Unbundling Property Rights

Throughout the first eight decades of the twentieth century, the idea that corporations should be run in the interests of all of their “stakeholders”, rather than just for their shareholders, slowly but steadily gained acceptance and credibility in academia, in the courts and in boardrooms in the U.S.A. Then, in the space of a few years in the 1980s and early 1990s, legal scholars, finance scholars and other academic elites rejected that idea and legal advisors to corporations began advising managers and directors to justify everything they do in the name of share value. These scholars and legal advisors have, in effect, resurrected an old view of corporations—the idea that a corporation is a bundle of assets that belongs to shareholders—although they have wrapped it in clever new neoclassical economic theory. The economic theory they appeal to is that managers and directors should be viewed as the hired “agents” of shareholders who are the true “owners.” The “bundle of assets” view of firms is attractive to scholars of law and economics because it fits much more neatly into neoclassical economic theory than either managerialist or stakeholder models of the firm do.

It also seems, at first blush, to be consistent with lessons learned from the collapse of communism in the 1980s about the importance of private property for economic efficiency and sustained economic growth. The importance of private property is that it aligns incentives. If the party who controls the use of an asset also reaps the benefits from using it efficiently—and bears the costs of its misuse—that party has a significant incentive to see that the asset is used well. Hence institutional arrangements that bundle the right to control and benefit from assets together with the responsibility for bearing the risks associated with the use of those assets will, according to property rights theory, lead to efficient use of society’s resources.

But while private property rights are surely important, property is not the only institution that matters for economic development. In fact, corporations, which are surely some of the most important institutions for wealth creation in capitalist economies, regularly violate the private property axiom. It is in the very nature of publicly-traded corporations that property rights are unbundled and carved up among the many participants in the corporate enterprise. Control rights are separated from income rights and from the responsibility or liability for misuses of property. The corporation itself (a fictional legal entity), rather than any individual participant or group of participants in the enterprise, is the legal “owner” of assets used in production and of the output of the enterprise and control over a wide range of decisions about the use of the assets is vested in the board.

For many economists and legal scholars, the “separation of ownership from control” in corporations has long been troubling. Theorists argued that crippling governance problems should arise as soon as decisions are made and control rights are exercised by parties who do not bear all the risk associated with the use of the assets. According to a number of leading financial scholars, in fact, the poor profit performance of the corporate sector in the U.S.A. in the 1970s was the result of empire building and self-serving strategic choices by lazy and incompetent managers who were...
not kept on a tight enough leash by the true "owners", the shareholders. By the 1980s, these scholars argued, the problems had grown so great that shareholders were prodded to assert more control, which they did by means of a wrenching round of hostile takeovers, leveraged buyouts, and boardroom coups and constant pressure on corporate executives and directors to improve stock prices.

For shareholders' rights advocates and other scholars who start from the view of corporations as bundles of assets that belong to shareholders, the fixation on share value and shareholder control is thought to follow naturally and obviously from the view of shareholders as the "owners" of corporations. More sophisticated advocates of this point of view recognize the need for a more complex analysis. These scholars concede that property rights have already been unbundled in corporations and hence, it makes little sense simply to assert that one set of claimants in a large firm are the "owners" and even less sense to draw implications from that assertion about who should have what control rights over corporations.

Residual Claimants

But they argue there is still good reason for the fixation on share value and shareholder control rights. Legal scholars Frank H. Easterbrook and Daniel R. Fischel explain this reason as follows:

"Voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete. Votes could be held by shareholders, bondholders, managers, or other employees in any combination... One might expect voting rights to be held by a small group with good access to information—the managers. Yet voting rights are universally held by shareholders, to the exclusion of creditors, managers and other employees..."

The reason is that shareholders are the residual claimants to the firm's income. Creditors have fixed claims and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of shareholders, whose claims stand last in line.

As the residual claimants, shareholders have the appropriate incentives... to make discretionary decisions. The firm should invest in new products, plants and so forth, until the gains and costs are identical at the margin."3

Because shareholders are residual claimants, Easterbrook and Fischel argue, shareholders have the moral and legal standing to be treated as "owners" of the corporation (even if they are not legally owners of the corporation's assets) and to be given important control rights.

According to this theory, the answer to the question of what social role corporations should play, whose interests they should serve and who should have what control rights, is not determined by some simple assertion about who the "owners" are. Rather, it is derived from an analysis of who receives the "economic residual" generated by the enterprise and who therefore bears the economic risk. We should maximize the value of common stock because common stock is the claim on the economic residual created by the corporation. Maximizing its value, it is therefore argued, is equivalent to maximizing the total wealth generated by the activities undertaken by corporations.

