

**Part I:**

**Sharing Sovereignty:  
From Autocracy to  
Parliamentary Democracy  
Without Revolution**

## **Chapter 2: Team Production, Organization, and Governance**

In the days before histories were recorded, there were few distinctions between governments and other organizations. Both were evidently largely familial and clanbased. As agriculture emerged and people settled in particular places, the variety and size of organizations and governments tended to increase, and distinctions began to emerge between organizations that could impose rules only on their own members and those that could impose rules on persons outside their organizations. That more activities took place within formal organizations and within territories ruled by governments does not imply that all activities were organized from the top down, as in totalitarian states, nor do the distinctions between governments and other organizations imply that the procedures used by territorial governments had become completely different from those used in other organizations. More people were simply being organized to engage in more tasks, because the advantages of formal organizations with artificial incentive systems had increased for both the leaders and members of organizations.

With such distant beginnings in mind, the analytical history of this book begins with an analysis of the emergence and evolution of formal organizations. All organizations share the property that they are formed to advance goals that can best be achieved by coordinating the efforts of more than one person. All organizations make decisions that focus the organization's resources on particular activities and induce their members to function as more or less productive teams, rather than as unproductive assemblies of individual shirkers and rent seekers. It is these effects that make them "organizations," rather than simply groups of unrelated persons, each doing their own thing. Hunting clubs, farm cooperatives, churches, commercial enterprises, pirate ships, and governments all select projects to undertake and provide internal incentives for undertaking them.

Economics and managerial science analyze solutions to organizational incentive problems. The first half of chapter 2 discusses several natural solutions to internal incentive problems drawing on that literature and extending it to take account of culture. The remainder of the chapter and the rest of part I of this book focuses on the emergence and evolution of standing procedures for making organizational decisions, that is on organizational governance.

To "organize" a team, decisions have to be made about a number of practical details: what is the purpose of the team, how can team production be used to advance that purpose, and what kind of team members make team production cost effective?. After the team is assembled, decisionmaking continues, as purpose, team members, and use of team members are adjusted to

correct initial mistakes and adjust to changing circumstances. There are many ways that an organization can choose its objectives and strategies; although some procedures work better than others, and consequently only a few templates for governance tend to be widely used at a given time and place.

Elinor Ostrom (2005, ch. 8) argues that a very large number of contemporary institutions can be classified using a relatively small number of general characteristics, although great variety may exist in the specific institutions among all organizations. This allows the theory of formal organizational design to be far simpler than the organizations themselves, the specific problems addressed by them, or the environments in which they function.

The present chapter and the next two may be regarded as an effort to provide a somewhat simpler, less fine-grained schema for analyzing institutions (organizations) than the one proposed by Ostrom, although it is very much in the spirit of her work. Of particular importance for the purposes of this book are solutions to the problem of organizational governance based on the “king and council” template. Chapters 2–4 provide a series of explanations for the widespread use of this form of divided government by both “governmental” and “non-governmental” organizations. Chapter 5–8 demonstrate that the king and council organizational template provides a number of ways for parliamentary democracy to emerge gradually from more or less authoritarian territorial governments and without revolutions.

### **A. Formeteurs, Team Production, and the Founding of Organizations**

To begin with, all formal organizations have a beginning; formal organizations are initiated by an individual or group of individuals with particular purposes or goals in mind. A hunting party is to meet at a particular place and time, a barn or house is to be raised, a new product is to be made and sold, trade is to be expanded or contracted, an idea is to be promoted or dismissed, a swamp is to be drained or protected, a village is to be defended or attacked, rights and privileges are to be created, extended or reduced. In this, formal organizations differ from “spontaneous” systems that may be said to emerge without much conscious thought, as with galaxies, ecological systems, or trading networks—although these too may be said to have a beginning, and the latter may also be said to be “piece-wise” the result of intent.

Many formal organizations also have an end. Small organizations often end when their goals have been achieved, as with informal “pickup” sports games and academic conferences. Some organizations only function well because they include particular constellations of personalities and

talents and end when critical members depart. Others end because important incentive or decision problems are not solved and the organization is unable to produce sufficient surplus to sustain itself. Hunting clubs must produce food to be self-sustaining. Churches must attract sufficient donations to maintain their clergy and buildings. Economic enterprises must produce sufficient revenues to pay employees and assure reasonable profits for entrepreneurs. Governments must have sufficient tax resources (and/or loyalty) to retain control of their territories.

