

## **Chapter 3: Organizational Governance in the Long Run**

### **A. Governing in the Long Run**

All of the conclusions reached in chapter 2 about how formeteurs create organizations to advance short and medium term goals also apply to cases in which formeteurs attempt to advance long-run goals. Organizations created to advance long term goals have to overcome the same recruiting, motivational, and adaptation problems, which implies that they will have recruiting, reward, and governance systems that are fundamentally similar in most respects. Formeteurs that found organizations to advance long term goals confront similar problems and many of their solutions will also be similar. Formeteurs of such organizations, for example, are likely to be aware of the difficulties of robust organizational designs, so likely to pay even more attention to “best practices” when selecting governance and reward systems.

There are, nonetheless, significant differences between organizations designed to advance long term goals and those expected to be short lived. Perhaps the most obvious of these is that durable organizations will outlive their founders. In the long run, their formeteur(s) will necessarily turn over policymaking authority to successors of one kind or another. It is also likely that somewhat larger adjustments of the procedures of governance and other standing policies will be necessary in the long run than in the short run, because more unfamiliar (low probability and new) circumstances are more likely to be experienced in the long run than in the short run. Other members of an organization’s governing team (and their successors) will also need to be replaced.

Long run solutions to the problems of governance consequently include standing procedures for replacing their government officials, as well as procedures for adjusting the standing procedures of organizational governance. The latter, it turns out, are constrained by advantages of stable, predictable governance in the long run, as well as institutional conservatism. It turns out that the king and council template provides a variety of “natural” solutions for many long-term governance problems.

### **B. Decision Costs, Standing Policies, and Organizational Rule of Law**

Organizational governments face a continuing stream of decisions to be made. Should “we” continue what we are doing or change, and if the latter, how so? Because not every problem or opportunity can be analyzed simultaneously, a common decisionmaking procedure is to group

problems into more or less independent and separable subsets that can be dealt with one at a time. That is to say, organizational governments tend to use an “other things being equal” methodology analogous to that which is widely used in natural science, engineering, social science, and history. After such problem sets are identified, they can be ranked from most important to least important (from those most likely to those least likely to affect formateur interests significantly). This allows the time and attention of policymakers to be efficiently allocated among problem sets. Information is gathered and analyzed, as necessary, to rank both problems and alternative solutions for the problem class at hand. When this is done perfectly, the most important decisions are made first, the second most important second, and so forth.

If circumstances are stable and few mistakes have been made, past decisions will left in place. They will need to be revised only when new problems emerge or new relevant information becomes available. These policy decisions are normally enforced by the organization’s standing procedures for reward and punishment. Rule followers are rewarded and rule violators are normally punished (or not rewarded). In this manner, sequential decisionmaking by an organization’s governing body tends to create a more or less stable set of policies and rules for the organization. The result is a series of standing policies and rules that remain in force for significant periods: an organizational “law of the land.”

The stability of these standing procedures and policy decisions is increased by many of the same considerations that support rational institutional conservatism for internal reward systems. Forward-looking formateurs realize that predictability allows somewhat lower rewards to be paid to risk-averse team members through time and also tends to reduce intra-organizational conflict over decisionmaking procedures and responsibilities. Any hypothetical advantages from alternative rules remain abstract, untested, less studied, and so more risky. Moreover, changes in the standing rules will be resisted by those who had expected to profit from the existing routines, which increases the cost of changing the rules and further increases their stability.

### *Risk Aversion and the Economic Advantages of Stable Rules*

To illustrate the economic advantages of stable rules and patterns of enforcement, consider the effects of revising the organization’s artificial reward system. Suppose that the standing rules initially specify that if a team member performs duty D, he or she is entitled to reward R, but if not, he or she receives punishment Z. If the team member decides to leave the team, he or she receives payoff X. In chapter 2, following the rules was called “working” and disobeying the rules was called

“shirking,” which are plausible interpretations of choices to “follow” or “disobey” the rules that advance organizational (formeteur) objectives. A ruleful-behavior inducing reward system has payoffs  $R > Z > X$ .

Instability and arbitrariness in rules, rewards, or punishments make the payoffs associated with following the rules stochastic, rather than certain. For example, suppose that, rather than certain reward  $R$ , there are two possible rewards for rule-following behavior,  $R_1$  and  $R_2$ , which are received with probability  $P_1$  and  $P_2$  when duty  $D$  is performed. Similarly, rather than punishments  $Z$ , there may be penalties  $Z_1$  and  $Z_2$  received with probabilities  $F_1$  and  $F_2$ . In such case, it is anticipated long term (average) rewards and punishments that matter rather than the specific rewards and punishments; here  $R^e = P_1R_1 + P_2R_2$  and  $Z^e = F_1Z_1 + F_2Z_2$ .

**Table 3.1**

**Inducing Rule-Following Behavior**

Team Member A		Team Member B		
		Obey	Disobey	Exit
Obey	$R^e, R^e$	$R^e, Z^e$	$R^e, X^e$	
Disobey	$Z^e, R^e$	$Z^e, Z^e$	$Z^e, X^e$	
Exit	$X^e, R^e$	$X^e, Z^e$	$X^e, X^e$	

The cell entries are the (expected) subjective payoffs for team members A and B for obeying or disobeying organizational rules and for leaving the organization.