Versions of Easterbrook and Fischel's formulation of the problem (which itself represents the culmination of a large body of scholarship beginning with the work of Ronald Coase and continuing with contributions by Armen Alchian, Harold Demsetz, Eugene Fama, Michael Jensen, William Meckling, Oliver Williamson, Oliver Hart and numerous others)4-8 have served as the basis for most of the discussions about corporate governance that have filled the legal, finance, and business journals in recent years. It is the accepted wisdom, if not outright dogma.

Firm-specific Investments

The analysis is brilliant as far as it goes. The problem is that it does not go far enough. Undoubtedly there are some corporations in which shareholders are the only residual claimants and in such cases, wealth is created most effectively by maximizing the stream of profits earned for shareholders. In such cases, the most efficient use of corporate resources is probably encouraged by enhancing shareholder control over residual decision making. But, as an empirical matter, most modern corporations do not fit the model underlying this analysis, and in practice, shareholders are rarely the only residual claimants. As some new work in the economics of organizations is beginning to recognize, any time there are parties other than shareholders who make investments specific to a given corporation—employees with specialized knowledge or skills, to cite perhaps the most prominent example—shareholders are no longer the only residual claimants in that corporation.

"Firm-specific investments", then, create several complex governance problems in a firm, especially when such investments include a mix of physical assets (or other alienable "property" such as patents and brand names) and human capital that are dependent for their effectiveness on each other. First of all, whenever investments in specialized inputs can create value, it becomes advantageous for the participants in the enterprise that uses those inputs to maintain long-term relationships with each other in order to extract the full value from the investment each has made. The problem is that it is difficult to write contracts that can govern such relationships over an extended period of time and that are flexible enough to respond to changing circumstances.
Second, if assets are dependent on each other—more formally, co-specialized, such as a highly specialized machine (or to use a more salient example in today’s economy, a highly-specialized inventory tracking system) together with the team of people who developed it and who have mastered its use—by definition, neither has much value without the other. It may be possible to measure the total economic surplus (or “rents”, to use the economic vernacular) that is generated by using these assets together, but there is no way to determine how much of that surplus would be allocated to which party. The division of rents in such cases is a matter of negotiation, in which precedents, rules of thumb, bargaining skills, and other non-economic factors may play a big role.

Despite the complexities that arise in enterprises in which firm-specific investments by a number of parties are needed, the Easterbrook and Fischel model assumes that it is possible to write satisfactory, enforceable, long-term contracts with most participants in the firm, including employees, suppliers, and creditors, so that such participants are paid fixed amounts that are not contingent on how well the enterprise as a whole functions. Then, what is left over after these fixed obligations have been met can be assigned to shareholders. It is on this point that the Easterbrook and Fischel/shareholder rights model falters.

Whenever employees must acquire firm-specific skills or knowledge (and if they did not need such skills, why would firms enter into long-term relationships with them as “employees” rather than simply hiring their services on spot markets?), the division of rents generated by a firm becomes subject to what B. Klein, R. Crawford, and A. Alchian (1978) first called “the hold-up problem.” A simple example will explain what this is.

Knowledge Capital

Suppose that a company wants to go into business manufacturing widgets, using a unique machine designed and built by company engineers just for this purpose. To operate the machine, the firm will have to hire a team of workers who must be trained to use that machine. Once the workers are trained, they are in possession of their specialized skills (or “knowledge capital”) and the firm is in possession of its machine. But neither has much value without the other.

Once the business is operating, if the workers are paid only their opportunity cost (the wage they could get elsewhere), they will have nothing to lose by threatening to walk out and take different jobs. Therefore, because the firm needs them to operate the widget machinery, the workers are in a good bargaining position to try to capture some of the rents generated by the widget business by threatening to quit if they are not paid more.

One solution for this problem is for the firm to contract with the workers to pay them somewhat less than their opportunity cost during their training period and in exchange, pay them more than their short-run opportunity cost once they are fully trained and the business is up and running. Employees would accept such a delayed payment plan and the associated commitment on both sides to a long-term relationship only if the expected value of the whole stream of wages exceeds the opportunity cost of a stream of spot contracts. In other words, under the employment relationship, the firm explicitly shares with employees some of the economic rents from the enterprise. This makes it more costly for employees to walk out, thereby reducing their bargaining power in future negotiations over the division of rents.

But, of course, this solution presents the opposite problem. If the workers helped pay the cost of training (e.g. by accepting a lower wage during the training period) in exchange for a promise of higher wages later, the managers of the firm are then in a position to expropriate some of the rents promised to workers by threatening to close down the business unless workers agree to work at a wage that is lower than what they had been promised.

The Division of Economic Surplus

The example illustrates a point made earlier. While the total economic surplus generated and captured by a company may be a function of technology and external markets factors, the division of that surplus among all the parties that contribute firm-specific inputs is a matter of negotiation and bargaining strength among parties within the firm. And the significance of this fact for the debate about corporate governance is that, in any firm where firm-specific skills or knowledge are an important input (which is probably most firms), the employees’ share of the rents can always be increased at the expense of the shareholders and vice versa: share value can always be increased at the expense of employees.

