

## I. Toward a Theory of Organizational Governance

- A.** In addition to adopting internal reward and recruiting systems, formeteurs often adopt procedures for making and revising policies.
- Formeteurs recognize that their initial policy decisions (standing reward systems and goals) are provisional, rather than final.
  - They also recognise that they may have to revise their strategies for dealing with the external world as changes take place.
- B.** In order to make decisions and revise past decisions, information has to be gathered in order to identify and rank alternative goals, conditional reward systems and recruiting systems.
- i. Most economic models of the firm assume that this part of the conduct of business is intuitively obvious--simply adopt the best available technology.
    - However, decisionmaking in dynamic environments is rarely trivial or easy.
  - ii. The durability of an organization is substantially determined by its standing procedures for analysis and decisionmaking--that is, its government.
- C.** As in other aspects of organizational design, there are common problems faced by all organizations and common solutions adopted.
- i. Many, perhaps most, organizational governments are forms of the king and council template.
  - ii. There are many reasons for this and in this lecture we will explore a subset of the more important reasons.
- D.** It bears noting that the enterprise of governance is broadly similar in essentially all governments.
- i. All types of government create and enforce laws through threats of one kind or another (conditional rewards and punishments).
  - ii. All organizational governments have routines for making policy decisions.
  - iii. For example, within national goverments:
    - In a democracy, those inside and outside of government are subject to the same laws.
    - In an aristocracy, members of the ruling elite are not normally above the law, but often subject to a somewhat different law than others.
    - In dictatorships, the dictator may be formally placed "above" the law of governance, but all others have to follow the law as it applies to them.

## II. Natural Organizational Governance

- A.** Perhaps the most “natural” form of organizational governance is the one (implicitly) assumed by most economists and also by many political theorists.
- i. Formeteurs may simply retain their initial authority to make and revise all major policy decisions after their organizations are up and running.
    - A single formeteur may retain complete control over an organization’s policies in cases in which the organization is founded by a single individual.
    - A ruling committee or council may retain control over an organizations policies in cases in which a small group founds an organization.
  - ii. Such “authoritarian” decisionmaking procedures have many advantages for formeteurs and their organizations.
    - Formeteurs often have a superior understanding of organizational possibilities, which justifies their initial investment of time and attention to assemble a team and devise methods for advance particular goals.
    - Formeteurs know their own goals better than others are likely to and normatively have leadership skills that allow them to form and motivate groups at lower costs than others.
    - Leadership skills often include a relatively large informational base and the ability to persuade others that it is in their interest to defer to the formeteur’s direction.
- B.** As organizations increase in size, informational problems become more complex.
- i. An organization’s conditional reward structure may require a good deal of monitoring of team member performance.
  - ii. The external circumstances may change in unpredicted ways, and require the organization’s goals and/or conditional reward system to be revised.
- C.** To assist in gathering information and evaluating alternatives, formeteurs will often find it useful to assemble a team of “advisors,” who specialize in such tasks.
- i. However, a team of advisors is not necessarily value enhancing, because formeteurs usually confront what Wintrob calls the **dictator’s dilemma**.
  - ii. Because of a dictator’s control over organizational rewards, it is often in the interest of “advisors” to simply tell the dictator what he wants and/or expects to hear.

- iii. As a consequence, in-house advisors may not add much to a dictator's stock of information or improve his/her/their decisions.
- iv. Advisors, like other team members, have to be motivated and selected.

**D.** To address this dictator's dilemma requires somewhat more sophisticated institutions for "advice production."

- i. To advance informational goals and reduce bias, formateurs will often use committees representing diverse interests.
- ii. To enhance the value of the information passed on to the formateur(s), the committee may be advised to use majority rule.
  - Under majority rule, median voter outcomes tend to emerge.
  - In the context of an advisory committee, the median voter outcome can be thought of as a median estimator.
  - Median estimators tend to be relatively robust and unbiased estimators.
  - (Condorcet's jury theorem relies, implicitly, on these estimation properties.)

**E.** To motivate the committee, it is often useful to delegate some genuine decisionmaking authority to them.

- i. This may be part of their motivation system--authority being a good that many people value.
  - Even limited authority may increase a person's status, have reputational effects that increases the value of their information services for others, and may produce opportunities to benefit from the efforts of rent seekers.
- ii. Delegation also tends to free formateur time and attention for other tasks--such as leisure and forming new organizations.
- iii. Given such advantages, it will often be sensible for a formateur (or council of formateurs) to adopt a divided form of organizational government in which the authority to make policy is shared between the formateur(s) and their advisory committee.
- iv. That is to say, the **informational interests** is sufficient reason for "kings" to have "councils."

**F.** Similar, but slightly different informational advantages can also induce "councils" to have "kings" (chief executive officers).

