# Contracts and Hierarchies: A Moral Examination of Economic Theories of the Firm

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ABSTRACT: An influential set of economic theories argue that the firm is a nexus of contracts that institute a hierarchy to overcome the problems of incomplete contracting in the market. However, the economic theory of the firm as a hierarchy violates the moral requirement to respect the autonomy of those who contract into the firm. The internal logic of the theory depends on a morally unacceptable abdication of a part of the employee's capacity to set her own ends in the future. So a different theory is needed to understand the nature and purpose of the firm. The development of such a theory can benefit from business ethicists engaging with existing economic theories of the firm to explore concepts like contracts, agency, and property.

KEY WORDS: theory of the firm, hierarchy, autonomy, law and economics, corporate governance

What is the nature of the firm, and what is its purpose? Economic theories of the firm try to answer the questions of why firms exist and what are their boundaries (Holmstrom & Tirole, 1989). However, they are not mere academic inquiries. Economic theories can have important implications for managerial practice because they can shape how we view relationships inside the firm and act in light of them. For instance, some have argued that economic theories of the firm provide reasons for why we ought to have different sets of norms that govern behavior inside and outside the firm (Heath, 2006; Singer, 2016). Economic theories of the firm have also been adopted in law and corporate governance to shape our economic lives in important ways. For instance, the theory of the firm as a nexus of contracts designed to overcome various forms of agency costs (e.g., Alchian & Demsetz, 1972; Jensen & Meckling, 1976) has had enormous influence on how we govern the corporation in both law and practice.

Unfortunately, as is the case with other aspects of economic life (e.g., Marti & Scherer, 2016), the widespread influence of economic theories of the firm may have had detrimental effects on society. Sumantra Ghoshal, for instance, has famously critiqued the "absurdities in theory leading to dehumanization of practice" in management studies, arguing that the combination of agency theory and transaction cost economics within theories of the firm has produced managers who are "now very familiar in practice: the ruthlessly hard-driving, strictly top-down, command-and-control-focused, shareholder-value-obsessed, win-at-any-cost

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business leader" (2005: 85). It is not surprising, then, that many business ethicists have critiqued economic theories of the firm. Some have argued that economic theories ignore morally salient features within the firm and thus contribute to unequal relations between employers and employees (Néron, 2015). Others go even further and argue against the very use of economic language to describe the firm. John Hendry, for instance, argues that the usage of economic language de-values and de-humanizes stakeholder relationships because it reduces morality within the firm to an "economic morality," which is solely "the morality of money and power" (2001: 225).

But are economic theories of the firm inherently harmful to how we describe, govern, and manage the firm? Is there anything that can be salvaged from nearly a century of theorizing about the nature and purpose of the firm? The language of economics is solidly entrenched not only within the study of organizations but also corporate governance more broadly. Business ethicists face a steep uphill climb if they seek to reinvent the wheel and offer an entirely new account of the firm. On the other hand, if there is something that can be salvaged from economic theories of the firm, both business ethics and organizational studies may be able to agree upon a shared foundation from which new theories and applications can emerge in ways that have both normative and descriptive value.

This article will attempt to salvage something from economic theories of the firm by disaggregating the two primary concepts used by economists—contracts and hierarchies—to describe the firm. Although many business ethicists lump economic theories of the firm into one large family of theories (e.g., Boatright, 2002), there are at least two distinct strands of theories that emerge from their differing emphasis on the concepts of hierarchy and contract. The hierarchy concept has been utilized since the earliest economic theories of the firm, and it forms the basis for one large tradition of economic theories that have been very influential. Within this view, the primary purpose of the firm is to minimize the costs associated with market transactions, and the nature of the firm is a hierarchy that can reduce such costs under certain circumstances (e.g., Coase, 1937; Williamson, 1975). The contract concept has also had a long history, and it presents a significant challenge to the hierarchical view. The contractarian view of the firm argues that the primary purpose of the firm is to facilitate the aims of firm participants and that the nature of the firm is a nexus of contractual relationships between them (e.g., Alchian & Demsetz, 1972; Easterbrook & Fischel, 1991). Although later theories of the firm emerged from relying on other concepts such as agency (Jensen & Meckling, 1976), property (Grossman & Hart, 1986), and/or relational contracts (Baker, Gibbons, & Murphy, 2002), the concept of contract is often foundational to these accounts of the firm as well.

The main claim of this article is that there is a serious flaw with one of these two families of theories. It will argue that the economic theory of the firm as a hierarchy violates the moral requirement to respect the autonomy of those who contract into the firm. If the hierarchical firm is indeed a contractual response to potential costs of transacting in the market, it would only achieve its purpose by granting the employer a right to disregard the employee's capacity to determine her own ends.

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Attempts to qualify the economic logic of the hierarchical firm by appealing to real-life conditions, on the other hand, undermine the very purpose of the hierarchy and expose the theoretical inconsistency of deriving the nature and purpose of the firm from economic theories that were intended to explain a firm's "make or buy" decision. The contract concept, on the other hand, is not morally deficient in a similar manner, and theories of the firm that rely on contracts—along with other concepts like property rights and agency—deserve greater collaborative attention by organizational theorists, management scholars, lawyers, and business ethicists alike.

