

5. The Contracting Environment

This chapter outlines the main features of a public choice approach to a contracting environment. Contracting is about convergence to a contract point, but in the process of convergence there are X-factors, including bargaining power, rent-seeking, altruism and the role of institutions inter alia that frustrate the realisation of the equilibrium point. In particular, we focus on the concept of agreement and on the mechanics of reaching an agreement. We interpret contracting as reaching agreement in the neighbourhood of a contract point. The contract point is defined as an equilibrium point, illustrated by the Edgeworth-Pareto point in Figure 5.1. This translates into the long run equilibrium point in microeconomics, $LMC = \text{price}$, the perfectly competitive equilibrium.

Coase (1937) had argued that ‘the distinguishing mark of the firm is the supersession of the price mechanism’. If the price mechanism determines the exchange in a competitive equilibrium model, why is there a need for a firm? In a world of uncertainty and information asymmetries, a firm acts as a nexus of contracts between the exchanging parties. In arriving at those contracts, employees and employers are reaching agreement in a firm environment. Contracting in such an environment is also intrinsically about corporate governance. The chapter challenges the relationship between corporate governance and the methodological foundation of assessment criteria, used by competition agencies, with responsibility for policing firm behaviour.

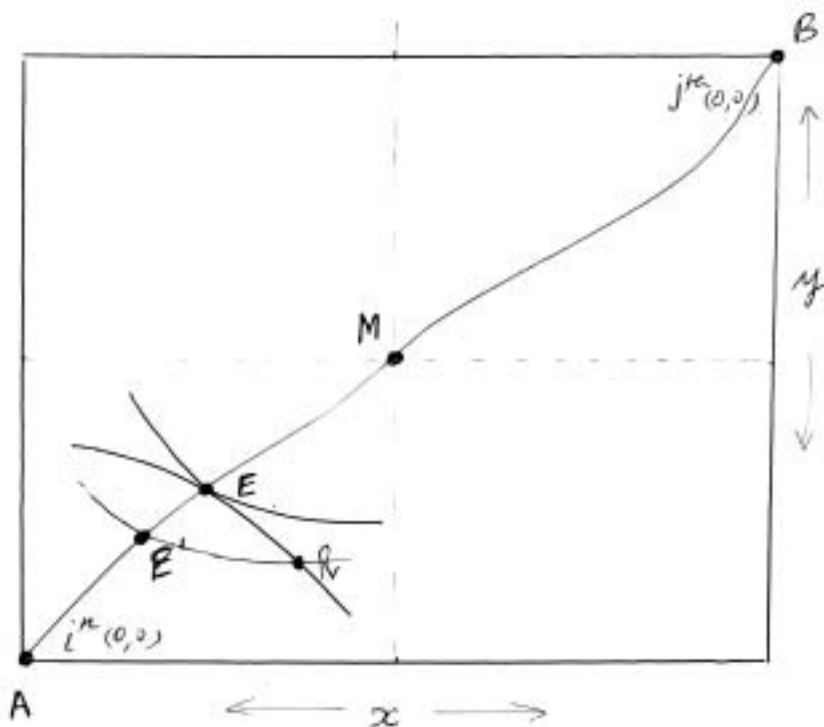
In comparing the basis of a legal contract and contracting, McNutt reconsiders an economic exchange from first principles in a forthcoming book¹. In the interim, the reader is referred to Atiyah (199x) for a fuller discussion of the law of contracts, to the late Rosen (1992) for an interesting discussion of the economic nature of contracts and to Salanie (1998) for a discussion on the dynamics of both complete and incomplete contracts. This chapter will review the salient points of the mechanics of exchange including a review of both the opportunity cost and the bargaining costs that may be involved in the computation of an X-factor. A standard Edgeworth-Bowley box diagram is deployed, Figure 5.1. The concept of the s-firm is introduced. The s-firm is a concept that evolves from an earlier analysis of contracting within the boundary of the firm, McNutt (1996). Emphasis is placed on stakeholders in the firm and on clarifying the contracting relationship between an employer and employee. The s-firm has a role much like the law (or the

courts) in acting as guarantor for an (explicit) contract. In other words, if a breach of contract occurs or if the parties are at an off-contract curve point, the law and the s-firm respectively act as a third party mediator.

MECHANICS OF BILATERAL EXCHANGE

In this section bilateral exchange and the legal nature of a contract are reconsidered. The objective is to set the stage for a comparative analysis of breach of contract in law with an off-equilibrium (off-contract curve) outcome in economics. In a representative situation of bilateral exchange, as illustrated by Figure 5.1, an agreement is reached between two parties on the rate of exchange, a price. When a price is agreed, the two parties enter into a bilateral exchange, trading x for y . The parties have reached agreement, and contracting has occurred. It is analogous to exchange in the supply and demand interaction that underpins modern market equilibrium.

Figure 5.1 Contracting



Bargaining and the Economic Nature of Contracts

A contract, however, is a form of bilateral exchange between a promisor and a promisee for the future delivery of a product or service at an agreed price. The contract as a form includes provisions and contingencies for any possible breach of the contract. Essentially, the contract as written is a kind of disequilibrium-solving mechanism to ensure that two parties today, who have reached agreement, will exchange in the future. A breach of contract could arise ex-post if one of the parties takes the view that the terms of the contract do not best serve its interests. In this case, a party to the contract may incur the penalties determined by law or in the contract.

The Edgeworth curve or *contract curve* in Figure 5.1 is a classic illustration of the economic nature of contracts. The starting point of our deliberation is not the egalitarian mid-point, M, but a Rawlsian original position, a real world starting point at R. At the point R, the *j*th individual is on a higher difference curve relative to the *i*th individual. The distribution of the products (*x*,*y*) is biased towards the *j*th individual. The contracting objective is to arrive at a mutually satisfactory outcome, an equilibrium point E or E' as illustrated. Both points are Pareto efficient. In other words, there are no better alternatives to either E or E' that will improve the position of one agent without harming that of another. Moving from E to E' on the contract curve, however, would disadvantage the *j*th individual. However moving from R to either E or E' benefits the individual that moves to a higher indifference curve; note, moving from R to E benefits the *i*th individual while moving from R to E' benefits the *j*th individual.

Therefore a Pareto improvement would occur if the parties move from a position of no contracting, an off-contract curve point at R, to a contracting position on the Edgeworth curve, either at E or E'. This is the condition of *Pareto optimality*. Each individual will have to move from an initial position to the final equilibrium point, incurring a trade-off cost as measured by the exchange ratio, Dx/Dy . Therefore in such a move, contracting involves transfer and transaction, both of which have the potential to contribute positively to value-maximisation. A free rider problem may well arise; if so, a partial solution emerges, a 'holding' position with one party policing the move to an efficient outcome.