- Such institutions can improve intra-organizational monitoring by reducing free rider problems.

**G.** Thus, a fairly straightforward case can be made that organizational governments tend to be drawn from the "**king and council template.**"

- i. The king and council template is a decisionmaking institution that has both a chief executive and a committee, each with some authority over the policy choices of interest.
- ii. If you think about this a bit, you will see that this is an extremely common form of government in all sorts of organizations: firms, clubs, churches, and national governments.

**H.** There are also other reasons for the interest of formateurs to relinquish part or all of their initial control over their organization's policies.

- i. For example, formateurs of contemporary commercial enterprises often give up part of their control over their organization in exchange for investments by those who purchase voting shares.
  - By "going public," formateurs become "shareholders in" rather than "owners of" their enterprise.
  - Such trades of authority for money often increase the resources available to their organizations, albeit at the cost of reduced control over their organizations.
  - Similar transactions often took place between European kings and parliaments in the period between 1400 and 1900, as developed below in Part II of the book, and analogous transactions took place between local rulers and "free towns" in the late medieval period.
- ii. No threats of violence were necessary for such shifts of authority to occur.
- iii. "Sharing policymaking authority is partly driven by informational and time allocation problems that emerge as an enterprise increases in scale and complexity and partly by other practical advantages that can be realized by shifting and trading authority within their organizations.

### III. Constitutional Organizational Governance

**A.** To the extent that an organization has standing procedure for making policies, it can be said to have a constitution.

- i. A constitution in this sense is a collection of "rules for making rules."

- ii. There are a variety of reasons why such procedures tend to be fairly stable through time, including many of the same ones that justify “rational institutional conservatism” for an organization’s conditional reward system.
  - Stability increases predictability of the organization’s rules.
- iii. Well designed, a constitutional government also increases survival prospects for an organization.
  - They improve information gathering and policy selection.
  - Indeed, the menu of governmental designs that formateurs choose from tends to include only successful ones that promote durability.
  - The worst governmental structures all fail and so are not observed!

**B.** Constitutions in this sense create “political property rights” for those with positions of authority, that can in principle be traded among those with

**C.** However, no constitution is perfect. And, when this is recognized by formateurs, there will also be **standing procedures for amending** their organization’s constitution.

- Normally these will require “trades” between those already in possession of authority.

**IV. That an organization’s laws are for the most part purposely adopted have a number of implications.**

**A.** The laws adopted generally advance the aims of the rulers be they a dictator, aristocracy, or broad cross section of the citizenry (a majority in well-functioning democracies).

- i. Laws will be revised as those interests change through time.
- ii. They will also be revised as mistakes are discovered, or new better theories of the effects of law come to be widely accepted.

**B.** Insofar as the interests served remain constant, laws and institutions *tend* to **“improve”** through time.

- i. As legal experiments are made, new laws may be found superior to old laws.
- ii. The laws in place are the **most efficient** ones that the “rulers” **know of**.
  - Old laws will be replaced by new laws whenever new laws are expected to better serve the interests of those in power.

- Thus, changes in information can lead to new legislation and improvement.
- Laws in general and laws governing governance (constitutions), thus, have an evolutionary character that reflects accepted historical experiences.

**C.** If the interests of the ruler change through times, laws will change for reasons having nothing to do with increased effectiveness or efficiency.

- It also bears noting that the interest of “the government” may differ from the general interest of its citizenry.
- Thus, increased governmental efficiency *may actually make the average citizen worse off* rather than better off in cases in which the interests of rulers differ from those of its citizens.

**D.** Purposeful behavior thus has some clear implications for the types of performance of different kinds of governments through time.

- i. There should be a general tendency toward more effective governance in the sense that the “rents” (social surplus) should tend to be more and more concentrated in the hands of those that have the power to write new laws (to govern).
- ii. There should be a general tendency toward more security, in the sense that those in power are increasingly likely to retain power through time.
- iii. The first of these implications suggests that wealthy “elites” should emerge under dictatorships and aristocracies, but not within well-functioning democracies.

- Evidence of this can be seen in the physical architecture, music, and art of aristocratic-royal Europe as opposed to modern Europe or the contemporary republican and more representative governments of the Netherlands (1600-1800) and USA (1700-present).
- However, unfortunately for future tourists and historians, not every elite spends its “rents” on durable forms of amusement (architecture, music and art).