To be clear, this article is a normative and theoretical critique of the economic theory of the firm as a hierarchy. First, it is a *normative* critique because it questions not whether hierarchy is the dominant mode of firm organization in the real world but, instead, whether the idea of a hierarchy *should* be the dominant mode of explaining the nature and purpose of the firm. Second, it is a *theoretical* critique because it does not give a final answer to the question of whether authority relations should be the dominant mode of firm organization in the real world. Instead, the article is an attempt to change how academics and practitioners view the nature and purpose of the firm at a theoretical level. Even if authority relations do and should continue to pervade how we organize into firms, the claim is that we should not view the firm as a hierarchy that exists to minimize transaction costs because it would result in disrespecting the autonomy of the firm's employees. Third, a normative and theoretical critique is different from a mere semantic dispute or an argument for arguments' sake. Whether or not we call various power relationships within the firm as hierarchies is beside the point. What matters is how we view their *purpose*. The economic theory of the firm as a hierarchy views the purpose of the firm as the minimization of transaction costs. And if our view of power relationships within the firm rests on a mechanism for cost minimization that is at odds with respect for autonomy, we ought not accept such an account nor allow it to influence how we structure our economic lives. And changing our views of the purpose of the firm will have significant real-world consequences, including implications for law, corporate governance, and managerial practice. Rather than an argument for arguments' sake, the proposed shift in how we view the nature and purpose of the firm will motivate changes at these levels in addition to academic discourse. Lastly, this article is not an attempt to defend economic theories of the firm that have come to represent the contractarian view nor an attempt to present a comprehensive and/or a morally acceptable theory of the firm. Instead, it merely attempts to point out a problem with understanding the firm as a cost-minimizing hierarchy if we truly take seriously the idea that we ought to respect the autonomy of those who participate in the firm.

This article proceeds as follows. The first section provides a historical overview of economic theories of the firm as a hierarchy. Beginning with Ronald Coase's critique of Frank Knight's account of the firm and ending with a discussion of the idea that the firm is a nexus of contracts, it presents the ways in which the concepts of contract and hierarchy are typically evoked within economic theories of the firm. The second section begins the critique of economic theories of the firm as a hierarchy by examining the moral limits of contracting. It argues that respect for autonomy prohibits contracts by which one abdicates one's ability to determine one's ends in

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the future, even if one desires to do so. The third section turns directly to economic theories of the firm as a hierarchy and argues that they disrespect the autonomy of employees. It presents the logic of why a hierarchy is needed to overcome a potential hold-up problem and argues that contracting into such an arrangement entails a morally unacceptable abdication of a part of the employee's capacity to set her own ends. The fourth section addresses potential responses to such a critique. It argues that attempts to rescue the hierarchical theory by appealing to the possibility of exit or by conflating employment contracts with other service contracts only do so by denying the need for the firm within the hierarchical theory in the first place. The fifth section discusses future areas of research. It points to the promise that lies within economic theories of the firm that emphasize other concepts like contracts, agency, and property for future collaboration between business ethicists and organizational theorists.

## CONTRACTS AND HIERARCHIES

This section provides an overview of the concepts of contract and hierarchy within economic theories of the firm and distinguishes two types of theories that emphasize one concept over the other. Economic theories of the firm typically begin with the baseline assumption that markets serve an important and valuable coordinating mechanism for production in society. Among other things, markets promote economic efficiency associated with resource allocation and production. Whereas firms centralize production under a manager-entrepreneur who directs the effort of his employees, markets utilize the price mechanism to coordinate production in a decentralized manner (Coase, 1937). This decentralized coordination grants the market an important advantage for resource allocation. Because each individual has localized knowledge about his or her circumstances, relying on individuals to make allocative decisions within their particular contexts leads to greater aggregate social welfare than a centralized mechanism for coordination (Hayek, 1945). Moreover, markets also promote the efficiency of production by supporting the division of labor. The division of labor into specialized functions drastically increases productivity—and thus wealth and welfare—in society (Smith, 1776). Without a robust market, however, economic actors would not be able to specialize in producing a particular good because they would also need to focus on producing the wide variety of goods needed for their survival. By providing avenues to trade for the diversity of goods that we need to survive, markets allow us to focus on increasing the productivity of our labor through specialization.

Given the advantages of allocating resources through markets, the question goes, why should firms exist at all? Why do firms persist in floating separately in a sea of market contracting like "butter coagulating in a pail of buttermilk" (Coase, 1937: 388)? An important precursor to theories of the firm focused largely on the effect that uncertainty in the market has on the division of labor (Knight, 1921). The future is riddled with both risk and uncertainty. Risk refers to the ways in which future outcomes are indeterminate in probabilistic—and thus calculable—ways. Uncertainty, on the other hand, refers to indeterminacies in the future that cannot

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even be calculated. Under uncertainty, the importance of execution fades into the background, and "the primary problem or function [becomes] deciding what to do and how to do it" (Knight, 1921: 268). Because supply and demand factors of the future cannot be calculated in the present, Knight argues that economic life is fraught with uncertainty. Under this theory, markets and firms both exist as successful adaptations to deal with uncertainty. The production of goods and services to a market is a useful method of dealing with the uncertainty of demand because it consolidates a large segment of potential customers who do not always know what they want in the future. Within such an arrangement, however, judgment about anticipating future demand under conditions of uncertainty becomes extremely important. And because there are some people who possess superior economic judgment than others, the increased importance of economic judgment confers an advantage to the centralization of production under the authority of a specialized class of manager-entrepreneurs (Langlois & Cosgel, 1993). What results, then, is the rise of firms controlled by manager-entrepreneurs who assume economic responsibility for uncertainty because they believe that they can anticipate the aggregation of future demand within a market better than others.

The first major theory of the firm is a response to Knight's argument. Ronald Coase argues in his seminal article that Knight's argument about the firm does not explain why firms exist at all (1937). If the firm exists simply because a certain class of manager-entrepreneurs believe that they can anticipate future demand better than others, there is no reason to think that a firm would be necessary. A market arrangement could produce the same results because the confident entrepreneur could simply enter into contracts with suppliers of goods and labor to profit from his ability to forecast future demand. But a theory of the firm must explain why a firm exists in the first place and, if there are good reasons why it exists, why there isn't one giant firm. In other words, it must provide an account of the reason for the firm's existence and its boundaries. Coase's famous argument addresses both of these points. He argues that the firm exists because a hierarchical power structure for allocating goods and labor in production for the market can be more efficient than market contracting under certain circumstances and that the boundaries of the firm can be explained by the relative difference in efficiencies. The crucial insight here is that economic activities in markets and hierarchies are subject to different types of costs. Transactions in markets have marketing costs, which include costs associated with discovering relevant prices, negotiating and executing contracts, and entering into long-term relationships in light of an uncertain future. Production in hierarchies, on the other hand, have organizing costs, which include costs associated with bureaucracy, managerial mistakes, and the loss of independence experienced by employees. Within this line of analysis, firms are hierarchies that exist when marketing costs exceed organizing costs for coordinating resource allocation. In other words, the nature of the firm is a hierarchy, and its purpose is cost reduction.