For example, the *j*th individual may prefer to remain at R. In such circumstances there is a wealth effect accruing to the *j*th party. Therefore, with wealth effects, a Pareto inferior allocation of resources will persist if it is possible to introduce a Pareto improvement by either improving the position of one or both contracting agents. Given the two end-states, a contract and an

off-contract end-state, each (selfish) individual in the contract would attempt to arrive at an ordering of end-states that corresponded with a Pareto ranking. In any set of feasible end-states the one believed to be better than any before is defined as Pareto efficient and the one believed to be the best would be the one that was Pareto optimal. The issue for economists to consider is whether or not any efficient end-state can be achieved by a market system. The public choice scholar would answer in the affirmative given an appropriate distribution of property rights, vide Chapter x pp. If there was a procedure available that could be relied on to secure the required distribution of property rights, the best end-state could be achieved by combining this procedure with the market, a position argued by Sugden (1981).

However as shown by our discussion in Chapters 12-14 on economic power and equality, such a procedure depends on the underlying income distribution. The inequality points, E and E', in Figure 5.1 are Pareto non-comparable. In the emergence of different economies, many different institutions are established including a government, a legal and courts system, a political system and an industrial system with competing firms. Social contract theory or *contractarianism* tries to answer questions concerned with obligation. The idea has its origin in the liberal tradition, in that it emphasises that society and its institutions have no inherent or natural rights over the individual. In effect, they would have those rights only that the individual considers in an original position. Against this background, public choice scholars should be re-evaluating whether or not a certain institution is contracts binding. If individuals in a state of nature had agreed to that institution or contract, then the institution or contract would be deemed to be contracts binding.

Pareto and Coase

Although a point on the contract curve is said to 'Pareto dominate' any off-contract curve point, the Pareto criterion cannot compare points on the contract curve. This condition of Pareto non-comparability is silent on the issue of equity and is therefore a weakness in the Paretian ethic as an ethic with universal appeal. Alternatively, we could begin with the premise that wealth effects exist. Therefore bargaining power, the ability to minimise the Dx/Dy ratio, is correlated with income. As alluded to earlier, the position of the starting point, R, in Figure 5.1 does signal the inequity in the underlying income distribution among the contracting parties.

Contracting, implies that a Pareto optimal point has been reached by agreement. In effect, there are no wealth effects and this is implicit in the

Milgrom and Robert's value maximisation principle. But in a rich-poor world there are high positive transactions costs, for example, communication costs, strategic costs and the inability to pay. High prices in a market solution remove the relatively poorer agents from the exchange. In non-market outcomes, such costs would have to be minimised by recourse to the law of contract in order to ensure that private agreements are Pareto efficient. If not, there could easily be a breach of contract.

In some respects this is the quintessence of the Coase Theorem: if transactions costs are zero, efficient allocations will arise with private agreements so that the initial allocation will not influence the efficiency of the final allocation. This would support a 'homestead principle', that the first claimant of an ownerless resource is *de jure* the owner, as a method of allocating the resource initially. A somewhat broader interpretation of the Coase Theorem would state that provided there are no wealth effects and that the efficiency maximisation principle applies, then the value-maximising activities to which the contracting parties agree, are independent of their respective bargaining power or of the initial position before contracting.

However, the principle of Pareto improvement accommodates only two outcomes *viz* (i) both parties gain or (ii) somebody gains-nobody loses. It does not consider the possibility of (iii) somebody gains somebody loses. The latter is anathema to the spirit of the Paretian ethic. If in a contracting environment, one party expects to lose in a negotiation, that negotiation is either suspended or (relative) bargaining power is improved. This allows for a period of renegotiation, Salanie (1998). If we add the assumption of zero transaction costs to the broader interpretation of the Coase Theorem and define inability to pay as a (high) transaction cost, contracting parties with lower bargaining power or less income may have no Paretian alternative but to enter contract under the principle somebody gains-somebody loses.

In such a set of circumstances, contract law, paradoxically, may offer no legal redress. This is considered in a different context in Chapter 13 when we arrive at our conclusion that pro-poor redistribution policies do not benefit the poor. One resolution is the input of third party institutions to remedy the outcome, for example, poor relief agencies, consumer watchdog bodies or government legislation on minimum standards for product safety or building regulations. In the case of the latter, the gainer in the contract may become the defendant and liable to damages.

Ownership, Efficiency and Bargaining

Embedded in any contract curve analysis is an abridgement of property rights.

One of the earliest property rights principles in resource allocation is ‘the homestead principle’, that the first claimant on an ownerless resource is *de jure* the owner. Used as a working principle during the expansion of the frontier in US history, its net effect was to maximise the value of the public lands available for private use. While common or judge-made law acknowledges this principle as a pragmatic solution in natural law ethics, the principle derives from metaphysical axioms concerning the nature of reality. Not only does it have a ‘first come, first owned’ basis in law, it also maximises value of the resource. For example, owners of the land may wish to sell the land for £1 an acre while others may value the land at £10 per acre. Exchange in this case would maximise value. Therefore if contracting parties are able to bargain together effectively and can effectively implement and enforce their decisions, then the outcomes of economic activity will tend to be efficient (at least for the parties to the bargain), Milgrom & Roberts (1992).

However, it is imperative that we distinguish between bargaining across outcomes, issues or decisions and contracts *per se*. Bargaining is voluntary act, contracts, however, require enforcement and therefore the cost of arriving at an efficient outcome must include the enforcement costs of contracts. But there is an efficiency reason for enforcing contracts: the contract signals information to the market. In the context of bargaining and enforcement, information and co-ordination is required, particularly where there is an absence of asymmetric information.

The Neo-Classical approach to the firm, would argue that the system of markets can solve the co-ordination problem effectively and efficiently. From a public choice perspective, the costs of co-ordination are positive in any market, but a market exists in the first instance provided there is a system of property rights, perfect information across economic agents and zero transaction costs. The traditional representation of a product-market is perfect competition. If transaction costs are high in this market, a firm is required, and the firms collectively make up the market structure. Public choice scholars have demonstrated that there are non-market solutions [say] in the case of accidents or pollution. In other words, with high transaction costs the law is required.

The Neo-Classical approach presumes that property rights exist. In fact, they are exogenous in a standard microeconomic model. This is short-sighted as a rights dispute can easily translate into a dispute on ownership. If there is disputed ownership, contracting has no valid basis in law. However, there is a resolution of any such dispute and it is contingent on information. In our example of *The Bamboo Flute*, the allocation of the flute amongst the economic agents, the determination of ownership, depended on the

information at hand at the time of decision. Rules of distribution in the example are clearly value-based. There is a Marxian-Nozickian rule, a Bethamite-Utilitarian rule and a Rawlsian rule of redistribution. Each rule does resolve the allocation problem but the distribution outcomes differ significantly.

Ownership of the flute and the property right will reside with a different individual under each of the three rules. The relevance of this is that each rule focuses on the end-state in the same way as the value maximisation hypothesis looks at the end-state of an agreed contract. In many respects the value maximisation hypothesis is not dissimilar to the application of the Bethamite-Utilitarian rule to contracting. On the other hand, a contract is not an end product as justice can be achieved in the process of transfer and transaction. There is a historic precedent in the just contract and the Scholastic's concept of a just wage in the 12th century. Elsewhere, McNutt (1987) has argued that if a transaction or contract is just then both contracting parties will agree to it. However because they agree to a transaction or contract does not mean that the transaction or contract *per se* is just.