Consider the widget-making firm again. Over time, to maximize the value of equity, firm managers should continue operating as long as the present value of the expected stream of profits from the widget operation equals or exceeds the scrap value of the machine. The problem is that the accounting measure of “profits” of the business does not include all of the real economic surplus being generated by the activities of the widget business. Some of that surplus goes to employees in the form of higher wages. These promised higher payments to workers—their compensation for their firm-specific investments—are viewed as a cost to the firm, however. More generally, firm-specific investments
by participants other than shareholders will always drive a wedge between what is optimal for shareholders and what is optimal for society as a whole.

A socially optimal decision rule would require that the firm continue to operate as long as the present value of the economic surplus generated by the business is positive. A decision rule that maximizes share value, on the other hand, would require that the firm shut down whenever the present value of the profits (total surplus, minus the portion captured by workers in the form of higher wages) of the business falls below zero. The real economic surplus generated by the business could be positive and quite high, but if it is not high enough at least to cover the promised higher wages, managers seeking to maximize share value should not keep the business going. From the point of view of shareholders, the business would suffer losses in every period if it did so.

In other words, the higher wages promised to employees for their investments are, in fact, not truly "fixed". They come out of the economic surplus generated by the firm (the residual) and they are paid only as long as the firm continues to generate a large enough surplus. If employees have a high level of confidence that the surpluses will be large enough and that they will therefore continue to earn a wage premium, they will be motivated to make the necessary firm-specific investments. But if employees begin to believe that firms will routinely shut down and downsize, as soon as the surplus is squeezed, employees will have less incentive to make those firm-specific investments.

**Investments in Firm-specific Human Capital**

The problems introduced by investments in firm-specific human capital can theoretically be resolved in several ways without necessarily changing the legal structure of control rights in firms or requiring that managers and directors be accountable to stakeholders other than shareholders. But it would require significant changes in the way labor is compensated. Some critics of my point of view may argue, for example, that if the rents generated by widget making fall below the level required to pay the promised higher wages to employees, those employees will have a strong incentive to renegotiate their agreement with the firm to keep it from shutting down the widget operation prematurely. Share-value-maximizing managers, in turn, will have an incentive to engage in such negotiations. Therefore, the argument would continue, the presence of firm-specific human capital should have no bearing on whether firms should be run in the interest of shareholders.

But labor economists commonly argue that workers resist such renegotiations and wages are consequently downwardly rigid. The reason given is that, in large complex businesses, where firms are not required by law to share detailed, audited cost and revenue information with employees, employees may not be able to distinguish between cases in which rents are truly too low to support the promised higher wages and cases in which managers are just trying to expropriate promised rents from employees. If wages are rigid and management wants to reduce the amount of rents paid out to employees, it must actually lay off employees rather than cut their wages. Rigid wages thereby serve to strengthen the bargaining position of employees by making it costly for employers to try to expropriate rents. In any case, there is strong empirical evidence that employers adjust to declining rents by cutting jobs rather than by cutting wages.

Other critics may argue that firms do not actually promise "fixed" high wages. Instead, they make an implicit promise to share the rewards of the enterprise "fairly" and that this promise is credible to workers because the firm must maintain its reputation for fairness if it is to continue attracting skilled workers in the future. This supposed solution to the governance problem breaks down, however, if market conditions shift so that the firm has no need to hire new workers in the future. If a firm is in a declining market and needs to reduce, rather than expand, its workforce, it no longer has the same incentive to play fair.

The reputation argument will also break down if employees and potential employees lose confidence that reputation matters to firms. That could easily happen if firm identities (to which reputations are attached) are vulnerable to frequent or dramatic alterations. For these reasons, the waves of takeovers, buyouts, spinoffs, corporate reorganizations, restructuring and downsizings that have repeatedly struck the corporate sector in the U.S.A. since the late 1970s have probably done serious damage to the usefulness of reputation as a mechanism for ensuring a "fair" allocation of rents from firm-specific investments.

If firm-specific investments in human capital are not being rewarded satisfactorily, then we as a society will neglect such investments. How important are investments in firm-specific human capital to total wealth creation in corporations? No one knows for sure, of course. But labor economists who believe that firm-specific human capital may be quite important to wealth creation point to three kinds of evidence that employees accumulate valuable firm-specific skills if they stay with the same employer for an extended period. First, wages typically rise with job tenure by more than they would be expected to rise solely as a result of the employee's increased general experience. These higher wages are generally taken as evidence that the employee becomes more pro-

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ductive as he accumulates firm-specific human capital.