Risk aversion implies that even if the same average payments are received by team members, the subjective value of those rewards and punishments is lower than that of the original completely predictable case. To further flesh out the illustration, suppose that the subjective value of reward  $R$  is  $U = R^{(0.5)}$ . Let  $R = 100$ ,  $R_1 = 50$ ,  $R_2 = 150$  and  $P_1 = P_2 = 0.5$ . The expected subjective value (utility) of certain reward  $R$  is  $(1.0)(100)^{(0.5)} = 10$ . The expected utility of the stochastic system of rewards is  $(0.5)(150)^{(0.5)} + (0.5)(50)^{(0.5)} = 9.66$ . The average reward for the stochastic system has to be more than five percent greater than the certain reward to generate the same subjective value.

When rewards are arbitrary or unpredictable, it will cost more to generate the subjective rewards that are greater than punishments and that are subjectively greater than rewards available outside the

organization. As rewards and punishments become less predictable, the net benefits of continued association with the organization becomes riskier, and less valuable for risk averse team members. In nasty environments, exit may not be an attractive option, but it is still a constraint on the arbitrariness of organizational incentive schemes. Even a pirate ship eventually arrives at port. In this manner, the economics of reward systems and exit possibilities reduce arbitrariness within voluntary organizations and also reduce the flexibility of reward systems.

Formeteur arbitrariness is thus constrained to the subset of “whims” that help solve team production problems or which have minor costs relative to the satisfaction obtained by the formeteur(s). Arbitrariness is acceptable to team members only if  $R^e > X^e$ , that is to say, only if the average reward for following the organization’s rules are greater than that associated with opportunities outside the organization.<sup>14</sup>

Risk aversion on the part of team members also implies that an organization’s government cannot costlessly adjust the organization’s rules to obtain modest short-term efficiency gains, because such adjustments tend to reduce rule-following behavior and increase recruiting and retention costs. The anticipated efficiency gains (or formeteur advantages) from reforms have to exceed the higher retention and recruiting costs associated with less predictable reward systems.<sup>15</sup>

### *Organizational Rule of Law*

As the standing rules becomes well-known throughout an organization, there will be an obvious distinction between day-to-day decisions made using standing procedures and revisions of the standing procedures and policies.<sup>16</sup> Insofar as the standing rules are generally believed to advance the interests of the organization, a widespread belief in the “rule of law” or “custom” as a norm might emerge among an organization’s government and among its membership. Such ideas will be

---

<sup>14</sup> Advantages associated with manipulating exit costs are discussed in chapter 4 for the case of territorial governments. Exit cost–manipulating systems tend to increase retention at the same time that they increase the cost of recruiting new team members from outside the organization or territory of interest.

<sup>15</sup> In cases in which errors are made in detecting disobedience, the expected payoffs will have a similar probabilistic structure. In this case, there will be some probability that an obedient team member will be punished (receive  $Z$ ) rather than rewarded. And there will also be some probability that a disobedient team member will be rewarded (receive  $R$ ) rather than be punished. Monitoring also tends to reduce the cost of compensation systems. See chapter 4 below.

<sup>16</sup> Buchanan and Brennan (1985) argue that this is a key distinction between constitutional and nonconstitutional decisionmaking.

encouraged by the organization's leadership insofar as they increase organizational surplus or support their authority by, for example, reducing personnel costs or internal conflict.

Of course, organizational rule of law does not necessarily imply equality before the law in the sense used by modern legal scholars and liberal political theorists. Neither rewards nor punishments are likely to be uniform for all members of an organization. For example, senior members and relatives of the formeteurs may be subject to lower (or higher) standards of conduct and different punishments. Team members with greater exit costs or less attractive external opportunities may be paid less for the same work than those with lower exit costs and better external opportunities. Within large organizations there are also asymmetries in policy making authority. Policies made at "higher" levels of the organization bind others "below" them. In this manner, asymmetries in authority creates a hierarchy in which one's "level" is determined by one's relative ability to impose rules on others in the organization. This is not to say that all rules are developed "top down," but it is to say that those at lower levels have less influence over policy than those at upper levels, essentially by definition.

Such unequal and asymmetric reward and punishment systems can, none the less, be systematic and rule based. They may be stable for long periods of time, because they advance the interests of "law-abiding" team members and forward-looking organizational governments.<sup>17</sup>

A subset of a prominent organization's standing rules may also be incorporated into a community's civil law in places in which such rules are widely believed to increase efficiency, equity, stability, or justice. There are, for example, many communities and regional governments that were originally founded by organizations such as firms, military organizations, and churches. Trading posts, military bases, and monasteries often catalyze the formation of towns and cities. Colonial enterprises often create regional and local governments in order to advance their economic, military, and religious agendas.