Bargaining and the Legal Nature of Contracts

The historical precedents in law for an understanding of contract are in the legal constructs of promises and agreement. The legal nature of contracts interprets a contract as a promise or set of promises for the breach of which the law gives a remedy or the performance of which the law in some way recognises as duty. Contract is an agreement, an offer made and accepted. And a valid contract is one that meets all of the legal requirements for a binding contract and valid contracts are enforceable in court. Related issues may include 'contract by conduct' and the complementary issue of 'meeting of the minds' in arriving at the contract terms, *vide* Atiyah (199x).

In developing a contracting environment our approach is to focus on *contracts as enforceable agreements*. In English Law, for example, emphasis is placed on agreement-as-bargain form of the *simple* contract with little or no emphasis on promises. Simple contracts differ from *formal* contracts in that a simple contract is an agreement or bargain not made in deed. So therefore we ask, how do promises and contracts differ? And does the difference have an economic significance?

Consider the following typology, whereby promises plus an agreed exchange (reciprocal act) equates to a contract. In this typology, contracts are promises and not all promises are contracts, The latter is defined in English law as a gratuitous promise or gift of no reciprocation. For example,

Mr A proposes to give his cow to the butcher in return for some reciprocal act or promise of performance. The agreement-as-bargain form implies the enforcing of promises that form part of an agreed exchange, a bilateral contract or an agreement. The agreement-as-bargain form is not about contracting, that is, the reaching of agreement and therefore the contract per se, if enforced, would have no economic basis. In other words, value is neither maximised nor agreement reached.

A more utilitarian view would probably look at the aggregate value of the contracting parties, but may not be concerned with how the aggregate value is distributed between the parties. The assumption that parties will bargain in ways that leaves each of them better off assumes that they have perfect information about each other. In the famous case of *Smith v Hughes (1871)*, the defendant, a racehorse trainer, having agreed to buy some oats from the plaintiff farmer, refused to pay for the oats when they were delivered. The defendant maintained that he understood the agreement to be for old oats not green oats as actually delivered by the farmer.

This case posed the following question: to what extent should the law, contract law in this case, find agreement on a person's inner intention or on outward appearance. It is an interesting question as it raises the issue of subjective or objective approach to a contract. Lord Denning MR in *Storer v Manchester City Council (1974)* argued that 'a contract is formed when there is, to all outward appearances, a contract, protecting good faith, it promotes both commerce and fairness'. The economic significance of protecting good faith translates into a value maximising contract (promoting commerce). However, whether the end-state – the contract or bargaining outcome – is fair depends on one's philosophy and is therefore a subjective response.

The outcome may be unfair, especially as it will affect the underlying distribution of wealth. Consider the case of the farmer v the rancher, a dispute about erecting a fence or not. The Coase Theorem states that the most efficient outcome will obtain. But what about access to water rights? If 100 homesteaders group together and deny the rancher access to the water, his wealth (as measured by the numbers in the cattle herd) will reduce in value unless the cattle have access to the water. Similarly if the rancher has access to the water and his cattle roam the range, the wealth generating capacity of each homestead tillage farm will be reduced.

Consideration and Post-Contractual Opportunism

Economic analysis of legal rules identifies the related issue as a *second best problem*, that is, one party to a contract misled the other party into thinking

intent on entering a contracting environment. If you made a mistake and did not mean what you said or intend to do what you did, the resulting exchange is not a value maximising exchange. In such circumstances a Posnerian solution would require a tort liability to deter such careless behaviour. This raises the question of legal obligation in torts. A Coasian solution - the Coase Theorem depends on [i] zero transaction costs and [ii] no wealth effects - would impose the tort liability on the party with the higher transaction costs. So, for example, if you live on a street and own a tree which overhangs the pavement and a branch falls off and injures a pedestrian, you have a legal obligation in torts but the farmer with many trees on his land has no legal obligation as transaction costs are much higher.

Perfect contracts in a Coasian world, therefore, would require the following set of conditions to hold: full information between contracting parties, many contracting parties, zero transactions costs and no third party effects. Transaction costs include strategic holdout, monitoring costs, strategic costs and ability to pay. In the case of the latter, consider the case of Ms A, who has a nice house with a grand uninterrupted view and her neighbour decides to strip mine in front of the house; value of the mine = £250,000; if Ms A values the house at £400,000 could she pay the neighbour at least £300,000 to stop mining? She may have to re-mortgage the house to ensure an efficient outcome.

A possible fifth requirement that is more economic in its orientation and increasingly legal in interpretation, is that of individual rationality supplemented by well-ordered preferences and a principle of maximisation. The legal concern over 'transactional incapacity' would arise in this instance. Basically, if any of the five requirements do not hold, the contract is defined as imperfect [incomplete]. And post-contractual opportunism will arise in a contracting environment when one party can exploit a loophole in the incomplete contract and gain an advantage.

It is against this background that one can appreciate the difference of legal opinion on the merits of a more traditional exchange model of consideration and the reliance model of enforcement in contract law. Contractual liability is based on breach of promise but not every promise will be enforced even if it was meant as a binding commitment. The promise must be supported by consideration if it is to be enforceable. The contract is a promise-based obligation and the traditional formal model of law is the offer-acceptance model. Some exceptions of interest to economists include general trading situations that are analysed in law as 'invitations to treat' rather than as offers. Albeit, how this would apply in the case of 'window displays' in a retail shop is of interest. If goods on display represent a shopkeeper's offer, inviting

acceptance from customers then there are two possible defences for the defendant-shopkeeper in his public interest role *viz* a [i] limited stocks defence and a [ii] choice of customer defence. In the latter the defendant may have a public duty not to sell dangerous products or to exercise discretion in the sale of products to customers.

This further gives rise to the 'no consideration, no contract' school of thought. Consideration means something that is of some value in the eye of the law - it may be some detriment to the plaintiff or some benefit to the defendant. In order to constitute consideration a performance or a return promise must be bargained for. It is worth noting that in commercial contracts there is no problem over consideration when the contract is made. This arises because the contracting parties will have agreed on a value for money exchange. This school of thought facilitates a Posnerian influence and allows it to infiltrate contract law as in the economic analysis of torts. There is an overlap between a public choice and the law and economics approach to contracts. A public choice approach would emphasise property rights, fairness and justice in a contracting environment, issues that play an integral part in the economic interpretation of established legal concepts such as contract.

OWNERSHIP AND THE s-FIRM

Earlier, we had shown that a rule-based resolution of the allocation problem is intricately linked to ownership and property rights invested in the individual. In this section a new approach for evaluating ownership within the firm is presented wherein the worker has property rights short of ownership. Emphasis is placed on the worker-stakeholder firm, *the s-firm*. The level of enterprise activity depends on the worker-stakeholders' property right in the s-firm, which translates through *enforceable contracts*, into the right *to choose how much to produce*, a reward for enterprise which is denied workers in the Keynesian world of enterprise activity. The contract is analogous to a rights allocation mechanism, a general self-interested process for ensuring the willing transfer of rights and the transfer of rents across the different worker-stakeholders in the s-firm for reward. It is therefore incumbent upon management to adapt productive opportunities within the s-firm (to an assurance of maximum work effort across worker-stakeholders) and to mobilise ownership in order to realise the productivity-enhancing activities of the s-firm.