Second, job turnover rates (both layoffs and quits) typically fall with job tenure. This is also construed as evidence that employees accumulate firm-specific human capital that makes them more valuable to the firm and the jobs more valuable to the workers. The third piece of evidence is the fact that the costs of being laid off are typically larger for workers with more tenure.

Maximizing Wealth

If workers had only generic skills that they could easily take with them to the next job, labor markets would not be expected to exhibit any of these three features. Indeed, in industries such as general construction contracting, where workers can take all their relevant skills with them from job to job, they often do exactly that and do not accumulate tenure with any one employer. The most compelling evidence that firm-specific human capital is important is the simple fact that much economic activity is organized in ways that involve long-term stable employment relationships rather than a series of spot contracts and subcontracts.

Robert Topel finds a very strong connection between job seniority and wages, with wages in the typical employment relationship rising by 25% for a worker with ten years of seniority, even after controlling for other factors. As for the costs typically experienced by workers who are permanently laid off because a plant has closed or moved, Topel finds that "not only are costs large for the typical worker, but they are higher for experienced workers... and... for workers with greater job seniority." (1990, p. 209)

Topel reviewed a large sample of workers who had lost their jobs through business closings or layoffs in the mid-1980s and found that, on average, these workers earned about 14% less on their next jobs. The longer the worker had held his previous job, the greater the earnings loss. Workers who had eleven to twenty years of seniority earned 28% less on their next job, while workers with twenty-one years or more of seniority earned 44% less on their next job.

The survey data Topel used covered men of prime working age only, but if his findings can be generalized to the entire labor force, they suggest that as much as 14% of total wages and benefits paid to employees of corporations in the U.S.A. may represent a return to firm-specific human capital. This actually should not be surprising because, if the preceding arguments are correct, work is organized within firms precisely in those circumstances where firm-specific investments are important.

From 1990-1993, non-financial corporations in the U.S.A. paid out a total of $8.5 trillion in compensation to their employees. During that same period, those corporations earned $991 billion in pretax profits. If all of the accounting profits are counted as economic surplus, and 10% of compensation is counted as economic surplus, then accounting profits represented only about 54% of the total real economic surplus generated by corporate activity in the U.S.A. during those years. The rest of the surplus went to employees as a return on their specialized human capital. From the point of view of managers fixated on maximizing share value, the portion that went to employees was undoubtedly regarded as one of the costs to be reduced, rather than part of the real wealth created by corporations. Yet the return on firm-specific investments in human capital is part of what society as a whole should want to see maximized.

The Ground Rules of Governance

Corporate governance arrangements influence the efficient use of society’s resources and the ability of firms to create new wealth not only through their effects on the risks, rewards, prerogatives, and claims of shareholders, but also on the risks, rewards, incentives and motivations facing other participants in the firm. Governance systems, broadly defined, set the ground rules that determine who has what control rights under what circumstances, who receives what share of the wealth created, and who bears what associated risks. Governance systems thus help determine how decisions are made about spending resources on building organizational capabilities, and how management and employees are evaluated and compensated. In industries and firms where human capital is critical, these factors are likely to affect wealth-creating behavior substantially. A firm’s employees are much more likely to be motivated to find new ways to innovate or cut costs, for example, if they have confidence that they will share in the wealth created by these activities—that it will not be expropriated from them by other participants in the enterprise—and if they believe that management will listen to them and devote resources to their ideas.

In this context, corporate governance discussions that start from a premise that corporations are a bundle of assets owned by shareholders, that measure wealth creation only in terms of the share price of corporate stock, and that focus only on the power relationships between shareholders and managers have the emphasis wrong. Reforms built on this premise may even destroy wealth-creating capacity. To be sure, the shareholder-management nexus is important. But it is not the only relationship within the corporation that is important to wealth creation. Cor-
porate governance discussions need to acknowledge this reality explicitly.

Pursuing the Interests of All Stakeholders

First, management and boards of directors should understand their jobs to be maximizing the total wealth-creating potential of the enterprises they direct. Second, depending on the issue and the enterprise at hand, some stakeholders will matter more than others in some decisions. Third, where it is concluded that employees or other stakeholders have significant specialized investments at risk, their rights and obligations as owners should perhaps be formalized through compensation schemes, organizational forms, or other arrangements that place significant amounts of the company’s equity under the control of the at-risk stakeholders and that assign control responsibilities commensurate with their equity stake to this group.

If stakeholders are defined to mean all those participants who have substantial firm-specific investments at risk, then the idea that firms should be run in the interest of all stakeholders, far from being at odds with sound economic reasoning, is actually a reasonable and appropriate basis for thinking about corporate governance reforms. Rather than abandoning the idea that firms should be run for all the stakeholders, contractual arrangements and governance systems should be devised to assign control rights, rewards, and responsibilities to the appropriate stakeholders—the parties that contribute specialized inputs.

References


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