### **C. Constitutional Organizational Governance: Written and Unwritten Charters**

Standing decisionmaking procedures and norms do not have to be written down to characterize an organization's government or reward systems, although this is often done in large organizations to increase predictability and reduce conflict. Written rules increase certainty for those subject to their rewards and punishment systems and reduce conflict by reducing the scope for disagreement about what the standing procedures really are. Formeteurs adopt written rules not because they

---

17

operate behind a veil of ignorance or necessarily believe in the “rule of law” as an abstract principle of justice, but for the practical reason that stable well-understood procedures tend to improve the performance of their organizations and reduce their costs, just as written contracts that specify the terms and duties of agreements between independent persons and organizations tend to increase the value generated by such agreements. Without such standing rules and systematic rewards and penalties, the cost of team production would be higher, and organizations would lose productive team members to other organizations in which rewards and punishment are more predictable. Even pirate captains often use written contracts to attract and keep an effective crew on their ships (Rediker 1989, Anderson and Gifford 1996, and Konstam 1998, Leeson 2007).

A written charter for an organization can be regarded as its “constitution” insofar as it describes the core procedures for making standing policy decisions, the selection process for membership of its decisionmaking bodies, and describes how authority to make and revise policies is distributed. It bears noting that such core procedures and constraints are normally far easier to describe than are the many informal relationships that completely determine an organization’s decisionmaking procedures. In cases in which such informal practices are also durable, stable, and significantly affect policymaking decisions, it may be said that large organizations have both written and unwritten constitutional rules. The fact that a written description is incomplete, however, does not imply that written rules have no effect on an organization’s practices. It only implies that the *de facto* standing decision procedures and compensations systems are more complex than represented in writing.

Although there is a sense in which an organization is only as old as its charter, there is also a sense in which every charter tends to be far older than the organization described. Both the written and unwritten parts of an organization’s charter normally include procedures and norms taken from organizational templates that proved successful in earlier times.<sup>18</sup>

#### **D. After the Founders: the Problem of Succession**

At some point in time, every durable organization has to move beyond the period in which formateurs dominates their organizational governments. In some cases, this may occur because the

---

<sup>18</sup> See, for example, Sterzel (1994) for a concise overview of the historical antecedents of contemporary administrative law and procedures in Sweden. Evidence of the importance of innovations in writing and record keeping is developed in Dudley (1991, 2000), who provides a historical and economic analysis of how informational technologies can affect the size and scope of territorial governments. Although his analysis focuses on bureaucratic reforms within territorial governments, his analysis of the importance of information technology clearly applies to other organizational bureaucracies as well.

formeteurs decide to transfer all of their authority for making policy decisions to others, so other matters can be focused on, perhaps founding other new organizations. In other cases, formeteurs may retain control until they become incapacitated because of illness, age, or death. Formeteurs do not live forever. In both cases, the transition from formeteur to successor governments is often a crisis point for organizations, because effective governance often ends with a formeteur's departure. The formal rules were developed with the formeteur goals and talents in mind and the supporting culture of the enterprise may have largely been based upon deference to the founder(s). The departure of the formeteur(s) thus tends to undermine both the governance and culture of their organization.

### *Solutions to Intra-Organizational Conflict Can Increase Succession Problems*

Although durable organizations outlive their founders, it bears noting that durability in this sense is not always in the formeteur's interest. A formeteur often becomes wealthy or widely respected as a consequence of his or her organization's success. Successfully solving team production and governance problems often produces profits, prestige, and power.

To the extent that these are largely consequences of successful standing procedures, others inside and outside the organization may attempt to obtain those rewards for themselves by taking over the organization's government. The greater the rewards available to the organizational leaders the more it pays to seek such high positions. Competition over who will rule an organization can be intense, but such internal competition is not always good for the organization, because it diverts the time and attention of formeteur(s) and potential rivals away from solving organizational problems. By doing so, it tends to reduce and/or consume a substantial part of the organization's potential surplus. Moreover, those engineering successful takeovers (and palace coups) normally replace the organization's top officeholders (those with the most policymaking authority), which usually includes the formeteur(s), as noted in chapter 2.

Formeteurs naturally take the risk of being pushed aside and losses from internal rent-seeking into account when choosing their organizational designs. One organizational strategy used by many formeteurs is to make themselves "irreplaceable." Opportunities for rivals to secure the experience and broad support necessary to become an organizational rulemaker may be blocked in various ways. Potential rivals may be rotated among distant posts or banished from the organization when serious threats are detected. The responsibilities of other senior team members may be narrowed

and routinized beyond the point of economic efficiency to make them easier to replace and also less able to replace the formeteur.

This method of maintaining control and reducing internal conflict makes the formeteur's policymaking experience unique within their organization and critical for their organization's continued success. In such cases, it will be widely understood by team members that replacement of the "ruler" would tend to reduce the effectiveness of organizational decisionmaking. This further reduces support for possible rivals and increases opposition to such takeovers. It also reduces the "leadership rents" available to potential rivals. In this manner, organizational designs that create "irreplaceable" rulers tends reduce unproductive conflict within the organization and increase the expected returns of those holding leadership posts.<sup>19</sup>

Unfortunately, while advancing formeteur interests, that particular solution also implies that a formeteur's departure or death tends to greatly reduce the efficiency of his or her organization. The death or exit of a founder in such cases tends to create an organizational crisis. It reduces the effectiveness of organizational governance and produces new conflict for control of their organization among possible successors. These effects reduce the organization's ability to respond to new circumstances, reduce its surplus, and may also undermine the organization's internal culture by reducing cooperation among other team members.<sup>20</sup> It is for such reasons that many clubs, family businesses, small churches, and dictatorships often disintegrate shortly after their founder's death or departure.