Ownership and (Property) Rights

A different enterprise culture that may contribute to a greater realisation of productive enterprise has emerged. It is best characterised by firms offering flexible working hours, minimal fringe benefits, retraining opportunities, subsidised child care while encouraging tele-working, outsourcing, sub-contracting; it is an enterprise culture interspersed with contract workers, contingent workers and ‘portfolio workers’, an enterprise culture within which it is predicted that ‘the supply of enterprise seems destined to outstrip the demand’. We refer to such firms as *s-firms* and the workers are defined as *stakeholders* in the firm, they are part of the firm, managing themselves, monitoring quality and productivity.

This is in contrast to the neoclassical model, Arrow (1994, p7), wherein

“workers are *not part* of the firm. [T]hey are inputs purchased on the market, like raw materials or capital goods. Yet they (or some of them) carry the information base [.....] *they are neither owners nor slaves*. There is therefore *a dilemma in defining the firm as a locus of productive knowledge [our italics]*”.

Earlier debates on privatisation, Prentice and Holland (1993), revolved around the issue of ‘people’s shares’, *Volksaktiem*, and about empowerment of workers. In this section we focus on the empowerment of workers, and proceed to identify the hallmarks of an s-firm by re-evaluating the concept of ownership within the s-firm. Since there is no concept of absolute ownership in law, ownership is characterised by a set of rights, for example, (property) rights in the use of resources by the s-firm and by different stakeholders in the s-firm. The emphasis is on providing incentives and in increasing the scale of profit opportunities within the s-firm rather than in insulating the worker against risks and contingencies.

The s-firm

The s-firm is not a worker’s co-operative; within a worker’s co-operative ownership is acquired outright by the workers, whereas within the s-firm, property rights short of ownership, accrue to the stakeholders. The s-firm is recognisable as a proper subset of Eichner’s (1985) ‘megacorp’ which operates not one but several s-firms in each of the industries to which it belongs with each s-firm embodying (in the form of a fixed set of technical coefficients) the least-cost technology and a menu of property rights and

enforceable contracts. What are s-firms? If the s-firm is not a co-operative, do workers have ownership in the firm?

This section will attempt to answer these questions. Reconciling the attributes of the s-firm with those of a more traditional neoclassical firm is a pre-requisite for an economic evaluation of profit opportunities within a modern firm. The essential point is reconciling Arrow's dilemma in defining the firm is that worker-stakeholders have (property) rights short of ownership, in the s-firm. The entrepreneurial skills of the workers and the s-firm are *co-special assets*; in other words, the skills, reminiscent of Becker's firm-specific human capital, complement the asset value of the s-firm. More importantly, the skills are highly specific to the s-firm in which the worker operates. In this case, the workers are at a disadvantage and any breakdown in bargaining between the workers and the owner will lead to large costs on both sides, Milgrom & Roberts (1992). However, unless bargaining costs are prohibitive, the Coase theorem dictates that the workers and the owner will agree on some value-maximising agreement. Efficiency is not affected in this case, but the redistribution of the value will be skewed in favour of the owner.

This is the real social cost of *hold-up* as workers - receiving less of the value of the firm and consequently less (property) rights in the firm - have no incentive to improve productivity or work-effort. As argued by McNutt (1994), management failure to assign (property) rights across workers will reduce the amount of productive enterprise, the f-factor. But where are these property rights located and in what sense are they characteristic of the s-firm? The (property) right to choose how much to produce is a reward for enterprise. The production output may be owned by the s-firm but the firm specific human capital is embodied in the worker-stakeholders. Management must realise *a la* Arrow (1994, p7) that

“embedded in workers, managers and technical personnel is an important part of the market's valuation of the capital of a firm, though not property in the usual sense [our italics]”.

It is this realisation that should create the contracting environment within which workers and management re-evaluate the worker-management relationship. In addition, workers realise independently of management that an *assurance* of collective work-effort within the s-firm (induced by an increased probability of unemployment in the s-firm's product-market coupled with less job security in general) increases the amount of productive enterprise. We suggest that changes in the modern corporate environment is facilitating an s-firm enterprise culture. With increasing unemployment and a

growing labour force, modern firms are less compelled now than hitherto to offer job security. Against this background the workers *per se* have to consider themselves as stakeholders in the firm, having (property) rights short of ownership in the firm, in order to create a pro-worker enterprise culture and avoid the exploitation of workers.

The Domain of Profit Opportunities

Within the traditional theory of the firm, emphasis is placed on what we shall call the proprietary firm, the *p-firm*; the paradigmatic example is the microeconomic textbook neoclassical firm. Management's goal within such firms is long-run profit maximisation and workers are often regarded as expendable costs. In the neoclassical model, for example, the p-firm is capable of operating only a single plant with a management team limited to one or two owner-entrepreneurs. Managerial discretion is limited however as profit opportunities are diminished by conflicts within the firm, conflicts which emanate from principal-agent type problems so characteristic of the management-worker relationship. Consequently both management and worker's objectives in the p-firm begin to undermine the role of profit opportunities in ensuring the economic performance of the firm.

The p-firm is subject to decreasing returns when it expands output beyond the minimum efficient scale plant. Management make one decision continuously over time on how much to produce. Investment occurs *infrequently* in the Neo-classical p-firm but when it does occur the firm can be expected to rely on bank financing because of the firm's inability to generate funds internally. The decision on the amount of employment is *left to the firm*, Blanchard and Fischer (1989). With such hallmarks the environment of a p-firm is *not conducive* to realising profit opportunities as the legitimacy of worker's rights within the firm is relegated to short term objectives. In the p-firm management "is more nearly the essential definition of the firm", Arrow (1994,p7). Furthermore, the most successful companies rely on a process of 'entrepreneurism' (management are assumed to have a monopoly of ideas) that can be better accommodated within the framework of the s-firm.

Change of Ownership

The s-firm is an organisation of pairwise individuals; the atmosphere within the firm is co-operative rather than adversarial. As pairwise individuals the stakeholders realise that their respective contributions to the work-effort are

not necessarily mutually exclusive. In other words, any dispute within the firm can be resolved by compromise and negotiation. In particular, any dispute over the use of real resources within the firm can be so resolved. One thinks of ownership from the perspective of shareholders or workers' co-operatives, where ownership translates into shares or an intangible stake in the firm. As alluded to earlier, ownership is about (property) rights and the nature of the s-firm allows worker-stakeholders to have a property right short of ownership in the firm, contingent on an enforceable contract between the worker-stakeholder and the s-firm.

The legal nature of the s-firm is principally about the assignment of those (property) rights and the elimination of quasi-rents. For example, an unequal assignment of rights and the existence of quasi-rents generate conflict within the p-firm and undermine the level of productive profit opportunities available to that firm. In other words, rights and quasi-rents circumscribe the conduct of enterprise and the intra-firm [stakeholder] conflict retards the scale of profit opportunities. The nature of the s-firm, however, is such that it represents the embodiment of property rights across the various stakeholders in the firm. The firm uses the real resources of society in order to produce; each worker-stakeholder privately holds the rights to the use of the resources.