It was not until the 1970s when academics began to notably challenge the traditional assumption that firms are hierarchies that exist distinctly apart from markets. In one of the earliest attempts to blur the strict distinction between firms and markets, Alchian and Demsetz emphatically argued that viewing the firm as a hierarchy is a

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"delusion" and that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people" (1972: 777). Jensen and Meckling took this insight in one further direction and made the now influential claim that firms are "simply legal fictions which serve as a nexus for a set of contracting relationships among individuals" that exist merely as a matter of convenience (1976: 310).

The depiction of the firm as a nexus of contracts rather than a hierarchy has been influential within a variety of fields. Within microeconomics, the traditional account of the firm was a "black box" production function that unilaterally converted inputs into outputs in the market. The theory of the firm as a nexus of contracts transformed this view by bringing market principles *inside* the firm. Rather than a unilateral hierarchical relation that converted inputs into outputs, the firm was reconceived as a complex set of bilateral exchange relations among inputs to the firm, thus making it possible to apply microeconomic tools to organizational analysis (e.g., Fama & Jensen, 1983a, 1983b; Gibbons, 2005). The nexus-of-contracts view of the firm quickly began to have significant influence outside the field of economics as well. In law and corporate governance, for instance, scholars quickly adopted the nexus-of-contracts view and argued that corporate law should exist simply as default rules that instantiate "contract terms" that a majority of firm participants would wish to adopt (Easterbrook & Fischel, 1991). And although earlier works typically argued that a majority of firm participants would wish to establish a shareholder primacy norm, later works drawing on the nexus-of-contracts tradition utilized the same contractual insight to argue that managers and/or boards of directors ought to promote the interests of all of the firm's stakeholders rather than merely its shareholders (e.g., Blair & Stout, 1999; Freeman & Evan, 1990).

The success of the nexus-of-contracts formulation in economics and organizational studies quickly led to its adoption within the hierarchical theory of the firm itself. As a result, there is general agreement among economists that a firm is constituted by a nexus of contracts. Nevertheless, underneath the semantic commonality lies a crucial difference in both the nature and purpose of the firm that depends on whether the concept of contract or hierarchy dominates. For economic theories of the firm in which contracts dominate, the nexus of contracts is merely an *overlap* of contracts that differ in no way to market contracts. Some views within this group of theories even go as far as to argue that the firm itself is not a very helpful category for examining complex economic phenomena (e.g., Gulati, Klein, & Zolt, 2000). Within this view, the nature of the firm is merely an aggregation of market contracting at best, and the purpose of such an aggregation lies solely in convenience, efficiency, and/or other desires of firm participants, subject only to the demands of the market for corporate governance. On the other hand, economic theories of the firm that emphasize hierarchy understand the nexus of contracts as a vertical power relation between contracting parties that is *separate* from the contracts themselves. Within these views, the firm is a nexus of contracts only to the extent that firm participants *contract into* the power relationship. The most prominent example of such a view is that of Oliver Williamson, who argues that the firm is an institutional structure in which organizing decisions are made by fiat rather than through an on-going

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negotiation (1975, 1985, 2002). Other views within this group of theories shift the locus of power from the manager to the board of directors (e.g., Bainbridge, 2003; Blair & Stout, 1999), but the key insights are essentially the same. Within this view of the firm, the nature of the firm is a hierarchical power relationship between the manager-entrepreneur and the worker, and, as will be seen in a later section of this article, the traditional purpose of such a power relationship is to minimize the costs associated with transacting in the market.

Given the crucial differences in economic theories of the firm as a nexus of contracts depending on whether the concept of contract or hierarchy dominates, a moral examination of economic theories of the firm can benefit from disaggregating the concepts of contract and hierarchy. Take, for instance, John Boatright's argument that the normative justification for the nexus-of-contracts theory of the firm ultimately rests on the mutual agreeability of economic organization to all firm participants, assuming a fair bargaining process and the internalization of costs to third parties (2002). By conflating theories that emphasize hierarchy with those that emphasize contracts, Boatright focuses on the moral issues associated with contracting even though his discussion centers primarily on economic theories of the firm as a hierarchy. Unfortunately, as the next sections will attempt to show, overlooking the importance of hierarchies within economic theories of the firm as a nexus of contracts can lead to a lack of attention to the ways in which the power structure of the firm can result in disrespecting the autonomy of employees, even if employees voluntarily agree to such an arrangement ex ante.

## THE MORAL LIMITS OF CONTRACTING

This section begins the critique of economic theories of the firm as a hierarchy by analyzing the moral limits to contracting. In many economic accounts, contracts are often nothing more than voluntary exchanges for mutual advantage (Buchanan, 2001; Williamson, 2002). Other ingredients that are necessary for a legal understanding of contracts, e.g., mutual assent and consideration, are not a matter of concern for most economic theories of the firm. However, regardless of whether theories of the firm take a narrow or an expansive view of contracts, this section will take the view that there ought to be at least one necessary ingredient for contracting to be morally acceptable—respect for the autonomy of contracting parties. Whereas typical service contracts that limit one's own freedom in the future can be consistent with the autonomy of contracting parties, this section will argue that contracts that grant one party a right to determine the actions of another are morally unacceptable because they fail to respect the autonomy of the one who grants such a right.