**E.** Organizational history is “piecewise” rational, but not necessarily globally so.

- i. Generally, the choice is among a subset of possible laws, namely those that other societies have already tried out.
  - This body of experimental evidence is increased by new experiments and new results through time

- Thus, successive laws tend to more effectively promote the interests of the rulers, whoever they might be.
- ii. However, the best of all possible laws or institutions is unlikely to be in place.
  - The set of laws considered by policy makers tends to be a subset of laws and institutions that already exist, rather than all possible laws and institutions.
  - Since only a subset of the set of all possible laws is evaluated by rulers (and their staffs), the law will not be the "most" effective laws possible, only the most effective laws that are known.
- iii. To say that laws are purposely adopted and/or left in place, is not the same as claiming that "the law" is fully understood by those controlling government.

#### V. **Constitutional Gains to Trade: Transitions between types of government.**

- A.** Insofar as those in power tend to be made worse off by changes in in the division of policy making power and/or range of interests represented, we would expect to see relatively few constitutional bargains and very few radical transformations.
- i. Insofar as such transformations take place gradually and peacefully, we would expect to see changes in either the interests or opportunities of those in power.
- That is to say, new gains from institutional exchange among those inside government or between those inside and outside government must emerge.
  - Because governmental institutions already tend to benefit those in authority, the revisions of government tend to be small and peice wise rather than large and revolutionary.
- B.** It is possible within the king and council templates for a series of shocks to peacefully shift most authority from kings to councils or from councils to kings--although this normally requires a long series of constitutional bargains.
- When combined with changes in selection procedures for council members, the result can be democratic governance.
  - (Notice that no revolution or constitutional convention is required for this.)

#### VI. **Governments differ from most organizations because their members and their citizens are not as free to leave as in smaller less encompassing organizations.**

- A.** This allows government to produce some kinds of activities that voluntary clubs, firms, and religious organizations will find difficult or impossible to undertake.
- B.** It also allows them to use greater use of coercion (significant penalties) to control the game because exit tends to be unavailable or a less attractive alternative.
- i. Because of the latter, governments will be able to exercise more control over their members and over those "served" than other organizational forms.
- None the less, it remains the case that someone (the formateur?) benefits from governmental organizations
- ii. In some extreme cases, only a single person, the dictator or emperor, may be better off.
- Others in society may gain as well, but only because this in some way increases the welfare of t he dictator, by encouraging loyalty, the production of security services, or the production of additional tax base.
  - For example, the government may provide goods and services, but only insofar as such policies advance the interests of the dictator.
- iii. In other cases, it may be argued that government advances the interests of a small elite, an aristocracy of some kind.
- iv. In still others, it can be argued that essentially everyone in the society governed is better off.
- Under social contract and popular sovereignty theories of the state, the entire citizenry is considered to be the "formateurs."
  - Governments formed by contract can solve a wide variety of public goods and coordination problems for those within the community of interest
  - They may also discourage externality generating behavior that makes people worse of as with public health and many environmental regulations.
  - (How to contrive such governments is by no means an easy task, but modern theories of constitutional governance attempt to understand how it can be done.)

## VII. Appendix: A Digression: Two Reductionist (Essentialist) Theories of the Origin of the State

- A.** There are essentially two "pure" theories of the origin of government, and these theories also represent the two polar visions of the "exploitative" and "productive" state. .
- i. One postulates a state that emerges out of skill in organized force. Such a state is created when one party conquers all those within a given territory. The rulers of such a state, simply impose their will on all those within its domain. In the limiting case, the ruling group is a single individual, a dictator, who finds it in his interest to form a state as a method of enjoying the fruits of power. (Olson, Tullock)
  - ii. The other pure theory of the state conceives a state as emerging out of voluntary agreement. That is to say, individuals find it in their interest to create a state as a means of advancing common ends that can best be accomplished with collective means. Under this theory, any coercive means used by the state to collect taxes and assure national defense are grounded in an agreement that in the absence of such methods, free rider problems would prevent the state from advancing the interests of all that agree to the social compact. (Locke, Rawls, Buchanan)
- B.** Mancur Olson has pioneered work on the productive, but coercive state. He demonstrated that any dictator has an encompassing interest in the welfare of his "citizens" insofar as by increasing their welfare the coercive regime may secure greater tax revenue or security.
- C.** James Buchanan has extended the social contract theory of Hobbes by applying modern tools of economic analysis and game theory to the design problem of social contracts.
- i. His concept of social contracts is more optimistic than that of Hobbes (although less optimistic than Rawls) in that he believes that Leviathan can be constrained by a constitution.
  - ii. The contractarian theory of the state suggests that combination of property rights and a state (property right enforcer) can allow groups to escape from the dilemma of the thieves in a manner that potentially make all better off (net of the cost of the state).
  - iii. That is to say, there are at least occasionally mutual gains that can be realized by agreeing to be "coerced" by a third party--rule enforcing government or tax collector.

**D.** (These two theories of the state **may both operate simultaneously**. Note that an invading army can be a very strong reason to join forces under a social compact. Defense alliances are often voluntary agreements to repel a dictatorial invader! Moreover, Pirates and other organized groups of roving bandits often create formal agreements.)