New organizations are created every day, because new (potential) advantages from joint enterprises are constantly being imagined. They may be created by single individuals with very narrow purposes in mind, as often assumed by economists about the origins of organizations with profits as their principal goal. Or, new organizations may be formed by groups of individuals or organizations that wish to advance common purposes, as often assumed in rational choice-based analyses of private clubs and treaty organizations and in contract-based theories of the state. Intermediate cases also exist in which a small group organizes a larger one, as when tribal leaders organize a “work gang,” a group of investors create a new production team, or a group of political activists organize a mass demonstration of support or opposition to existing policies. And, cases also exist in which a large group organizes a small one to advance common interests, as when members of a club or cooperative organize small groups to produce services for the cooperative or create an “oversight committee” to manage such activities.

The individuals or groups that found an organization will be called “formeteurs” and the persons recruited by formeteurs will be called “team members.” Except in the very unusual cases in which an entire society is the formeteur, organizations are not be designed to maximize their membership’s or society’s welfare, but rather to maximize that of their formeteur(s). This does not imply that member interests are ignored, only that team members are not the persons to focus on if one wants to understand organizational incentive and governance systems.

### *Why Organizations Are Founded*

Many scholars have remarked that man is a social animal, and that some instinct drives people to form groups of one kind or another. This book suggests, in contrast, that groups come together, because people are often more effective in groups than as unaffiliated individuals. There are often good practical advantages for hunting, farming, building, worshipping, and governing in groups. If an instinct exists, it is because group activities generally advance individual interests.

Team production, however, is not entirely natural for human beings, although it often advances shared interests. A variety of incentive and governance problems have to be overcome for a group of individuals to become an effective team. As a consequence, most productive groups are *organized* in some way.

The left-hand side of table 2.1 illustrates a common incentive problem faced by informal groups that simply share the output jointly produced. The output might be fish caught or fruit harvested from a natural pond or orchard. The “natural cooperative” is assumed to be viable, in that its members produce more jointly than they would have by working alone. The group may be better at finding the best fishing spot or trees to exploit, or the natural cooperative’s sharing of output may simply reduce the risk associated with a bad day of fishing or poor choice of fruit tree. Consequently the exit option is not exercised ( $2 > 1$ ) and group production is undertaken, rather than solitary production.

<b>The Shirking Dilemma for Team Production in Natural Cooperatives</b>				<b>Table 2.1 An Artificial Incentive System as a Solution to the Shirking Dilemma</b>			
	Team Member B				Team Member B		
	Work	Shirk	Exit		Work	Shirk	Exit
Work (A)	3, 3	1, 4	1, 1	Work (A)	R, R	R, R-P	R, 2
Shirk (A)	4, 1	2, 2	1, 1	Shirk (A)	R-P, R	R-P, R-P	R-P, 2
Exit (A)	1, 1	1, 1	1, 1	Exit (A)	2, R	2, R-P	2, 2

The cell entries are output shares, which provide the rank order of subjective payoffs for the team members (A, B). (Utility is assumed to vary directly with rewards or output shares.) The dilemma in the “natural cooperative” case” is that both team members shirk, rather than work.

However, the natural cooperative produces less output than it could have, because its members “shirk” too much, rather than “work,” in equilibrium. “Shirking” may involve a number of behaviors, including low effort at productive activities, high effort at unproductive activities, or various combinations of each. Group members may simply fish from convenient spots and/or take only the low hanging fruit. They may harvest fish or fruit too early or too late. They may take fish or fruit home that should have been turned over to the shared harvest. The assumed equal distribution of the natural coop’s production also tends to limit opportunities for taking advantage of specialization. Fish and fruit may go uncaught and unpicked in difficult locations; fishing nets and

ladders may be under produced, because the group's output is shared equally among all members of the coop, regardless of effort levels, risks taken, or investments made.

Most formal organizations differ from natural cooperatives in that they use "artificial" incentive and recruiting systems. In the case illustrated, team production can be increased by replacing the "natural" system of rewards on the left with the "artificial" system of rewards on the right. Under the artificial reward system, the formeteur promises to pay  $R$  dollars (or units of output) to people who join his organization and work and threatens to impose a penalty of amount  $P$  on those who join and shirk. Those harvesting fish or fruit too early, for example, may be paid less than those who wait until the appropriate time.

A new formal organization is viable, as long as the anticipated net reward ( $R$ ) from being a member of the formal organization is larger than that available from the natural coop (2). The formeteur(s), for example, can promise to pay 2.2 units of output to team members, and threaten to impose a punishment of 1.1 unit of output for shirkers. Solving the shirking dilemma makes team members better off than they would have been in the natural cooperative and in this case generates an organizational surplus (of 1.6 units of output) for the formeteur(s), which provides an incentive to form the organization. In such cases, natural cooperatives tend to disappear as individuals exit to join formal organizations offering greater rewards.