Respect for autonomy requires acting consistently with the recognition that we each have a dignity that proceeds from our freedom to exercise our rationality to set our own ends. An end refers to the source of value for our actions, i.e., something for the sake of which we act (Kant, 1797: 6:385). And unlike non-rational beings that merely follow their instincts and desires, we can use our rational faculty to determine our ends and act accordingly, even if it goes against our instincts and desires (Kant, 1785). For instance, a plant might adjust the direction in which it grows based on

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the direction of the sun, but it does so as a part of an instinctual response to external stimuli. It is not free to adjust its direction for reasons that it determines for itself. On the other hand, I can refrain from stealing your loaf of bread because I can choose to respect your claim over the bread, even if my hunger would otherwise drive me to take it. Autonomy refers to this freedom to exercise our rationality to determine our ends, i.e., to act for the sake of that which we choose to value for ourselves. Respect for autonomy refers to acting consistently with this freedom in ourselves and in others. As a result, it is not synonymous with mere respect for the satisfaction of desires. In fact, respect for autonomy may require that we act contrary to our desired preferences if they conflict with our rational capacity to set our own ends.

Respect for autonomy in contracting requires acting consistently with the freedom of each party to the contract to exercise their rationality to determine their own ends. At the very minimum, one must recognize that one's counterparty is acting toward ends that are distinct from one's own ends and ensure that one's actions under the contract are consistent with not only the ends that one has but also the ends that the other person has. If I contract with you to sell you a barrel of oil and then deliver a barrel full of water topped with a thin layer of oil, I fail to act consistently with the end that you had in choosing to contract with me. Rather than respecting your autonomy to set your own ends, I treated you as a mere instrument to achieve my own ends without any regard for your ends. Furthermore, respect for autonomy requires acting consistently with the very capacity to set one's own ends. For instance, I disrespect your autonomy when I effectuate an exchange unilaterally without considering your capacity to set your own ends. If I choose to leave a barrel of oil and then take money from you without obtaining your consent, I wrong you by treating you as a mere instrument for my own purposes. It does not matter if you would have consented to the exchange. I disrespect your autonomy merely by ignoring the fact that you may have had ends that were inconsistent with my own because I would, in doing so, be treating you as if you didn't have the capacity to set ends for yourself.

Because respect for autonomy entails acting consistently with the capacity to set one's own ends, it prohibits contracts by which one abdicates one's ability to determine one's ends in the future, even if one desires to do so. One paradigmatic example of such a contract is a slavery contract. A slavery contract is inconsistent with respect for the autonomy of the slave because it aims to turn the slave into a mere instrument of furthering the owner's ends (Kant, 1797). If I sell myself into slavery, I disrespect my own autonomy by granting another person a right to ignore or override my own capacity to set ends for myself. It is obvious why such an arrangement would disrespect the slave's autonomy if the owner coerces her to act against her will. However, the problem exists even in the best possible circumstance in which the owner benevolently refrains from asking the slave to do what she does not want to do. The slavery contract still disrespects the slave's autonomy in such an instance because the essence of slavery is the abdication of the freedom to act in accordance with one's own ends. A slave must act as an instrument of the owner to further the owner's ends, regardless of what might be the slave's own ends. As a result, a slavery contract disrespects the autonomy of the slave, even if the owner

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and the slave's ends coincide. Both the slave owner and the slave act inconsistently with the slave's freedom to set her own ends by granting the slave owner the right to direct the slave's actions for the owner's ends without any regard to the slave's capacity to set her own ends.

Unlike slavery contracts, ordinary service contracts can be consistent with respect for the autonomy of contracting parties because they can enable contracting parties to pursue their chosen ends in the future. Contracts are useful because they can help us manage the uncertainties of the future by limiting our future actions through the exchange of rights and obligations that are specified in the present. For instance, suppose that I run a transportation business and would like to protect myself against the possibility of a prohibitive increase in the price of wages. I can promote my interests in a way that is consistent with your autonomy by contracting with you to drive my truck from New York to Los Angeles for $500 a year from now. Agreeing to such a contract entails an action in the present to exchange rights and obligations. At the time of contracting, I grant you a right to my $500 in exchange for an obligation to drive my truck from New York to Los Angeles a year from now. Conversely, you grant me a right to demand that you drive my truck in exchange for an obligation to render payment. Enforcing such a contract a year from now would respect your autonomy because it would amount to asking you to act consistently with the ends that you have set for yourself at the time of contracting. If the labor market shifts a year from now in ways that neither of us could have anticipated at the time of contracting, you are still obligated to drive my truck for $500 because *you* willed it at the time of contracting. My insistence on your performance does not contradict or ignore your capacity to set your own ends because *you* have granted me the right to do so in accordance with the ends that you had set for yourself. In fact, I respect your autonomy and help you act consistently with your determined ends by asking you to live up to your commitment. In other words, although ordinary service contracts restrict our freedom in the future, they can respect the autonomy of contracting parties by enabling them to extend their freedom at the time of contracting to govern their actions in an uncertain future.

An important limitation to contracts for services in the future, then, is the extent to which the rights and obligations being exchanged can be specified at the time of contracting. A contract for future services requires an exchange of rights and obligations because such a contract must exist prior to any service being rendered. Without an exchange of rights and obligations, there would be nothing to enforce if a party to the contract decides to not render services. However, rights and obligations do not exist in a vacuum. Instead, they are claims and demands that are made *to* or *that* something (Feinberg, 1970). As a result, a contract for future services entails contracting *to* or *for* something, i.e., specifying the rights and obligations to be exchanged. If parties attempting to contract for future services cannot specify what kind of rights and obligations pertain to their agreement, they would not have a contract at all. A mere agreement to come to an agreement in the future, for instance, is not a contract. Of course, there will be a continuum of specificity and comprehensiveness about the kinds of rights and obligations that can be exchanged in a contract. The more specific and comprehensive the rights and obligations are,

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the more complete the contract will be. Nevertheless, given the moral requirement of respect for autonomy that was outlined above, there are limits to the kinds of rights and obligations that can be specified and exchanged. A right to override or ignore another person's capacity to set her own ends, for instance, is not the kind of right that should be exchanged. This is why slavery contracts are morally unacceptable. And as the next section will explain, the very purpose of the firm in economic theories of the firm as a hierarchy is to grant the employer such a right. Otherwise, there would be no contract between the two parties since the firm exists to govern situations that neither party could have specified at the time of contracting. Therefore, it will argue, the idea of a hierarchy within such theories requires a conception of a contract that is morally unacceptable.