In contrast to many other governance problems, the irreplaceable formeteur does not have strong reasons to solve the resulting transition problems, although other members of the organization (and his or her heirs) may. Whether such formeteurs have interests that extend beyond their departure or death depends partly on their goals, partly on the nature of their organization's enterprise, and partly on the institutions in place.

### *Organizational Leadership Posts as Property*

The simplest solution to the succession problem confronted by an irreplaceable formeteur is to simply appoint a successor shortly before his or her departure. Leaving the decision to the last

---

<sup>19</sup> See Tullock (1987, Ch.2) for an overview of some of these strategies. See Hillman and Katz (1987) for a model of internal conflict over organizational rents.

<sup>20</sup> The modern contest and rent-seeking literatures demonstrate that conflict in such circumstances will often consume the entire surplus of the organization (Tullock 1967). See Buchanan, Tullock, and Tollison (1980) or Congleton, Hillman, and Konrad (2008) for rational choice research on how institutions can encourage or reduce unproductive conflict within a wide variety of settings.



moment reduces the risk of overthrow by a rival whose talents have been acknowledged by the organization's leadership. A similar appointment procedure can be used to replace loyal, productive members of a council as they depart. Although there are advantages to making such decisions at the last moment, there are also advantages for announcing the procedures through which these decisions will be made before the decision is to be made.

In such cases, persons who wish to be chosen will attempt to attract the formeteur's attention and favor. The rules of this succession game can be adjusted to assure that the formeteurs receive good service and advice from a broad cross-section of talented persons within the organization. Well-designed contests may also increase the organization's effectiveness.

Under such procedures, the top leadership post of the organization effectively becomes the "property" of the formeteur provides formeteurs with several reasons to adopt such procedures. . When the most productive supporter of the formeteur is appointed, the successor may be said to have bought the post in an "all pay" auction among insiders. When the post of "king" can literally be sold to the highest bidder—as true of many commercial enterprises—leadership positions can be auctioned off to insiders and outsiders. Both types of auctions create incentives for otherwise self-centered formeteurs to create effective durable organizations that address succession issues, because both internal and external auctions allow the formeteur to profit today from the future effectiveness of the organization after he or she is gone.

Unfortunately, as noted above, it is not always possible to design contests for top positions that limit the efforts of contestants to productive activities that benefit the formeteur(s). In practice, rivals often compete with each other in a manner that reduces the effectiveness of the organization, as with attempts to destroy the reputations of rivals by spreading falsehoods, or to destroy the rivals themselves. Nor is it always the case that the formeteur's departure can be fully anticipated.

Robust procedures for replacing organizational leaders must account for surprise departures, for the possibility that unproductive competition for the leadership posts takes place, and for the leadership's interest in avoiding overthrows.

## **E. Succession within King and Council Systems of Governance**

Within the king and council systems of governance, another method of addressing CEO succession problems is possible. Namely, the council may be authorized to appoint successors. Knowledgeable persons from inside the organization may be able to judge the skills necessary for effective organizational governance, which may differ from those necessary to launch a palace coup.

The entire council is unlikely to die or depart suddenly. The use of councils for such decisions also tends to reduce unproductive conflict when council members make decisions through majority rule (Congleton 1984). Replacement members of the council may be chosen by departing council members, the remaining council members, the “king,” or jointly determined.

In this manner, the king and council template allows an organization’s government to be gradually renewed by those with the largest stakes in continuation of the organization and the most intimate knowledge of its operation.

Such arrangements have been common historically within a broad cross-section of organizations, including churches, commercial enterprises, and national governments. A council of cardinals selects the new pope, and the pope selects new cardinals. A board of directors hires a new CEO and the CEO appoints (or nominates) new board members. A parliament or council of electors directly elects a king or indirectly determines them by specifying rules for succession. Kings often had the authority to appoint (or nominate) new council members, as with elevations to the noble chambers of parliament.<sup>21</sup>

### *Inheriting the “Throne”*

In cases in which an organization’s council cannot agree on a new CEO, because of problems associated with internal factions that produce majority cycles, conflict among council members can also consume substantial resources (including in some cases assassination of rival council members). Such occasions of council indecision and conflict tend to reduce their organization’s prospects for survival insofar as governance or continuity is important during the period of interest. In such cases, a more or less automatic method of selecting successors may prove superior to council deliberations.

A very common mechanistic solution to the transition problem is to make the formeteur’s oldest son his successor. By avoiding organization-threatening conflict at times of transition, such dynastic organizations have more resources available to weather the storms that confront every long-standing organization. It also reinforces incentives for formeteurs (and their successors) to consider the long-term consequences of their decisions carefully, insofar as parents value the future prospects of their first-born sons and daughters.<sup>22</sup> Perhaps surprisingly, several cases exist in which a council representing noble interests voted to make the office of king hereditary, as, for example, was

---

<sup>21</sup> The British King’s ability to appoint new members to the House of Lords, perhaps surprisingly, played an important role in early suffrage reform, as noted below in chapter 13.