In modern organizations, the most obvious conditional reward structures are those associated with wages, salaries, and promotion. The most obvious threats are wage reductions, demotions, and being expelled (fired) from the organization. In equilibrium, relatively few punishments are imposed by formal organizations, because relatively few team members shirk and because team members often have reasonably attractive exit options. Nonetheless, the threat of punishment remains an important part of artificial incentive systems, because it reduces the private advantage of shirking associated with natural cooperatives.

### *Choosing Reward Systems*

A broad range of team-production and recruiting techniques can be represented as solutions to prisoner's dilemma problems with exit (PDEs) similar to that represented in table 2.1. Coordination problems also exist, as stressed by Hardin (1999), but these are easier to solve than PDE problems, because solutions to coordination games are stable once established. Organizational PDE problems are also more challenging to solve than simple prisoner's dilemma problems, because the solutions

are constrained by exit options, and exit options tend to change through time, partly because formeteurs often compete with one another to attract team members.

An important feature of artificial incentive solutions to PDE problems is that the conditional payoffs of “the intra-organization game” can be manipulated by formeteurs to achieve the desired team behavior, but only within the limits determined by the exit options of team members. Self-interested formeteurs naturally favor reward systems that minimize the overall cost of solving the incentive problems at hand, because this maximizes the organizational surplus available for solving other problems and for advancing other formeteur goals.

The exit options of potential team members, however, create a minimum bound for expected rewards and a maximum bound for expected penalties (if any are imposed). Team members must receive at least as much compensation (adjusted for risk) as is available from other formal organizations and natural cooperatives. At the hypothetical extreme of what economists call perfect competition, exit options are so great and easy to realize that each team member has to be “paid” his or her full contribution to team production. As exit options become less attractive or more costly to realize, smaller rewards can be used to retain team members. In the extreme case of teams composed of persons without exit options (slaves), rewards can be set at subsistence levels and punishments used to encourage work in every case in which penalties are more cost-effective than rewards.

From the perspective of formeteurs, the ideal reward system aligns the interests of team members with those of the formeteur(s) at least cost in the circumstances at hand.

## **B. Formeteurs, Culture, and Organizational Opportunities**

In Schumpeter’s (1934) and Kirzner’s (1978) terms, a formeteur has, creates, or recognizes organizational opportunities that others do not have or cannot see. Consequently, “innovation,” “foresight,” and “boldness” are often associated with organizational leadership along with exceptional ability to recruit and motivate a team. Formeteurs may also be said to be less risk averse than others (Knight 1921) insofar as they are more willing to accept the risks associated with launching new enterprises. Formeteurs, however, differ from the entrepreneurs of classic economic models, because they form organizations, rather than engage in price arbitrage or product innovation alone. Formeteurs cannot be “loners,” although they tend to have unusual motivational skills and organizational insight.<sup>3</sup>

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<sup>3</sup> It should be acknowledged that many new organizations fail, which implies that this formeteur insight tends to be quite imperfect.

Organizational founders are often “charismatic leaders,” who can easily persuade team members to accept their direction. Such persons can solve many of the incentive problems of team production by encouraging personal and organizational loyalty. They induce team members to internalize various “duties,” such as working hard to advance the formeteur’s and “their” organization’s interest. Here, one can imagine the charismatic founders of fishing clubs, pear harvesting coops, and cherry-picking firms encouraging team members to “pull hard on the net,” “climb to the highest branch,” and “not miss anything.” Less skilled or naturally charismatic formeteurs will require more generous and sophisticated pecuniary reward systems to accomplish similar results, which is, of course, part of the reason that formeteurs tend to be relatively talented at assembling and motivating people.

If team members can be induced to work hard at advancing their organization’s goals simply because it is “the right thing to do,” reward systems can be simpler and in many cases less generous. When an organization’s internal culture causes individual members to feel worse off when they act in a manner that conflicts with organizational goals, even when his or her performance cannot be observed by others, monitoring efforts can be reduced. When team members are induced to feel loyal to the organization, subjective exit costs increase, which allows smaller rewards and larger penalties to be used to solve the organization’s internal incentive problems.

It is therefore not surprising that farming cooperatives, private firms, religious groups, and roving bandits all attempt to build team loyalty within their organizations and to promote other internal norms that reduce shirking and increase “team spirit.”

Efforts to develop and support an internal organizational culture may also indirectly support or produce complementary community-wide norms, particularly if several organizations in the same community promote similar internal norms. If team members prosper and take their internalized organizational norms home at the end of the workday, their “corporate norms” may be taught to children and friends. Such norms may also indirectly help solve other coordination, public goods, and prisoner’s dilemma problems among families and friends and within the community at large. Moreover, if some potential team members (employees) are easier to motivate with nonpecuniary rewards than others or are intrinsically more motivated to advance organizational goals, team production costs can be reduced by recruiting such “honest, hardworking team players,” which further encourages the spread of corporate norms in the communities from which team members are recruited.