## CONTRACTING INTO A HIERARCHY

This section discusses the attempt to justify the economic theory of the firm as a hierarchy on contractual grounds and argues that it ultimately falls short. Some defenders of the hierarchical theory argue that its conception of the firm is not problematic because it presents the firm as merely an arrangement with functionally defined roles into which economic actors contract (e.g., Boatright, 2012). Within this view, the hierarchical theory of the firm is merely one variant of the theory of the firm as a nexus of contracts (Bratton, 1989). Putting aside semantic commonalities and differences, however, this section will argue that the economic theory of the firm as a hierarchy is inconsistent with contracts that respect the autonomy of contracting parties. Because the very reason for a hierarchy within the theory is to grant the employer a right over the employee's actions in ways that could not have been specified at the time of contracting, the employee can only contract into the firm by disrespecting her own autonomy.

Modern economic theories of the firm as a hierarchy build on the Coasian intuition about the costs of contracting by recognizing that asset specificity and bounded rationality lead to hold-up problems that can frustrate market transactions. Asset specificity refers to the ways in which investments made in an asset within the context of an exchange relationship make the asset more valuable within that relationship than in other relationships (Williamson, 1985). Investments that lead to asset specificity are relationship-specific investments. For instance, suppose that Alfred is a manufacturer of widgets and that Betty is a worker. Further suppose that it takes time to learn and perfect the skill required for Alfred's proprietary process of assembling widgets. The effort that Alfred expends to train Betty to assemble widgets using his process is a relationship-specific investment. Learning this skill increases Betty's asset specificity to Alfred because the investment required to teach her will make her more valuable to him than to other manufacturers. Asset specificity introduces the possibility that, once a relationship-specific investment is made, parties to an exchange relationship will engage in opportunistic behavior to appropriate the difference between the value of the asset within the relationship and its value outside the relationship. For instance, if Alfred values a trained worker at $25 whereas the labor market values comparable workers at $20, Betty may contract

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with Alfred at $19 to beat out other competitors and then hold him up by demanding $25 once he expends the resources to train her. The possibility of being held up in such a way can lead to Alfred refraining from training Betty or even prevent him from contracting with her at all.

Asset specificity would not lead to a hold-up problem if Alfred and Betty could sign a contract that precludes any opportunistic behavior once relationship-specific investments have been made. Unfortunately, bounded rationality renders such contracts extremely costly and difficult, if not impossible, to make. Bounded rationality refers to the finite condition of human rationality (Simon, 1955). Because we are limited in our cognitive capacities, we are unable to process all the relevant information we would need to make a rational decision about the present and the future. The upshot of bounded rationality for contracting is that our contracts are always incomplete (Williamson, 1985). Because it is impossible to anticipate at the time of contracting all the various ways we may need to govern our exchange relationship in the future, there is a chance that an opportunity will arise in the future where one party can take advantage of another party once a relationship-specific investment has been made. For instance, suppose that Alfred and Betty agree to a contract in which he pays her $19 to assemble widgets in accordance with his proprietary assembly technique. To protect herself against possible exploitation in the future, Betty will not agree to the deal unless the contract specifies which tasks she will be performing. But after some time, suppose that Alfred wishes to alter his specified assembly technique that will double the speed of manufacturing. Unfortunately, the new technique will require Betty to perform an action that was not specified in their contract. The need for this change could not have been foreseen at the time of contracting because both parties entered into their contract under bounded rationality. The contract they signed was incomplete with respect to the possible range of tasks that Alfred would want Betty to perform in the future. Due to the incompleteness of the contract, Betty would thus be able to extract more payment from Alfred in exchange for her compliance with the new manufacturing technique. As a result, the potential for incurring costs associated with negotiation and the possible pay out to Betty might lead Alfred to abandon the new process altogether and/or refrain from hiring and training her in the first place.

Modern economic theories of the firm as a hierarchy argue that the firm is an arrangement that can preempt opportunistic behavior and thus enable mutually beneficial exchanges and relationship-specific investments to take place. Given that the hold-up problem resulting from asset specificity and bounded rationality makes market contracting inefficient, difficult, or impossible, it is in the economic interest of both parties to agree to a hierarchy ex ante that will govern their relationship when their contract runs out (e.g., Blair & Stout, 1999; Williamson, 2002). Within a hierarchical firm, when unanticipated circumstances arise, the incomplete nature of ex ante contracting will not raise concerns about one party holding the other party hostage because the power structure of the firm will have already entitled one party—the manager-entrepreneur or the board of directors—to make a unilateral decision as to how to allocate productive resources, including labor. This arrangement will allow both parties to enter into economic transactions without the fear of being held up and will

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allow the manager-entrepreneur to make an efficient amount of relationship-specific investments in the employee once they enter into a relationship. For instance, Alfred in the example above does not need to worry about Betty holding up his implementation of a new manufacturing process within a hierarchy because it entitles him to tell her what to do and obligates her to act under his direction. This will allow Alfred to not only hire Betty in the first place but also make an efficient investment in her to make her a more productive worker for his factory.

Unfortunately, contracting into a firm for the reasons provided above disrespects the employee's autonomy because the purpose of the firm within such an arrangement would be to grant the employer a right over the employee that could not have been specified at the time of contracting nor agreed upon at the time of performance. Imagine that Alfred would like his employee, Betty, to perform an action today. His request and her action would respect her autonomy if they were consistent with the ends that she sets *today* or if she had previously granted him the right in the *past* to request the action from her in accordance with the ends that she had set at the time of contracting. Yet, there would be no need for a hierarchy in either of these scenarios because a contract formed either today or in the past would be sufficient to govern their interaction. If it weren't for bounded rationality, both Alfred and Betty would be able to prevent the hold-up problem by specifying their mutual rights and obligations at the time of contracting to cover the full range of actions that Alfred would like Betty to perform in the future. And if it weren't for Betty's unwillingness to perform today, she would agree to Alfred's request even if it falls outside the bounds of their incomplete contract. The need for the firm only arises within economic theories of the firm as a hierarchy because it would be efficient for both parties under conditions of bounded rationality to agree ex ante to grant Alfred a right to demand Betty to perform actions that they could not specify at the time of contracting. Otherwise, they could specify and govern their relationship with a contract rather than a firm.