<sup>22</sup> See Buchanan (1983) for an analysis of disputes for inherited wealth and position. Usher (1989) and Tullock (2002) analyze dynastic governance in the context of nation-states.

true in Sweden in 1544. The “right” of inheritance is another sense in which a formeteur may be said to own his or her organization.

It bears noting that in most cases successors “chosen” in this manner tend to be less talented than the organization’s founders. Genetics suggests reversion toward the mean. However, successors can often be less talented than the organization’s founders without significantly reducing the effectiveness of the organization, because relatively efficient governance and internal reward systems are already in place. Moreover, access to education and the formeteur’s advisory council implies that the policy decisions reached by the formeteur’s heirs will be nearly as well informed, if not always as well judged, as those of the formeteur.

It also bears noting that this form of secession has effects on the balance of authority within the king and council system. A less talented successor CEO tends to become (and should become) more dependent on his or her council of advisors. This dependence simultaneously increases the relative policymaking authority of the council and frees the heir to devote his or her time to activities that are of greater interest than managing his or her parent’s organization. The new balance of authority tends to increase the long-term viability of the organization by improving governance.

That positions in organizational governments are often inheritable suggests that avoiding unproductive intra-organizational conflict over leadership posts is often more important than maximizing the talent of the persons with rule-making authority.

## **F. Organizational Interests: the Institutional Conservatism of Successors**

As noted above, formeteurs normally decide which forms of team production will be engaged in, which reward systems will be adopted, and the standing procedures for making organizational decisions. In the case of durable organizations, they will also choose procedures through which the offices of the organization’s government are renewed through time. The members of an organization’s successor governments thus tend to be selected by standing procedures and receive rewards from a stable system of pecuniary and nonpecuniary rewards. An organization’s officeholders have standing tasks and duties within their organizations that are supported by their organization’s reward and recruiting systems. These systems provide officeholders provide incentives for the successors to make decisions that tend to increase the effectiveness of the organization’s team production.

Although every member of an organization’s government has his or her own personal constellation of private interests, all members of the organization, including its governmental office

holders, have “induced interests” that are generated by the durable rules that characterize the organizations of which they are members. In this sense at least, a durable organization—or at least its government—may be said to have “its own” interests as implied by the systematic effects of its standing reward and selection systems on both team members and organizational leadership. Social scientists take account of such induced interests when they characterize senior managers of commercial enterprises as “profit maximizers,” democratic politicians as “voter maximizers,” and persons in the mass media as “publicity hounds” or “fame maximizers.”

Insofar as those procedures continue to advance the interests of top officeholders after the formeteurs depart, successors have interests similar to those of the founders. They will support the standing procedures of their organizations, because they facilitates their ability to make policy, solve team production problems, and reduces internal conflict. In cases in which successors believe that they could not have created an equally productive organization by themselves, they will tend to be even more defensive of existing organizational routines than formeteurs. Successors also tend to be loyal *organizational men and women*, because standing organizational reward and selection systems have long played an important role in their personal life plans.<sup>23</sup> In most cases, it is through their organization’s standing procedures for reward and renewal that successors rose to leadership positions and so “earned” their income, policymaking authority, and status. Institutional conservatism, in this case also can be employed to justify their relatively high income and prestige.

Moreover, durability itself may become an asset for recruiting and motivating team members insofar as it suggests that team members may count on their promised rewards. Durability may be demonstrated to team members with stories, pictures, or statues of past organizational leaders and past organizational successes. Remembering and honoring the past tends to important for the senior members of durable organizations for a variety of practical reasons.

---

<sup>23</sup> This characterization of organizational men and women differs from Whyte’s (1956), but bears more than a passing resemblance. As in Whyte, it argues that the personal goals of individuals do not have to change for loyalty to the organization to develop. Rather, it is induced by the organization’s incentive system and its success through time. In the present case, however, “organizational interests” are not limited to middle managers. Indeed, it may apply more to senior managers, who are often most tied to their specific organization’s aims and survival, because of specialization and their organization-specific knowledge of internal procedures and personalities.

## **G. Amending the Organizational Charter**

To argue that stability has advantages for formeteurs and their successors is not to say that a durable organization's practices are completely rigid. First, as noted above, all durable organizations have standing procedures that allow them to identify and respond to changing circumstances in a manner that advances organizational goals. That is to say, they have governments. A completely "rule-bound" organization does not simply repeat today what it was doing yesterday; it uses standing procedures to respond appropriately to new developments. Second, the standing procedures for making policy decisions are subject to modification. When other procedures have been demonstrated to work better than current ones or current ones fail, an effective organization will adopt new rules, because they better advance formeteur and successor interests. Improved organizational governance increases productivity and reduces decision errors, which allow larger and more consistent rewards to be provided to team members through time. However, institutional conservatism implies that such modifications will be infrequent and tend to be modest in scale and scope.