Each stakeholder has a (property) right, j_h , in the use of real resources by the firm. For the worker-stakeholder, the (property) right is invested in their respective work- effort; instead of taking the p-firm view that higher wages are paid to encourage increased work-effort, higher wages are considered as a means to *assure* increased work-effort when the work-effort cannot be observed before a productive opportunity is realised but only experienced in the course of employment, Nelson (1970), Holler (1987). Labour is assumed to be an *experience good* for the s-firm and the work-effort is not exogenously enforced. The work-effort solution proposed by McNutt (1995), implies that a work-effort better than a minimum is self-enforcing and subject to an enforceable contract.

Consequently the level of enterprise activity depends on j_h , the worker-stakeholder's share in the s-firm. The (property) right short of ownership assigned to a worker-stakeholder, for example, translates into his or her right to choose how much to produce. This is denied the worker in the p-firm. Therefore the s-firm incorporates a twin set of realistic microeconomic elements, enforceable contracts and (property) rights, and is located in an economy of heterogeneous *s-firms* enmeshed in a web of intricate stakeholder conflicts. The stakeholders engage in a contracting system of co-ordination and information sharing as a solution to the stakeholder conflict. The idea is not without precedent in history with the guild system in early industrial

Europe and the kinship networks in Tokugawa Japan.

Commodification

Primarily, the s-firm acts as an allocating mechanism for the transfer of (property) rights and economic rents across the contracting stakeholders. It is inevitable that conflict will arise in the assignment of (property) rights. For example, the worker-stakeholders may disagree with management on work practices or productivity awards. For each stakeholder there is an expectation of greater *employment* security. As an organisation dependent on stakeholder harmony, s-firm management are disciplined by the stakeholder's right to convert their respective expectations into a near-contractual obligation, backed by law. This could manifest itself in the demand for health and safety regulations, in the implementation of unfair dismissals legislation *inter alia*.

However, the corporate environment has dramatically changed. The epoch of organised capitalism or Fordism based on mass production and semi-skilled labour and an interventionist government, has been replaced by a new period of disorganised capitalism. In this new post-Fordist era, Pierson (1994) comments that:

“These new circumstances will not see the wholesale withdrawal of the state from intervention in the organisation and reproduction of labour power. Indeed the role of the state and the movement in and out of paid work may be enhanced”.

In what Offe (1984) calls ‘administrative recommodification’, the role of government in promoting fuller utilisation or commodification of capital and labour will emerge indirectly through corporate tax concessions, training programmes and subsidised industrial loans *inter alia*. In framing macroeconomic policy through its budgetary policy, governments could adopt a strategy of administrative recommodification. However, in practice, government budgetary fiscal policy often promotes a process of decommodification, that is, it undermines the circumstances for a fuller utilisation of labour resources. This is reflected in the continually high price of labour through social welfare payments or an absence of labour subsidies, in the perpetuation of a ‘welfare trap’ between employed and unemployed welfare entitlements and indeed in the toleration of profit repatriation by foreign companies. Decommodification is further facilitated by a government's inability to create productive employment within the public service.

The Technology Set of the s-Firm

McNutt (1994) defines the technology of the s-firm. A first intuitive approach would assume that changing the ownership shifts the production function represented by the production possibility frontier. In other words, productive profit opportunities arise because the production possibility frontier is moved in such a way that *given* worker-stakeholder inputs produce *more* output [that is, $Q^* > Q_1$] as illustrated by shaded area in Figure 2. This will impact on the measure of productivity within the firm as the marginal productivities will depend on H . The management team have the responsibility for ensuring compliance in order to realise the profit opportunities as they arise. Failure to assign (property) rights across worker-stakeholders will be reflected in the amount of productive enterprise, the f-factor.

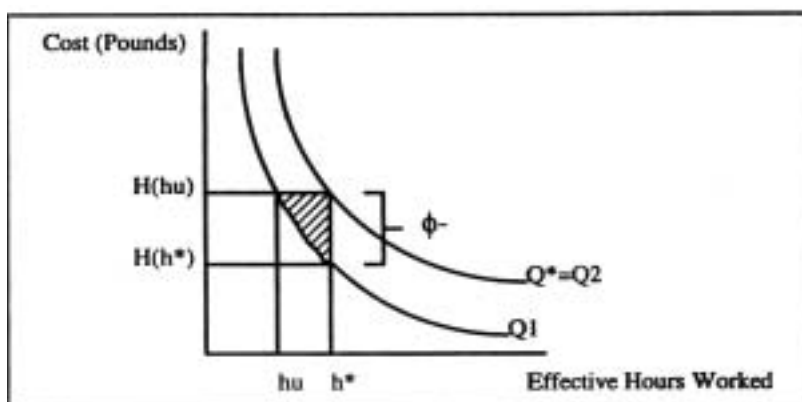


Figure 5.2 Effective Hours Worked

Within the s-firm there is no reason for the wage to be equal to the marginal product of labour. As in a Barro-Hall world, wage-rigidity is irrelevant for employment determination in the s-firm world. What is important for employment creation is an increase in capacity utilisation from Q to Q^* due to reduced shirking and greater work-effort from worker-stakeholders and the ability of management in high-wage firms to screen and obtain a higher quality labour force. The improved work-effort arises from an enforceable contract between management and the workers. For output to be produced at

the Q^* level, management has to ensure that the interests of the worker-stakeholders, interests which may range from an improvement in working conditions to the level of real wages to the level of profit opportunities, are satisfied.

In this context the decision on the amount of employment is contingent on the behaviour of the worker-stakeholders. The approach subscribes to the new-Keynesian view that nominal rigidities do not originate in the labour market. Within the s-firm, hiring and firing is less common than in the more traditional p-firm. Management create synergies across the worker-stakeholders which enables each stakeholder acquire their respective property right. In other words, property rights within the s-firm are more clearly defined as the firm-specific resources become more valuable. In the s-firm, zero transactions costs arise as the costs of negotiating, policing and enforcing contracts are zero.

Enforceable contracts

Conflicts across worker-stakeholders and management that may impact on the growth of the s-firm are possible, and the conflicts ought to be resolved. The problem may arise due to the hierarchical structure in modern firms which requires of each worker or manager a supply of work-effort and entrepreneurial talent respectively. While each individual stakeholder is contracted to the firm there is no such contract, implicit or otherwise, between the stakeholders. Consequently some managers and workers may be unwilling to supply their respective skills. Within a given organisation the competitive hierarchical structures may even militate against the sharing of entrepreneurial skills. It is the nature of the s-firm that every effort is made to ameliorate any adversarial fallout from the hierarchical structure. This can be achieved by enforceable contracts within the s-firm, in other words by coerced transfers of (property) rights in return for compensation, that is by *coerced compensated contracts*, McNutt (1995).