As a result, contracting into a hierarchy to prevent hold-up problems under conditions of bounded rationality boils down to an abdication of a part of one's capacity to set one's own ends in the future. When I contract with you to perform a service in the future, there is no implicit agreement that I will also perform services that neither of us anticipated at the time of contracting. Your right to demand performance from me is limited by the rights and obligations that were specified in accordance with the expectations we had at the time of contracting. For instance, if I contract with you to mow your lawn next month but you end up having to replace your lawn with a driveway next week, you have no right to demand next month that I sweep your driveway instead. But according to economic theories of the firm as a hierarchy, contracting into the firm involves granting such an expansive right to the employer. It argues that the very necessity of the firm arises from the inability for parties to specify the actions to be undertaken by each party at the time of contracting. And since a contract for future services requires an exchange of rights and obligations, contracting into such an arrangement must involve granting the employer a right to the employee's actions that could not have been specified at the time of contracting. What kind of a right over the employee's actions could the employer have when

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such a right could not have been specified at the time of contracting? The only possible right that enables both parties to bypass the hold-up problem is one that grants the employer a unilateral right to specify his demands over her actions in the future. Simply put, the economic theory of the firm as a hierarchy argues that employees contract into the firm by agreeing to do what the employer wants her to do, even if she will not wish to do it at the time of performance. Such an agreement is different from a slavery contract only as a matter of degree and scope, not of kind. Both agreements involve an abdication of the freedom to act in accordance with one's own ends. And as is the case with slavery contracts, contracting into the firm to overcome the problems of bounded rationality and opportunism entails disrespecting the autonomy of the employee by granting the employer a right to determine the employee's actions without any regard for the employee's capacity to set her own ends.

## DISCUSSION

This section argues that attempts to rescue the economic theory of the firm as a hierarchy do so only by denying the need for the hierarchy in the first place. Attempts to conflate employment contracts with other types of service contracts make the hierarchical nature of the firm irrelevant to the hierarchical theory's central argument that the firm exists to prevent hold-up problems. Similarly, granting the employee the right of free exit would collapse the hierarchical firm into a contract, and appealing to the costs of exit would render the hierarchy superfluous to the theory. As a result, the economic theory of the firm as a hierarchy must rest on the morally unacceptable account of contract described in the previous section if it is to rely on the concept of hierarchy as used within the theory.

First, defenders of the hierarchical theory might argue that contracting into a hierarchy entails sufficiently specifying rights and obligations at the time of contracting. Since all service contracts must contain some generalities over the kinds of activities the service provider is expected to provide, the employment contract need not specify rights and obligations beyond generalities of job functions and expectations either. Indeed, as noted above, there is a continuum of specificity with which rights and obligations can be exchanged in a contract for future services. No contract is ever perfectly specified, and the terms must often be broad enough to include a variety of possible rights and obligations. As a result, courts must often help set limits on how vague contracts can be and interpret contracts in ways that are consistent with the intentions of the parties at the time of contracting. An elaboration on the limits of contracting and the scope of specificity necessary for respecting the autonomy of contracting parties is beyond the scope of this article. It may certainly be the case that some contracts currently recognized and enforced by courts are morally unacceptable. Nevertheless, what is important for the purposes of this article is that the hierarchy envisioned in economic theories of the firm is designed to step in where contracts run out. Whatever the limits of morally acceptable contracting might be, the economic theory of the firm as a hierarchy exceeds the limits since it is intended to operate outside of the boundaries of what both parties can agree to

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at the time of contracting. If contracts could be formed with terms that were so broad that they could cover a range of actions that could not have been anticipated or specified at the time of contracting, there would not be a need for a hierarchical firm to overcome the hold-up problem. The broadly defined contract would be sufficient. However, the economic theory of the firm as a hierarchy argues that a firm exists because such a broadly defined contract could not be sufficient to govern the employment relationship. So it could not be the case that contracting into a hierarchy entails sufficiently specifying rights and obligations at the time of contracting.

Second, defenders of the hierarchical theory may argue that employees retain their capacity to determine their own ends because they retain their right to freely exit the relationship at any time of their choosing. However, the right of exit would undermine the very reason for imposing a hierarchy according to the theories described above. Once employees are given the right of free exit, the vertical power structure envisioned by economic theories of the firm as a hierarchy quickly collapses into nothing but a set of contracts. Again, as noted above, the economic theory of the firm as a hierarchy argues that the firm exists as an efficient alternative to markets because it eliminates the possibility of the employee holding up the employer in an attempt to appropriate the value that exists within their exchange relationship. The right of free exit would reintroduce this possibility because it would enable the employee to hold up the employer by threatening to quit if the employer does not increase her compensation. The entire point of the firm, according to the hierarchical theory, is to negate this threat by instituting a vertical power structure to compel the employee to act in accordance with the employer's wishes.

As an illustration of the way the right of free exit undermines the very purpose of the firm as a solution to the hold-up problem, suppose that Betty contracts into a hierarchical arrangement within Alfred's widget-making factory. Alfred hires Betty to assemble various parts to produce widgets at Alfred's direction and pays her the going rate of an assemblyperson, which is $25 an hour. Alfred spends a significant amount of time training Betty and teaches her his proprietary manufacturing method. Betty is a quick learner, and, after some time, she becomes a productive worker who is worth $35 to Alfred. Assuming that the price of a replacement worker in the labor market is still $25, the right of free exit gives Betty an opportunity to extract more money out of Alfred. He could pay her $5 more for several months and still be better off than if he hires someone new. The contract that Betty signed doesn't protect Alfred since it gave her the right to quit, and the hierarchy does Alfred no good since he cannot force Betty to keep working for him for $25 once she decides that she does not want to do so anymore. In other words, Betty's right of free exit puts Alfred right back in the place where he would have been had he entered into a service contract with Betty outside of the firm. The right of exit reintroduces within the firm the very thing that the firm is intended to eliminate according to the hierarchical theory, i.e., the economic inefficiencies associated with opportunistic behavior after relationship-specific investments have been made.