The possibility of amendment is partly a consequence of succession. Each new generation of organizational leaders will have some ability to adjust organizational procedures in ways that benefit themselves. In many cases, this will be done through informal bargains reached among the officeholders in a manner analogous to that developed below in chapters 5 and 6. Formeteurs, however, also have interests in choosing organizational designs that are somewhat flexible insofar as they are able to profit from the future performance of their organization.

Forward looking formeteurs acknowledge that their organizational designs are not perfect, that it is not the best possible design for all possible circumstances. As consequence, they will include formal and informal procedures for amending their organizational charters and tend to adopt institutional templates that allow such changes to be made without requiring their organizations to be reinvented every time a change in governance seems advantageous. Such forward-looking organizational charters increase the value of organizational leadership posts for their successors and allows them to extract part of that value through productive forms of intra-organizational competition associated with those seeking those positions of authority.

Forward-looking formeteurs will thus characterize amendment procedures for the procedures of organizational decisionmaking and will tend to adopt governance systems that lend themselves to

adjustments at many margins. The former allows reforms to be adopted as necessary, the latter allows them to be adjusted without reinventing the organization as a whole.

The king and council template allows both amendment procedures that are more restrictive than the procedures of day-to-day governance and includes a variety of margins for adjusting policymaking procedures. Amendments, for example, might require the assent of both the king and the council, whereas day-to-day policy decision may only require decisions by the king. The procedures of governance within that king and council can be adjusted to increase or decrease the scope of the king or council's authority to make decisions, and by changing the manner in which decisionmaking authority is shared in areas in which both the king and council exercise control. The balance of authority between the king and council, for example, might need to be adjusted to account for advantages of deliberation or speed when making policy decisions during times of crisis or to reflect changes in the talent and ambition of council members and kings. The procedures through which kings and councils are selected may also advance organizational interests if the goals of the organization change or if the pool of potential government officeholders changes through time.

The king and council template can also be used to alter the distribution of policymaking authority within an organization as it changes in size. The king and council template is scalable in the sense that it can easily be adjusted for use in large and small organizations. It is also nestable which allows hierarchical systems of policymaking authority to be developed by delegating subsets of policy making authority to "lower levels" of kings and councils. Regional offices and other subdivisions of a large organization may have their own CEOs and councils that make a variety of local policy decisions. A local government may be formed with its own governor and provincial assembly. The latter allows hierarchical governance structures to emerge, based on the king and council template, as the organization expands in size or scope.

### *A Digression on Contemporary Amendment Procedures*

Consistent with that prediction is the fact that the standing procedures for amending organizational charters and governmental constitutions tend to be substantially more difficult than procedures for changing day-to-day policies. For example, contemporary amendment procedures within democratic states normally require a broader consensus and longer process of review than is required to make day-to-day decisions. Article 5 of the U. S. Constitution requires amendments to be approved by a two-thirds majority of both chambers of the legislature and then approval by

three-fourths of the state legislatures. Ordinary legislation requires only majority approval in both chambers of the legislature and acceptance by the president, state governments are not consulted. Article 15 of the Swedish constitution requires amendments to be approved by two successive parliaments separated by an election. Ordinary laws require approval by only a single parliament.<sup>24</sup>

Similarly, revisions to the charters of contemporary private organizations are normally constrained by civil law, as well as provisions of the charters themselves. In most cases, external approval is also necessary. For example, section 11 of the charter of the American National Red Cross gives the U. S. Congress the sole power to amend its charter, although they may, of course, do so at the request of the Red Cross. The core policymaking procedures of international organizations, such as the European Union and many other treaty organizations, often require the unanimous agreement of treaty signatories.

### *The Advantages of Predictability Limits the Scope for Constitutional Reform*

To say that some institutional flexibility helps organizations survive in the long run, however, is not to say that organizational designs are completely flexible. Given the advantages of institutional conservatism outlined above, the procedures for changing organizational charters tend to be more time consuming and demanding than those required for making day-to-day decisions. To serve as “rules of the game,” an organization’s decisionmaking procedures and informal norms have to be reasonably stable in the short and medium term. The benefits of predictable standing policies would be lost, if an organization’s procedures for choosing policies became totally unpredictable. Consequently, even formateurs who retain complete control over their organizations have good

---

<sup>24</sup> The constitution law of the United Kingdom is nearly unique in not specifying an amendment process that is more complex than that of ordinary legislation. The constitution of the U. K. consists of a series of laws with special status rather than a single document. Generally speaking, majority approval in the House of Commons is, thus, sufficient for both new constitutional provisions and new legislation. The latter makes it difficult to discern clearly the difference between constitutional and ordinary legislation. Yet, as argued below in section C, the latter is not uniquely a problem for the United Kingdom. Most political constitutions include core procedures and constraints that are enacted as ordinary legislation.

A modern curiosity for constitutional theorists is the current Swiss constitution. It includes many checks and balances on both ordinary legislation and constitutional revision, and specifies a *less restrictive* petition to force *ordinary legislation* to be passed by referendum (50,000 signatures; see Article 89) than to force a proposed constitutional revision to be subjected to direct referendum (100,000 signatures, see article 120). A smaller minority can demand a referendum on ordinary legislation than for constitutional referenda. This implies that a greater supermajority is required for adopting ordinary legislation, without a referenda, than for adopting constitutional amendments.

reasons to use their power of amendment infrequently. Constitutional self-restraint reduces uncertainty for team members, suppliers, and customers.

