the concept of *concerted action* operational within the firm (Vanberg 1994, 135). It is precisely the cooperative team dynamics, which are not decomposable into bilateral agreements among the members, that make intrafirm relations different from the market ones (see also, Coleman 1990). Simon (1951) argues that the advantage of the employment relationship over the market contract lies in its *flexibility*. After the employee has submitted to the governance structure of the firm, her action can be adapted more fully to unforeseen future contingencies.

Asset specificity is another theme in incomplete contracting. Unlike the coordination approach, the asset specificity perspective highlights the organisational implications of *ex post* opportunism when relation-specific investments are involved (Foss 1999, 25). Williamson (1971, 1991) and his followers extensively discuss the implications of *opportunism* combined with Simon's concept of *bounded rationality* on different types of economic organisation. This approach resonates with the constitutional perspective of Gifford (1991).

Contracts of any complexity or time span remain imperfect. This is due to our ignorance about how future events will affect what is agreed upon. Despite this anomaly, the parties can agree as new events disclose that certain implicit terms are binding which thus help in mending the initial contract. In order for the implicit terms to be effective, the parties must share their meaning. Otherwise the agreement breaks down. In order to secure agreement the parties submit to conventions that bring coherence to their interpretations of implicit terms. This is to say that an underlying reason for a successful application of implicit terms and contracts can be found in conventions.

Spontaneous elements

The constitutional perspective of the present paper differs to some extent from that of contractarian philosophy as defined in Brennan and Buchanan (1985). The present approach takes into account, not only explicit agreements among firm members but also conventions. The perspective is related to approaches that emphasise the plurality and complexity of the relations within organisations. For instance, Herbert Simon states that

> To many persons, an organization is something that is drawn on charts or recorded in elaborate manuals of job descriptions. … In this book, the term organization refers to the complex pattern of communication and relationships in a group of human beings. This pattern provides to each member of the group a … set of stable and comprehensible expectations as to what the other members of the group are doing and how they will react to what he says and does. (Simon 1976, introduction to the third edition, as referred in Baker, Gibbons and Murphy 1997)

A number of writers within related perspectives share the understanding that implicit contracts and spontaneous procedures are essential components of organisational dynamics (see, e.g., Barnard 1938, Simon 1976, Granovetter 1985). The present study shares Barnard's view that many of the rules and practises are organisation-specific:

> [Consider] the lines of organization, the governing policies, the rules and regulations, the patterns of behavior of a specific organization. Though much of this is recorded in writing in any organization and can be studied, much is "unwritten law" and can chiefly be learned by intimate observation and experience. (Barnard 1976)

The present perspective is also related to Baker, Gibbons and Murphy's (1997) analysis of implicit contracts. They emphasise the role of management in 'the articulation of unwritten rules and codes of conduct, the development and maintenance of a reputation for abiding by these rules, and the use of subjective assessments and informal adaptation to events in the implementation of these rules' (p. 23). The present approach deviates from theirs in that the emphasis is on the role of conventions as constitutional constraints. The creation of implicit contracts is therefore not seen as being as 'conflict-laden' a process as Baker, Gibbons and Murphy suggest. Kreps' (1990) emphasis on the role of *corporate culture* gives some insight into these matters.

Corporate culture

Kreps' (1990) analysis of corporate culture discusses the realm that should reasonably be related to spontaneous processes within organisations. In Kreps' terms, corporate culture consists of 'the interrelated principles' that the organisation applies and 'the means by which the principle is communicated' to say 'how things are done, and how they are meant to be done in the organization'. Because corporate culture is 'designed through time to meet unforeseen future contingencies as they arise, it will be the product of evolution inside the organization…'. (p. 93-4) Corporate culture does not only consist of the basic principles, but plays a role 'by establishing general principles that should be applied' (p. 126). This may be taken to be related to the evolutionary idea that once a convention has been established, it becomes a reference point for future development.

The reason why the employees of a firm have reason to expect authority to be used fairly is their expectation that *reputation* is considered a valuable asset (p. 92). I would suggest that reputation alone does not ensure fairness in adapting to unforeseen future contingencies. We need

something that links reputation to new situations. That link is suggested to be in the form of conventions that provide shared interpretation of fairness and also a potential to establish shared reference-points for new events as they disclose themselves.

The present approach deviates from Kreps' analysis in that it does not assume any single and rigid focal principle (p. 130). When discussing the optimal size of an organisation, Kreps assumes that a corporate culture faces problems when the span of the principle is increased (p. 129). This is because the range of contingencies that the principle must cover must also increase. The applicability of the principle (or culture or contract in Kreps' terminology) becomes ambiguous when increasingly dissimilar contingencies are introduced (p. 130). A potential reason for this interpretation may be the disregard of rules in shaping interpretations of new contingencies. The essence of any rule is that it applies to a range of dissimilar events but what is equally important is that our perception of inexperienced events is based on our capacity to perceive them through *categories* of events, not as unique events as such (Hayek 1952). This alleviates the claim that when there is a gradual expansion of contingencies (organic growth of the firm) the rule necessarily becomes increasingly ambiguous. The relative rate of change between the categories of contingencies and the rule itself then becomes the key issue. External shocks aside, there is no *a priori* reason to assume that the change in a rule could not correspond with the changes in categories.