In the enforceable contract the passive party is obliged to render a personal service, that is, obliged to do something but get a financial reward in return or a public good within the firm (an assurance that all other workers are *not* shirking) or a share in the capital value of the firm. Enforceable contracts in the s-firm coincide with increasing monitoring and manipulation of the payoffs to both workers and management so that monitoring becomes a dominant strategy and compliance becomes the only best reply. Each worker-stakeholder realises that other stakeholders can adopt positions which conflict with their own. Indeed any worker-stakeholder has the capacity to respond in

such a way as to disadvantage the other stakeholders in this game of shirking-monitoring, thus retarding profit opportunities within the s-firm. The intuition behind the outcome in McNutt (1995) is that the worker-stakeholders realise the diseconomies (for example, loss of employment or closure of the s-firm) in supplying anything *less* than maximum effort.

In each specific case where stakeholders shirk, there is an element of conflict that has to be resolved. Indeed a co-operative solution in which neither stakeholder opts to supply the work-effort, is not uncharacteristic of some peer structures in the p-firm. The time and effort into the resolution of the dispute translates into high opportunity costs for the s-firm and thus high costs for the worker-stakeholders. In other words, for a representative worker-stakeholder, the opportunity cost of co-ordinating failure is positive - the opportunity cost argument has a parallel in Leibenstein's X-inefficiency where the real resources of the firm are channelled into unproductive areas of activity which may adversely affect the long term viability of the firm.

THE CORPORATE LANDSCAPE

In the competitive environment in which the s-firm operates there is an increased probability of unemployment, therefore the real resources of the s-firm are valuable to all the worker-stakeholders. In the modern corporate environment the structure of (property) rights between stakeholders and across worker-stakeholders in the representative firm has changed - the irrelevance of the p-firm is captured rather well by DeAlessi (1983) quoting Alchian:

“[d]ifferent systems of property rights present decision makers with different structures of incentives, resulting in different alignment of resources”.

Unless different incentive structures are put in place in the modern firm to reflect the different ownership structures, worker-stakeholders will continue to realise quasi-rents, thus retarding productive opportunities as they arise within the p-firm. The level of enterprise activity will depend on the assignment of worker-stakeholder rights. In a climate of job losses, stakeholder conflicts will arise, impinging negatively upon the realisation of productive enterprise in the firm. However, if the worker-stakeholder's (property) right in the s-firm can be compensated, increased work-effort may buffer the workers within the firm against layoffs.

In a later article, DeAlessi (1973) was rather more forthright in his criticism

of the proponents of the doctrine when he commented

“[T]he empirical evidence so far does not provide a definitive test of the hypothesis that different degrees of dispersion imply different outcomes to the firm’s decision process”.

Privatisation programmes in the 1980’s, with their wider share-ownership and the creation of a market for corporate control on the stock exchange, have not increased accountability or reduced bureaucracy. Ownership impacts on a set of property rights. These property rights may vary between different capitalist countries but it is imperative that they do not differ across stakeholders within each country. Public limited companies or firms are generally considered to belong to the private sector. Government, however, could still own some of the shares. Although privatisation can be interpreted as a reduction in the role of government in the economy it is still quite possible that privatisation may be a *rous* for government involvement in the economy, principally as a stakeholder in a privatised firm. Inefficient legal provisions, for example, and failure to determine the hierarchy within the privatised p-firm may precipitate an imperfect allocation of property rights. This would paradoxically relegate the behaviour of the privatised firm to that reminiscent of the firm when it was state-managed or government controlled.

A theory of property rights as applied to the s-firm requires a complete theory of the firm. In the absence of a clear definition of what the firm is, except a coalition of competing stakeholders, one may have to incorporate a rent-seeking dimension into the theory of property rights. The s-firm organisation as a coalition of competing stakeholders contributes to the dissipation of quasi-rents. Rent-seeking behaviour is a necessary information activity in an otherwise disaggregated s-firm organisation. However, the rent-seeking literature does not explicitly mention property rights, although *undesirable* rent-seeking may be interpreted as an abridgement of someone’s property rights in an *unwilling transfer*.

Sisk (1985) identified the unwilling uncompensated transfers as the essence of the undesirable Tullock-Posner-Krueger rent-seeking. Quasi-rents are positive when property rights are unassigned within the s-firm, Posner (1974), who had advanced the idea that property rights will be more clearly defined as the resources become more valuable. Worker-stakeholders will be prepared to enter into near formal contracting arrangements with the s-firm in return for a property right share, $\frac{1}{j}$ (of the value of the firm); the share may manifest itself in job security during periods of high unemployment in the industry, better working conditions or in the ability to choose the amount of work

effort.

Hidden Action

Since jointly controlled, 50:50 full-function joint ventures with parents having turnovers below the thresholds are now dealt with in practice primarily with national merger agencies, a greater degree of responsibility has been placed on these agencies. Competition and merger policy are processes that have to be centrally managed by a public funded agency. National agencies are accountable for the expenditure of a limited public budget and are faced, as are all public agencies, with the strategic issue of balancing the costs and benefits from expending public funds. The balancing is a measure of how effective the law is in reality.

More precisely, in a merger case there should be a measure of how efficient the law is in that particular case. Efficient law, for example, would focus on the level of fines, the degree of sanctions and on more effective enforcement, administering and policing of the law. The administering of the law, in our opinion, could facilitate a hidden action problem. Quite simply, the problem could arise with increased decentralisation. With the added dimension of the fallout from the Commission's *White Paper*, a hidden action problem could best be characterised by the following quote:

‘If a national authority were consistently lax or protectionist, or so legally inefficient that its actions are frequently annulled by national courts, or had been ‘captured’ by the companies [...] or if it was not subject to effective judicial review or if it was simply too small to do its job fully....’

A combination of any one of these factors could contribute to a hidden action problem, particularly if the greater degree of responsibility imposed on national merger agencies is not matched with additional resources. If the decentralisation and modernisation proposals of the Commission succeed through to implementation, and resources are devoted to national agencies and national laws in Member States are amended to reflect the new powers of the agencies, the hidden action problem may disappear.

Corporate Governance

There is the added concern that the legal definition of ‘full function’ in the Merger Regulation may not be exhaustive. The procedural rule is straightforward: if a joint venture is not full-function, the Merger Regulation

does not apply, irrespective of thresholds. However the Merger Regulation appears silent on the issue that if a joint venture depends entirely on its parents to sell its products and services or obtains from them all the products or services it sells or which sells its products or services only together with those of the parents, it is not full-function even if it has staff, funds and assets of its own.

However the real criterion for full function from a corporate governance perspective is whether the joint venture is as such present on the market. That it obtains all its inputs from its parents would then not be relevant, but if it sells only to its parents it is not on the market and thus not full-function. This raises a further issue, the nature of the firm and a related issue of corporate control. The latter has an important significance for competition law in practice. The decision in the *Philip Morris* case, for example, referred to a controlling interest and the likely competition implications thereof. The case had established that

“an acquisition by one company of an equity interest in a competitor does not, of itself, constitute a restriction of competition. However, such an acquisition may serve to influence the commercial conduct of the companies in question so as to restrict or distort competition [our italics].”