Third, defenders of the hierarchical theory may argue that all that a firm does is to increase the costs of exit without eliminating the right of exit. Like their employers, employees of a firm also make relationship-specific investments. Assuming that the

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employee also captures some of the value of her firm-specific investment, exiting the firm will involve incurring some costs if she leaves. And given the various costs of reentering the labor market to find new employment, it is not difficult to imagine that exiting the firm could be costly. However, notice again that the hierarchy does no work in such an account for why firms might be more efficient than markets. The costs of exiting the firm are a function of the interaction of relationship-specific investments and the labor market. Costly exit is perfectly consistent with a theory of the firm without any hierarchy whatsoever. In fact, there have been suggestions that a firm can be understood as a complex contractual arrangement that involves "braiding" governance mechanisms to gradually increase the costs of defection without the need for any strict hierarchy (Gilson, Sabel, & Scott, 2009).

What the objections addressed above highlight, however, is that the economic theory of the firm as a hierarchy is not descriptively accurate either. Employment contracts do not grant the employer a right to demand the employee to perform an action against her will. Instead, the law merely makes it costlier for employees to exit the firm when the employer demands that she perform an action against her will. In the United States, for instance, courts typically cannot compel an individual to perform an action against her will, even if she sufficiently specified such an obligation in the contract. Instead, the best that courts can do is have the individual who breaches the contract pay damages to the other party. Typically, because courts presume that the employment relationship is at-will, courts will not penalize the employee at all if she chooses to leave her employer. But even in instances where the employee clearly breaches her employment contract by refusing to perform the services to which she agreed or by acting in ways that are prohibited by the contract, courts will not be able to do much more than compel the employee to pay damages to her employer. In other words, the economic theory of the firm as a hierarchy truly contains "absurdities" that have led to the "dehumanization of practice" through its acceptance and implementation in the real world (Ghoshal, 2005: 85). The firm that hierarchical theories imagine exists only in our minds and is not reflected in reality.

To be fair, the intended level of analysis for economic theories of the firm is at the firm level, where the option to exit does not exist. Most economic theories of the firm are concerned with transaction costs at the firm level, and they offer answers to questions that relate to market competition. Thus, the primary question for most applications of economic theories of the firm is the "make or buy" problem, i.e., whether a firm should acquire a supplier, as GM did with Fisher Body in 1926, or maintain a contractual relationship with it (e.g., Klein, Crawford, & Alchian, 1978). And when firms purchase other firms, the purchased firm has no option to exit. At the intended level of analysis, then, economic theories of the firm do not have much of a problem in arguing that the purpose of the firm as a hierarchy is to prevent the hold-up problem by granting the acquirer a unilateral right to control the other party. But once taken out of the limited context of market competition and applied to broad areas of policy, law, and morality, economic theories of the firm as a hierarchy can offer no satisfying explanation for the nature and purpose of firms since they must account for the individual level of analysis in addition to the firm level. If economic theories of the firm as a hierarchy are true theories of

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the firm that attempt to explain why firms exist at all, they must be able to account for the genesis of firms at the ground level. Unfortunately, they are not descriptively accurate when it comes to how and why firms come to be constituted by individuals. Because employees have the right of exit in real life, firms cannot prevent hold-up problems in ways that the economic theory of the firm as a hierarchy argues.

When economic theories of the firm appeal to a hierarchy, they are referring to more than just an authority relation that establishes a line of command. Various philosophers have recognized that economic production in firms seems to require a command or coordinating hierarchy (Anderson, 2008; McMahon, 1994). But as Coase pointed out almost a century ago, the need for such coordination can be accomplished through market contracting. Economic theories of the firm argue that a hierarchical firm is necessary not for reasons of coordination but rather to overcome the hold-up problem by allowing the manager to direct the employee's labor without the need to renegotiate the terms of their contract. Without this power for the manager-entrepreneur to override the will of the employee, the idea of the firm as a hierarchy does not offer an economic advantage over markets at all. Yet, this right to direct the employee's labor in accordance with the employer's will entails a violation of the employee's autonomy. When the employer exercises his right to unilaterally direct the employee's labor against her wishes, he is not helping her to act consistently with the ends that she had set for herself at the time of contracting. And if the employer does not have this right because the employee has a right of exit, the hierarchy intended to prevent the hold-up problem collapses back into a contract without any means of addressing the problem at all. In other words, the economic theory of the firm as a hierarchy must rest on a morally unacceptable account of contracting if it is to rely on the concept of hierarchy as used within the theory.

## DIRECTIONS FOR FUTURE RESEARCH

The focus of this article is limited to pointing out the problems with how academics and practitioners often understand the nature and purpose of the firm as a cost-minimizing hierarchy. Nevertheless, if the idea of contracting into a hierarchy to minimize transaction costs is inconsistent with the moral requirement to respect the autonomy of contracting parties, where can we go from here? This section offers some directions for future research in business ethics that can overlap with various economic theories of the firm.

The first direction for future research might involve business ethicists giving greater attention to economic theories of the firm that give priority to contracts rather than hierarchies. A wide variety of recent economic theories of the firm attempt to prioritize contracts over hierarchies while nevertheless addressing the need for efficient governance of economic relationships. Attention to not only formal but also informal and relational forms of contracting has led to explorations of ways in which combining different modes of contractual governance can minimize, if not eliminate altogether, the inefficiencies associated with market contracting (Bernstein, 1992; Gilson, Sabel, & Scott, 2009, 2010; Scott, 2003). These complex forms of formal and informal contracting have also made their way into how economists

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describe intrafirm relationships. Building on the insight that the firm comprises not only complete but also incomplete contracts (e.g., Coff, 1999; Zingales, 2000), these theories look to combinations of various types of contracting as sources of economic efficiency and firm competitiveness (e.g., Baker, Gibbons, & Murphy, 2002; Gibbons, 2005; Gibbons & Henderson, 2012).