## VIII. Olson's Model of the Policies of a Secure Dictatorship

- A.** Democracies have historically been a very small minority of the governments in existence.
- i. Thus dictatorships are an important type of government to analyze and also, as it turns out a fairly easy one to examine.
  - ii. (In spite of this, surprisingly little work has been done on dictatorship. Wintrobe, Tullock, and Olson have recent books and papers on dictatorship which account for most of the literature.)
- B.** The Olsonian model assumes that a dictator exists and models the fiscal policies that a profit maximizing dictator would adopt.
- i. The assumed rationale for political power is analogous to that of a slave holder in the old south, except that the plantation can not be sold.
  - ii. It turns out that a revenue maximizing dictator's interest in tax revenue leads him to provide public goods that increase national wealth (taxable wealth) and to tax at less than 100%.
  - iii. The latter implies that his subjects share in any prosperity induced by the dictator's public policies.
  - iv. And, moreover, insofar as the dictator can not fully capture the fruits of his subjects' labor, the "ruled" are made better off by the dictator, at least relative to what they would have realized under Hobbesian anarchy. That is to say, the conquered parties realize greater net of tax income than required for subsistence. (Of course, their alternative state might not have been the Hobbesian jungle.)
- C.** (Note that security interests may make a dictator less interested in the interests of groups whose support is difficult to obtain at the margin or if he has a short time horizon.)
- D.** The simplest model is one where the dictator acts as an **income maximizing Leviathan** (as assumed in Brennan and Buchanan, and in Olson and McGuire).

- i. A secure dictator, whose rule is unchallenged by potential rivals or invaders, will select tax and expenditure policies to maximize his income:
  - $Y = t N y(G,t) - c(G)$
- ii. where  $y$  a function representing *average* or per capita national income and  $N$  is the number of subjects within the kingdom. Average income rises as  $G$  increases and falls as  $t$  increases.  $t$  is the tax rate and  $G$  is a national service that costs  $c(G)$  to provide.
- iii. First order conditions of ii characterize  $t^*$  and  $G^*$  for the dictator.
  - $Y_t = t + tN y_t = 0$  at  $t^*$  e. g. given  $G^*$  set  $t$  to maximize tax receipts
  - $Y_G = tN y_G - c_G = 0$  at  $G^*$  e. g. given  $t^*$  set  $G$  to maximize tax receipts
  - Because the tax base can be increased by services, and the dictator has an interest in the tax base, he can be said to have an encompassing interest in the wealth of his subjects. After all that is where his taxes come from.
- iv. On the other hand, this is not a complete encompassing interest. Note that  $G$  tends to be *underprovided* by the dictator insofar as he receives less than the complete marginal benefit from the service. The national income maximizing level of government services requires
  - $N y_G - c_G = 0$  not  $tN y_G - c_G = 0$
  - the marginal benefits from government programs should be set equal to the marginal cost of  $G$ .

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**C.** (Note that security interests may make a dictator less interested in the interests of groups whose support is difficult to obtain at the margin or if he has a short time horizon.)

**D.** The simplest model is one where the dictator acts as an **income maximizing Leviathan** (as assumed in Brennan and Buchanan, and in Olson and McGuire).

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- ii. where  $y$  a function representing *average* or per capita national income and  $N$  is the number of subjects within the kingdom. Average income rises as  $G$  increases and falls as  $t$  increases.  $t$  is the tax rate and  $G$  is a national service that costs  $c(G)$  to provide.
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  - Because the tax base can be increased by services, and the dictator has an interest in the tax base, he can be said to have an encompassing interest in the wealth of his subjects. After all that is where his taxes come from.
- iv. On the other hand, this is not a complete encompassing interest. Note that  $G$  tends to be *underprovided* by the dictator insofar as he receives less than the complete marginal benefit from the service. The national income maximizing level of government services requires

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- the marginal benefits from government programs should be set equal to the marginal cost of  $G$ .

### E. Practice Problems

- i. It bears noting that two dictators can be worse than one.
- ii. To see this consider the case of two toll collectors on the Rhine.
- iii. Each knows that the shipping along the river increases as public services are provided and falls as tax rates (tolls) increase other things being equal.
- iv. Let shipping be simply  $S = K - b(t_1 + t_2) + c(G_1 + G_2)$  and net tax revenue be  $T_i = t_i S - c(G_i)$
- v. Holding public services constant ( $G_i = k$ ) determine each river baron's optimal tariff rate. (Assume that neither river baron knows what the other is doing.)
- vi. Compare this rate with that under a single ruler.
- vii. Now, hold taxes constant, and determine the public service levels that will be forthcoming under the two vs. single river baron cases.