It was concluded that share acquisitions in competitors fall within Article 81 where they influence the market behaviour of the firms concerned so that competition between them is restricted. However, in a hypothetical case where a national merger agency is in no doubt that Firm B has a (relatively) strong degree of corporate control *vis-à-vis* its shareholding in Firm A, despite the relatively low level of its equity stake overall, then could this satisfy any concerns that competition is not affected?

This would depend on the strategic management of the joint venture. So, if management of the joint venture exercise a degree of independence from the parents, a degree far enough removed from the parent management, the joint venture, arguably, could qualify as an autonomous economic entity. However, any assessment of spillover effects in this hypothetical situation would have to focus on the control of the parent companies over the joint venture. And this necessarily should awaken the agency’s concern about co-ordination and co-operation, the very quintessence of the boundary of the firm.

The Boundary of the Firm

So much time and effort is devoted in competition evaluations to the definition of the relevant market, that little or no time is devoted to the definition of the *relevant firm*. One response would be to define the boundary of the firm as ownership and control. With² authority from *Anglo American/Lonrho*, a controlling shareholding in a company can arise with a shareholding of 27.5%, which will give rise to a presumption of control. Although a controlling shareholding in a company will give rise to a presumption of control, such a presumption can be rebutted by behavioural evidence of business autonomy that indicates *de facto* control, *vide Phillip Morris*. However, ownership (of a shareholding) may not generally imply a 'controlling' position in competition law. Faull & Nikpay had commented that

'an acquisition of shares that will not give an acquirer a legal or de facto majority of the voting rights cannot in itself confer control over the target company (p212)'.

Against this background, a national merger agency, by adopting a positivist public choice perspective, would be required to focus on enforceable contracts, that is, 'legally binding agreements', in determining control.

As argued in earlier chapters, Chapter x, ownership and a controlling position would be considered as complex contracting relationships. For example, the 'legal relationship', enshrined in an equity stake or shareholding, may allow companies and their investors adjust to circumstances that would enable them to adapt better to the economic situation facing them or may provide legal protection for investors. In other words, ownership and a controlling position are legal constructs and their integrity as such ought to be respected in any assessment of likely competition matters by national merger agencies.

An Enforceable Contract

A shareholder's agreement between any two or group of shareholders would suffice as evidence of ownership. An agreement as an enforceable contract between equity partners would represent a well-defined set of property rights. Well-defined property rights are an integral part of ownership and are necessary to achieve an efficient allocation of resources within the firm. In a different context, Posner (1992) had observed that

'without property rights there are no incentive to incur these costs (of investment)

because there is no reasonably assured reward for incurring them’.

If the agreement were to provide for one shareholder to manage or determine the strategic behaviour of the target joint venture or merged firm or to appoint a majority of the management board, then that shareholder would have control of the joint venture or merged entity.

The absence of such an agreement, however, would eruditely challenge any presumption of control. Therefore the non-existence of any shareholder’s agreement introduces the possibility that a shareholding in Firm A may be purely financial. Such an interpretation circumscribes the efficacy of any decision to focus on Firm B’s shareholding in Firm A while assessing the acquisition by Firm B of a remaining shareholding in Firm C.

In other words, no national merger or competition agency could argue that a shareholding *per se* is likely to influence the structure of the market through recourse to methods different from those that condition normal competition on the basis of (economic) performance. In the tapestry of competition evaluations, an evaluation of strategic issues pandemic in the market, for example, might lead one to conclude that a disputed shareholding is either a *sine qua non* for firm survival or part of a restructuring process in a consolidating dynamic market. Theoretically, as pointed out by Faull and Nikpay, ‘sole control could even be acquired by a company that does not hold any shares at all in the target company (p212)’.

A standard of ‘intelligibility of the offence’

The overlap between a contractual right to veto and a ‘legal relationship’ that further allows companies and their investors adjust to circumstances that would enable them to adapt better to the economic situation, raises the issue of the ‘intelligibility of an offence’ under the competition legislation and the assessment of the intelligibility of the offence under competition law. For example, when is an offence against Article 81 or 82 intelligible? An intelligible offence in our legal reasoning is defined as an offence that violates a robust and reasonably clear rule. Price fixing, for example, which is universally proscribed by competition agencies, would be an intelligible offence.

However, an x% shareholding ownership structure may not be an intelligible offence because recognising ownership rights can weaken a reliance on ownership structure *per se* as the bedrock of the alleged anti-competitive conduct. There are ownership rights within an ownership structure and therefore every ownership structure represents as a well-defined

set of property rights within the undertaking concerned. An acknowledgement by a national merger or competition agency of ownership rights would introduce, by default, a new standard of ‘intermediate degrees of ownership’ into their legal reasoning on control. However the introduction of such a standard would be inefficient without a robust and reasonably clear rule as to how the varying degrees of ownership *per se* constitute an offence under national or European competition law. Therefore an x% shareholding ownership structure is not an intelligible offence.

However, if control is deemed to exist at a threshold of (say) 27.5% on authority from case precedent, then a national agency could argue that the offence would appear to be intelligible, that is, Firm B’s 27.5% shareholding in Firm A gives rise to a presumption of control. However, a remedy of a lesser shareholding may be unintelligible in the absence of a precise and reasonably clear rule. For example, would a 25% shareholding have contributed towards the alleged offence? Would an 11% shareholding have contributed towards the offence, more or less than 25%? Would a 10.5% shareholding have contributed towards the offence, more or less than 25%? This relegates the significance of intermediate and varying degrees of ownership as a source of anti-competitive conduct.

Cross-Shareholdings

A decision to focus on Firm B’s shareholding in Firm A while assessing the acquisition by Firm B of a remaining y% shareholding in Firm C, raises a further question: how does B’s x% shareholding *per se* (not the market shares aggregated on the presumption of common control) in Firm A, actually alter the competitive structure of the market between A, B and C, such that

(i) a reduction in B’s shareholding in A to less than x% is a necessary condition to *compensate* for the prevention, restriction or distortion of competition

that

(ii) a reduction to an arbitrary shareholding (say) of less than x% is not sufficient to *restore* effective competition

and that

(iii) acquiring the remaining y% shareholding in Firm C in either case (i) or

(ii), does not in and of itself *constitute* preventing, restricting or distorting competition?

Such permutations in the shareholdings, beggars the question: why focus on an x%? What is intelligible about a shareholding above or below x% or any shareholding threshold, which is unintelligible about a lesser shareholding as an offence? In other words, what precise and reasonably clear rule has been broken that a reduction to an arbitrary shareholding is not sufficient to restore effective competition on the market?

Different ownership structures are not mutually exclusive

Ownership structure is seen from a transaction costs economics perspective, where ownership structure is an 'endogenous outcome of competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organisation of the company, firm or undertaking. It is the conclusion of a shareholder's agreement that would constitute a concentration under the ECMR. Different equity stakes or pairs of shareholdings are not mutually exclusive for competition policy assessment. If they do not represent different ownership structures it cannot be conclusively assumed that any one shareholding ownership structure is anti-competitive but not another, because

either one or both shareholdings may represent minority shareholdings

and/or

(b) the effect of any shareholding on the issue of common control at Firm A or C, could be inextricably linked to future variation(s) in ownership of the majority equity stake in either firm and could be inextricably linked to future variation(s) in ownership of the equity stake in Firm A or C or future variation(s) in the ownership of the divested equity stake in Firm A.