Theories of the firm that emphasize contracts are promising for a variety of reasons. Contractual theories typically rely on a depiction of intrafirm relationships as ongoing contracts that are constantly open to reformulation and reinterpretation. Within such a depiction of intrafirm relationships, the manager and the employee must continually share information and come to a shared understanding of each other's rights and obligations. As a result, the ethics associated with working within a contractual view of the firm might require a greater emphasis on maintaining equal and reciprocal relationships rather than simply accepting and/or taming a vertical power relationship. Furthermore, corporate governance theories still often focus primarily on the principal-agent problem between shareholders and management, both as a matter of law and practice. If firms are constituted by contracts that fully respect the autonomy of employees, giving priority to contracts over hierarchies might provide reasons for not only including labor within the governance of the firm but also for a multilateral interpretation of shareholders, management, and labor as all being principals and agents of each other. Lastly, building on the contractual concept of intrafirm relationships may also lead to changes at the social policy level. For instance, the master-servant model of hierarchical control is still considered to be the distinguishing factor of the employment relationship within the law. The contractual concept can provide a critique to such characterizations and point to the need for new theories of employment relationships in the law that better respect the autonomy of workers.

The second direction for future research might involve business ethicists engaging with economic theories of the firm that emphasize property rights as an alternative to hierarchies. Classic economic theories that view the firm as a bundle of property rights tend to focus on the incentives of firm participants based on residual rights of control (e.g., Grossman & Hart, 1986; Hart & Moore, 1990). On the other hand, more recent theories of the firm incorporate the insight that property rights constitute an important piece of the puzzle but nevertheless argue that the firm exists as a distinct entity apart from the market because it allows for greater value to be unlocked from combining various bundles of property rights held by firm participants (Asher, Mahoney, & Mahoney, 2005; Kim & Mahoney, 2010). Although there is more work to be done to flesh out a theory of the firm that incorporates elements of property rights into a contractual analysis of intrafirm relationships, a variety of property-rights-based theories of the firm are now ripe for greater attention from business ethicists, particularly since property rights are evolving and "embedded in human rights" (Donaldson & Preston, 1995: 83).

Nevertheless, reliance on contracts and property rights is likely not enough because firms are riddled with authority relationships. As a result, a third direction for future research might involve business ethicists taking a closer look at principles of agency within the firm. Rather than hierarchies that reduce transactions costs,

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authority relationships within the firm might be characterized more accurately as *agency* relationships. Currently within the United States, for instance, the relationship between the corporation and its directors are governed by the legal principles of agency. Furthermore, the agency relationship between the corporation and its managers has traditionally been understood to represent an underlying agency relationship between the firm's owners and its managers (e.g., Jensen & Meckling, 1976). From this point of view, directors and managers of a corporation, as agents, have a fiduciary obligation to act on behalf of the interests of their principals, i.e., the shareholders (Goodpaster, 1991). But many have also argued that these agency relationships should extend further out. For instance, when stakeholder theorists appeal to *fiduciary* duties to argue that managers have a duty to the firm's stakeholders (e.g., Freeman, 1994), they implicitly draw on an understanding of authority relationships between firm participants based on the principles of agency. In fact, given the complexity of agency relationships that can exist within the firm, some have even suggested that the firm is best described as a nexus of agency relationships (Orts, 1998, 2013).

Unlike hierarchical relationships, which are characterized by the exercise of power *over* a person, agency relationships are characterized by the exercise of power that is *granted* by a person. Of course, the two can coincide when one wields power over another—legitimate authority in wielding power over another person might require that one only exercise power over someone who has granted it, for instance—but they are distinct concepts. As discussed above, economic theories of the firm argue that hierarchical authority within the firm exists to grant the hierarch a unilateral right to exert his will over the subordinate against her will. On the other hand, agency authority only applies to actions taken by the agent that enable the principal's will. Whereas hierarchical power can be exercised in instances that could not have been anticipated by the contracting parties, authority in agency relationships only extends to actions that were *reasonably foreseeable* by the principal (Dalley, 2011). In other words, authority exercised through agency relationships must be consistent with ends that can be determined by contracting parties at the time of contracting. As a result, an account of the firm that incorporates agency principles and the element of reasonable foreseeability could go a long way toward a morally satisfactory theory of the firm.

Still, challenges will surely remain. As noted above, a true theory of the firm must explain why firms exist at all. Suppose, for instance, that authority relations exist in firms because they are somehow necessary to coordinate the complex allocation of goods and labor within the firm. How and why are the authority relationships within the firm distinct and superior to ordinary market transactions? And even if the authority relationship could somehow perform better than the price mechanism in coordinating labor and the means of production, why couldn't those who would otherwise participate within the firm simply enter into contractual arrangements to confer the manager with sufficient authority to coordinate their labor? On the other hand, if the firm is just a mere shorthand for such contractual relationships, does the firm exist at all? What would be the purpose of a theory of the firm that denied its existence? If the answers to these questions are to be consistent with important moral

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values like autonomy, business ethicists must engage with organizational scholars to address both the descriptive and normative issues associated with such questions.

## CONCLUSION

Theories of the firm matter because they articulate the nature and purpose of the firm. If we wish to respect the autonomy of workers, we must revisit the idea that the firm exists as a hierarchy to reduce transactions costs by giving the employer a unilateral right to exert his will over his employees. We should not view our autonomy as something that can be traded off against slight gains in our welfare nor as a mere cost of doing business.

Why shouldn't business ethicists and organizational theorists work together to construct a new theory of the firm that is descriptively accurate and morally desirable? It will not be an easy task to provide such a theory, as a theory of the firm must explain why firms exist and what are their boundaries. As Coase suggested nearly a century ago, reliance on common sense notions about the necessity for coordinating resource allocation will not be enough unless they can provide an answer as to why the coordination could not be accomplished through market contracting. Nevertheless, looking to contracts, agency principles, and property rights as essential pieces might provide a path for articulating why a firm exists and should exist. And once such answers are provided, we may be able to take the next steps in aligning our reality and practice with our new theory.

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