The advantages of predictable procedures together with the uncertainties associated with major reform proposals imply that proposed rule changes tend to be piecemeal, rather than whole cloth, and tend to be infrequently adopted in stable political and economic environments. Most charter amendments will address a particular class of problems and take for granted that most other standing rules will remain in force. For example, a business may increase the size or change the voting rules within its board of directors without changing the rules for electing directors or the relationship between the board and chief executive officer. A church may change its procedure for appointing ministers or priests without changing other management practices, religious doctrines, or the location and times of church services. A territorial government may change its suffrage rules or electoral procedures without changing other aspects of governance such as the number of chambers in parliament, the relationship between the executive and parliament, or the organization of the bureaucracy.

In this, the usual process of governmental reform tends to be similar to that of “normal” science. The “*ceteris paribus*” methodology of normal science allows progress to be made one step at a time as theories are refined in fields and subfields of study. Even reforms and “breakthroughs” that seem “radical” when adopted usually appear relatively modest with the benefit of history’s hindsight. Most theories in other subfields and fields remain unaffected by such breakthroughs. In the organizational context, the relative merits of governmental reforms (and their effects) also tend to be easier to imagine and analyze than are great shifts in organizational templates. An automobile company is more likely to change the models produced and methods of production than to suddenly reinvent itself by taking up spaceship design or deep sea mining.

## **H. Conclusions: Some Common Properties of Durable Organizations**

The analysis of chapters 2 and 3 suggests that there are a mind-numbing number of design parameters to consider simultaneously, when founding an organization. There are infinite varieties of reward systems, recruiting systems, and governance systems that can be imagined, and each combination of these systems tends to have different advantages and risks associated with them, which vary according to the goals to be advanced and the environments in which the organization will operate. If formateurs knew the properties of every constellation of decisionmaking procedures and internal incentive systems and could perfectly predict the future, they would pick the one that



most perfectly advanced their goals, that is, the most efficient organizational design. If, however, the range of alternatives is not entirely known and even what is known cannot be fully analyzed at reasonable cost, formateurs will realize that they can make a variety of mistakes when forming organizations and recruiting teams. In such cases, prudent formateurs will choose their governance, recruiting, and reward systems for the most part from existing organizational templates known to function relatively well, and perhaps adjust them a bit at the margin for the purposes at hand. Knowledge and calculation constraints rule out perfect solutions by formateurs.

This assessment of the problem of institutional design differs from the mathematical solutions characterized in the mechanism design literature in several ways. First, it acknowledges the limited scope of the knowledge of formateurs and also their limited time for appraising the alternatives they do know about. Second, the best institutional designs in the mechanism design literature are often of the “ridge line” variety that require net benefits to be maximized at every instant, as for example, in Holmstrom and Milgrom (1994). In such cases, myopic and long term analyses reach essentially similar conclusions about the best standing policies. Such solutions, however, characterize intertemporal optimization problems only under fairly restrictive mathematical assumptions; for example, when the objectives are concave, differentiable, and continuous and the constraints are convex and continuous.

In the real world, one cannot always climb to the top of a mountain range by simply striking out for the closest ridge and following it upward, because not every ridge leads to the top. The jaggedness of mountains is a problem for both partially and fully informed theories of mountain climbing and trail design. In the real world, most trails that climb mountains head upward for the most part, but they do not usually follow ridge lines or rise at every point.

The properties of alternative institutional designs also tend to be a bit ragged (non concave) and discontinuous. Nonetheless, much of what has been argued about reward and recruiting systems in Chapters 2 and 3 is compatible with the microeconomics literature on organizational incentive systems and mechanism design. The types of “mechanisms” that continue to attract the interests of formateurs and their successors will tend to solve the various internal incentive and recruiting problems analyzed in those literatures. Similarly the analysis of organizational governance developed is compatible with most contractarian theories of the state and most analyses of institutionally induced equilibria in governing organizations. In cases in which formateurs create an organizational government to which significant policy making authority will be delegated, the institutions of governance will tend to reflect considerations similar to those analyzed, for example, by Buchanan

and Tullock (1962). And it is possible that the profits of the organization will be distributed among formeteurs in a manner analogous to those described by Rawls (1971). Inequality among formeteurs may be tolerated only insofar as it increases organizational efficiency.

The processes through which those solutions tend to be developed and adopted, however, differ from those characterized in these literatures, however, in that organizational designs reflect a long series of modest experiments by formeteurs and their successors through time, rather than a single optimizing choice by a well-informed forward looking entrepreneur or constitutional convention.<sup>25</sup> Instead, the designs and experience of previous generations of formeteurs are assessed by persons contemplating the formation of new organizations. The organizational designs most chosen by successive generations of formeteurs provide a menu of organizational designs that will be particular interest to contemporary formeteurs, because they are known to have advanced formeteur interests in a wide range of circumstances in the past.