What is important to note here is that the concept of control in the ECMR is based on qualitative rather than quantitative criteria. The existence of shareholders' agreements should be taken into account by national merger agencies. However, the key expression in Article 3(3) is 'the possibility of exercising decisive influence on an undertaking'. Therefore the key question should be whether or not the acquiring firm will actually exercise the decisive influence. As pointed out by Faull and Nikpay:

'situations where no stable voting majority can be attributed to two or more minority shareholdings will not constitute a concentration under the ECMR (p216)'.

CONCLUDING COMMENTS

An important concern in any contracting environment, whether it is the Edgeworth exchange environment or the s-firm, is the allocation of (property) rights. More importantly, can the allocation of those property rights reduce rent-seeking and X-inefficiencies? An enforceable contract is one possible mechanism for resolving the dispute, McNutt (1995). The contract is a rights allocation mechanism, a general self-interested process for ensuring the transfer of rights and the transfer of rents across the different contracting parties and worker-stakeholders in the s-firm. Within the domain of neo-institutional economics, for example, it is the rules of the game that determine the extent of the negative contribution of the amount of real resources devoted to the dispute, Eggertsson (1990). The rules of the game in the s-firm, would require an enforceable contract between stakeholders in the first instance.

While the economic analyses of ownership within organisations concentrates on residual rights, a legal basis of ownership across workers within the firm is not fully explored in the literature. Unresolved ownership issues - popularised in the literature as co-ordination failures - may retard the scale of profit opportunities within any enterprise. The economic characteristics of the traditional p-firm, where ownership revolves around private shareholders may not be conducive to exploiting profit opportunities. Competitiveness increasingly depends on how work is organised and on the work- effort within the firm, Kogut (1993). We therefore attempt to articulate intra-firm distributional concerns, which may impinge on the level of profit opportunities available to the worker-stakeholders in the s-firm.

The notion of the s-firm with its jointness characteristic and attendant rent-dissipation (incomplete contracting) offers a basis for ownership. In particular, by applying this concept of ownership across workers in the firm, the labour input is *commodified* and terms like 'worker', and 'employee' are replaced by the term 'worker-stakeholder' or stakeholder. The supply of enterprise is the source of ownership. Management's role, therefore, is to assign the property rights within the firm without invalidating the work-effort. Their role affects both enterprise and output.

As an organisation dependent on worker-stakeholder harmony, the s-firm is disciplined by each stakeholder's right to convert their respective expectations into a near-contractual obligation. Thus economic performance

across firms depends upon *commodified* labour and *enforceable contracts*, thus ensuring a supply of worker-stakeholders whose best reply strategy is no-shirking. The contract between worker and the s-firm is analogous to a rights allocation mechanism, a general self-interested process for ensuring the willing transfer of rights and the transfer of rents across the different worker-stakeholders in the s-firm for reward. It is therefore incumbent upon management to adapt productive opportunities within the s-firm by assuring maximum work-effort across worker-stakeholders and mobilising ownership in order to realise the productivity-enhancing activities of the s-firm.

Modern economies are increasingly characterised by firms engaged in batch production and niche marketing while in practice we observe a move towards smaller production sites, short production runs and a growing division of the workforce into a skills hierarchy. These observations on the corporate economy and on the nature of the enterprise may suggest a need to re-orient our understanding of ownership and entrepreneurship that have been so frequently ignored in the theory of the firm. The increased internationalisation of business, vide our discussion in Chapter 15, coupled with deregulation may undermine the promotion of full utilisation of labour resources. In particular, there is the need for a contracting environment approach that stresses the importance of *idiosyncratic* elements of production within the enterprise.

In any assessment of the underlying structure of the market, attention should be focused on (strategic) competition *for* the market and to ascertain whether or not it has begun to substitute for (strategic) competition between firms in the market. If so the market will perform, that is, competition will occur, regardless of the level of concentration. It is possible that a proposed transaction or acquisition provides the potential for a pro-competitive restructuring of the market by introducing a measure of real competition through the supply chain. The strategic arguments should be considered in all cases. It is worth noting whether the internal organisation of the firm can play an important strategic role in affecting a firm's ability to compete effectively in the market and whether organisational design *per se* can be an effective device to address competitive pressures in a dynamic market. Competition agencies must be cognisant of the impact of their decisions as a signal to business, providing sufficient incentives for other firms to adopt an organisational design that would address competitive concerns. Any dominance that occurs in such a market exclusively reflects superior performance. Arguably, dominance is not extended in such a market because of market power; dominance is extended because of superior efficiency, because of entry conditions, demand conditions, strategic behaviour and

market imperfections. Market imperfections include product heterogeneity, X-inefficiency and supply chain

The essence of efficient competition law is injury to competition. Concerns about concentration are an empirical matter - it may simply not be the case that a highly concentrated market implies higher prices. Common control has more to do with legal rights than a matter of economic fact. Economic issues of dominance and superior efficiency are not only a matter of economic fact but also of practical importance, particularly in a dynamic market where there are a number of attenuating circumstances (which could persist post-acquisition) including the continuance of the historic levels of concentration in the relevant market, brand share, endogenous³ barriers to entry, potential competition from within the market (supply chain competition constitutes potential competition from within the market) and crucially, the strategic nature of the Irish market. Any effect on competition of a vertical arrangement must factor in the impact of the intensity of competition or lack thereof, on the prevailing structure (market shares) in the market. Superior efficiency is one way of competing against a rival competitor.

The effectiveness of competition policy is contingent on its ability to maintain and indeed re-establish effective competition in the market. The causal link between the cross-shareholding in Firm A and the impact of that cross-shareholding *per se* on both the competitive structure and the concentration levels of the market has to be called into question. As a consequence there is a pressing need to identify and explicate the underlying economic and legal arguments (both in competition law and in the economics of corporate governance), through which different ownership structures are, henceforth, deemed to (i) operate anti-competitively, either by altering the underlying structure of the market (harm to competition) or by eroding the competitive strength of rivals (harm to competitors) and (ii) contravene Articles 81 or 82, having as their object or effect the prevention, restriction or distortion of competition. In the contracting environment the value of competition law has to be measured by its contribution to company adaptability. In other words, competition law should be *enabling* company development rather than retarding or threatening the performance of (large) companies, and/or their management, with cross-shareholding networks.

ENDNOTES

1. The author has completing a book on law and economics from Edward Elgar and is due for publication in 2002.

2. *Vide Anglo American/Lonrho Case IV/M754 1997, [1988] OJ L149/21*

3. Endogenous barriers are entry barriers that all incumbents can either influence or wholly control. They include excess capacity, advertising, patents but also embrace a category of strategic choices, which can be applied or merely threatened, for example, pricing, rival advertising. I would also include competition in the supply chain, through vertical integration or whatever, in the strategic choice set