In Kreps' analysis, corporate culture seems to obtain a rather rigid interpretation. The situation is not alleviated by the use of interchangeable terms: focal principle, implicit contract and corporate culture (p. 130). If we assume only one focal principle or implicit contract applied in an organisation, there is reason to believe that, be it however clear and prominent, it does not provide much behavioural guidance in unforeseen future contingencies. But if we assume that there are several principles, and perhaps conventions, things change. For Kreps, this is not a solution, though, as he claims that a wider range of principles 'may increase ambiguity about how any single contingency should be handled' (ibid.). The reason for Kreps' doubt may be found in his general approach to corporate culture as being constructed by purposeful design. From the constructivist perspective the working properties of new principles are always uncertain and may only confuse the members of an organisation. My suggestion should at this point be rather obvious. I view corporate culture as being constituted by a system of conventions as well as designed principles. Conventions facilitate a wider range of principles without necessarily increasing ambiguity in interpreting unfolding contingencies. On the contrary, a central aspect of rules is that they shape our interpretations of dissimilar events. Even in the purest form of situational analysis, where we negotiate a situation which we have no previous experience of, we try to form a solution by referring to elements that bear some resemblance to our existing categories of recurrent patterns. This dynamic is often overlooked resulting in an unwarranted picture of our choice processes as being distant to rule following as a behavioural disposition.

In my terminology, corporate culture would be closer to the notion of the organisation's spontaneous order, which, although it partly results from rules and principles of designed origin, should not be taken as fully designed. In this reconstruction, conventions play a role as well as explicitly agreed rules do in creating corporate culture.

Another difficulty arises in Kreps' analysis because of its static nature. Kreps states that 'efficiency can be increased by monitoring adherence to the principle (culture). Violation of the culture generates direct negative externalities insofar as it weakens the organization's overall reputation.' (p. 126) In Kreps' treatment, corporate culture is (nearly) tangible. It seems to be easy to observe when it is strengthened, as well as when it is weakened. Both violations of the culture and their consequences seem to be readily measurable. Insofar as we remain in static analysis, corporate culture remains unaltered when all the parties follow it. Kreps claims that '[r]ewarding good outcomes that involve violations of the culture generates negative externalities [because it] weakens individual incentives to follow the principle and thus increases (potentially) the costs of monitoring and control' (ibid.). The static perspective of Kreps' analysis makes changes in corporate culture unfeasible. Any experimental activity is *a priori* announced detrimental.

In the present approach, experimental activity is central to the notion of change in human and social affairs. Although conventions may be unresponsive to situational variations, they will not remain unaltered. Even technological standards, which may, for a period of time, preclude alternative arrangements from emerging, will eventually give way to something new (see, e.g., Constant 1980). In order for a convention to change spontaneously, somebody may initiate change by violating the existing convention. The violation does not have to be dramatic in the sense that it may still be based on some other convention, such as general reciprocity, and receive its justification from that. Also, existing conventions may promote the emergence of new alternatives.

Conclusions

The broad goal of the paper has been to promote an understanding of the linkage between rational constructivist and spontaneous elements in the business firm's constitutional dynamics. Business firms as voluntary organisations embody much of the same dynamics as larger organisations such as nation states. On the other hand, it is clear that the interrelations among the members of business firms are distinguishable in many aspects from those among the members of a nation state. The broadly defined constitutional perspective can provide an explanation for institutional change within firms without introducing non-individualistically definable efficiency criteria, or without assuming away the subjective elements by referring to natural selection.

A central reason for my attempt to extend the constitutional approach to the firm by conventions is based on logic of reasoning. An analogy between a voluntary market exchange and a voluntary exchange of commitments in agreement upon a common rule is found

problematic because the efficiency consideration of the latter involves the rule that is yet to be agreed upon. A market exchange can be viewed as efficient within the rules that are already in place, whereas efficiency of an exchange that itself produces a shared rule cannot be derived from the exchange itself. Therefore, connecting a social contract with the conventions which define the shared understanding of the boundary between acceptable and unacceptable helps us to understand where the source of efficiency of an exchange upon shared rules is located.

The types of constitutional approaches to the firm, as represented in Gifford (1991) and Furubotn (1988) are seen slightly problematic. Gifford's treatment assumes epistemic capabilities from the part of the manager when designing an *efficient constitution* that may fall short in real life contexts. The present approach is equally sceptical about Furubotn's idea that a firm's constitution is a device by which profit maximisation *per se* is secured. It is maintained here that a social contract can only secure that the mutual interests of the participants are recognised at the *moment of choice*. Whatever *consequences* such a contract will produce as the future discloses are beyond the epistemic limitations of the participants.

The contractarian principles are essentially about the means, not about the ends, by which a collective endeavour is to be pursued if the individual is taken as the ultimate source of valuation. The normative content of constitutional philosophy does not carry from this normative individualist position to consequential assessment of utilities that are not present when a choice is made. The paper has discussed some central complications that such a position necessarily brings along. Shared understanding of appropriate modes of behaviour in the form of conventions is proposed to help us in understanding the interplay between evolution and design in the constitutional dynamics of business firms.

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