Knowledge problems and jaggedness do not imply that reaching the highest point in a mountain range is impossible or that hikers are necessarily walking on sub-optimal trails. Rather it implies that identifying the “top” and finding the best trails to the top will be the result of trial and error by a long series of mountain climbers who learn from one another’s innovations and mistakes. Although the best trail known at a point in time may not be the best that will ever be found, such trails may be used for centuries with only minor variations, as true of organizational designs. Similarly, the best trail will vary somewhat with the technology of transport and goals of those using them. The best foot trails, horse trails, and automobile trails share many properties but are rarely identical.

This is not to say that organizations are entirely products of history or technology. Each part of each organizational design on the “menu of best practices” is the result of past experiments and assessments by formeteurs about what “works.” In most cases, previous reforms of preexisting templates were undertaken with specific performance improvements in mind, and in cases in which the hypothesized improvements were realized, the reforms were not only kept but copied by other formeteurs and their successors. The historical requirements for survivorship of organizational templates are also affected by the decisions of formeteurs. Only those organizational designs that have advanced formeteur interests well enough to be copied by other formeteurs will be widely known or considered by them. Organizational experiments that failed to advance formeteur (and

---

<sup>25</sup> See, for example, Williamson (2002) or Spulber (2008) for overviews of this extensive literature.

successor) interests tend to disappear from the menu of organizational designs—although they may continue in “managerial mythology” as instances of designs and policies to be avoided.

### *Some Common Features of Robust Organizational Governance*

The common interests and problems of formeteurs imply that the menu of best practices for organizational governance share a number of properties, a subset of which have been identified in chapters 2 and 3. First, every durable organization will have a body of internal procedures for making policy decisions that serve as its charter or constitution for governance. The standing rules normally specify: the officeholders who participate in major decisions and the manner in which those officials interact to make decisions. The latter may include specific architectures for policymaking that group and/or assign tasks to subsets of officeholders. The standing procedures of long-lived organizations also include rules governing the selection and succession of officeholders, and standing procedures for modifying the organization’s charter.

Second, although the existence of an organizational government allows organizations to potentially change policies every instant and the existence of amendment procedures potentially allows organizations to reinvent their procedures of governance every day, durable organizations will not do so. Institutional conservatism is supported by the risk aversion of government officeholders and team members, as well as various economic advantages associated with being “conventional.” Durable organizations tend to have standing policies for recruiting and rewarding team members, because it is in the interests of most organizational governments to have predictable policies on these matters. The core procedures for making organizational policy decisions also tend to be stable, partly because of similar advantages associated with predictable policies, and partly because governance stability reduces unproductive internal conflict. Reward and governance systems are only adjusted in circumstances in which the benefits are expected to exceed the cost of lost predictability. The reforms adopted tend to be “piece-wise,” focused at solving particular problems rather than reinventing the organization. Such modest reforms preserve advantages associated with existing procedures and to avoid unforeseen costs generated by large institutional experiments. Although many such changes may be proposed and evaluated, only a few will be adopted.

Third, the founding charters and constitutions of organizations favor formeteur interests, because formeteurs normally draft their organization’s founding documents. For example, the number of formeteurs that found an organization affect the initial division of authority within the organization’s government. The standing procedures for governance are not be developed anew for

each new organization, but are substantially copied from successful organizations of the past. In many cases, the standing procedures are written down in formal charters, compacts, or other similar documents to reduce uncertainty. Formateur opportunities to profit from their organization, however, are constrained by the tasks undertaken and the environment in which their organization's operate. These limit the extent and kind of "leadership rents" that can be extracted from their organizations.

Fourth, the analysis predicts that successor governments tend to be more conservative than formateur governments, because subsequent leadership is more dependent on preexisting institutions for their positions of authority. Increased rational conservatism, however, does not imply that durable organizations exhibit complete institutional rigidity, but it does imply that experiments will tend to be relatively small and that strictly "organizational interests" tend to emerge on the part of an organization's leadership. Durable organizations will exhibit considerable continuity in their procedures of governance and amendment.

Fifth, the analysis demonstrates that the "king and council template" for governance can be used to address a variety of long term governance problems. The king and council template provides several robust solutions for succession problems and also allows authority to be shifted between the king and council in a manner that can improve organizational decision making. King-and-council based governments thus can be "finely tuned" to take advantage of new circumstances and the talent and skills of successors and formateurs without changing the fundamental architecture of the organization's government. These advantages, in addition to the informational advantages discussed in chapter 2, suggest that it will often be prudent for formateurs (and their successors) to adopt forms of organizational government based on that template.

Of particular importance for the main purposes of this book are the subset of durable organizations that are or become territorial governments. When the above analysis is applied to territorial governance, it implies that governance will tend to be rule bound, but flexible, and that policymaking authority is likely to be shared in practice, rather than vested in a single person or committee. This contrasts with most pure models of dictatorship and democracy analyzed by most political scientists and political economists. It also challenges the practical relevance of political theories that rely on or defend undivided sovereignty, such as Hobbes' (1651) theory of social contracts. The reforms of territorial governance of greatest interest for this volume are those that can account for the peaceful emergence of parliamentary democracy from organizations that are initially based on relatively autocratic forms of the king and council template.