### *Culture and Organizational Opportunities*

It bears noting, however, that not all norms or propensities to cooperate provide opportunities for formeteurs. A community that supports a “work ethic” requires fewer formal organizations and less sophisticated artificial incentive systems within its organizations, because its informal reward and punishment systems will solve many team production, coordination, and rent-seeking problems. Members of natural cooperatives in such cultures are encouraged to “show up” and “do good work” by their peers within the organization and also by their friends and families (Congleton 1991b). Other norms may reduce the effectiveness of artificial reward systems. For example, team members may cooperate to “escape” from prisoner’s dilemma games designed by formeteurs, such as competitive piece-rate schedules, with coordinated work “slowdowns” and “sick-outs.” Other internal norms that predispose team members to work, rather than shirk, also simultaneously reduce organizational costs and the need for formal organizations. Simulation studies by Axelrod (1986), Boyd and Richerson (1992), and Vanberg and Congleton (1992, 2001) demonstrate that strategies of conditional cooperation can be privately advantageous for individual team members in settings in which exit is possible and organizations last more than a few periods.

Both norms that reduce the need for artificial incentive systems and norms that make artificial incentive systems more difficult to design make formal cooperatives less viable, which reduces formeteur opportunities for creating formal organizations.<sup>4</sup>

A niche for formal organizations, nonetheless, remains unless the norms of conditional cooperation solve all coordination and team production problems, or completely undermine all systems of artificial incentives (Ostrom, Walker, and Gardner 1992). For example, Congleton and Vanberg (2001) show that the ability to target punishments at shirkers can be sufficiently important to the success of joint enterprises that norms may emerge so that team and community members will punish shirkers, even if personally costly. Team members will often have better information about who is shirking and thus be better able to target penalties at those “not carrying their load.” Such norms, however, are not always sufficient to solve the externality and coordination problems that must be addressed. Active management and active rule enforcement are often necessary to solve team production problems.

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<sup>4</sup> See Congleton (1982) for a relatively simple rational choice model of organizational inertia and bias.

This niche tends to be increased by other culturally transmitted values that allow formeteurs to economize on rewards by solving team production and coordination problems with praise, status, and informal perks for “outstanding work,” rather than with (or in addition to) money or physical output rewards. Community norms may encourage persons to keep their promises, be punctual, and follow instructions. Indeed, formeteurs may also be informally rewarded for founding organizations with additional status or opportunities within some communities. Here one might note the number of plaques, ribbons, medals, and certificates handed out to successful formeteurs for “outstanding achievement” by nonprofit organizations, such as territorial governments, military civic organizations, schools, and profit-maximizing firms.

### *Culture Somewhat Reduces the Convergence of Reward Systems*

Whenever a variety of methods can be used to achieve the same end, formeteurs will use the combination that is least costly to implement, other things being equal. This common economic interest of formeteurs generates considerable convergence among organizational reward systems. Complete convergence in reward systems does not occur, however, because not all motivational devices are equally available to or subject to manipulation by all formeteurs.

Some organizational goals are better aligned with preexisting local norms than others, which implies that some organizations have larger pools of potential team members that are “naturally” predisposed to promote their goals than others. For example, during the medieval period in Europe, it is clear that religious orders were able to attract very talented members with relatively small pecuniary rewards, because so many persons in their communities were already interested in advancing the same religious goals. Similarly, in the nineteenth and twentieth centuries, formeteurs that created new politically active groups to advance nationalistic, economic, or ecological goals could often draw from relatively large pools of patriots, economic liberals, and greens to write books and give speeches, staff their interest groups, and support their political parties.

Culturally favored organizations can assemble more effective teams at less cost than organizations with other goals. Conversely, the willingness of “customers” to pay for the services provided by organizations also varies somewhat, which allows some organizations to provide stronger pecuniary rewards than others. As a consequence, the feasible mix of pecuniary and nonpecuniary rewards varies somewhat among organizations. Investment bankers are generally paid more than fishermen and pear pickers.

The best feasible combination of conditional rewards, consequently, tends to be more similar among organizations that produce similar services than among those producing different ones. For example, contemporary religious organizations and governments rely extensively on selection, internal values, culture, and financial rewards—roughly in that order—to motivate their team members. Commercial organizations also attempt to recruit team members who are easy to motivate, but usually rely more extensively on conditional pecuniary rewards (hourly wages, bonuses, sales commissions, stock options, and promotions), than on internal culture to solve their team production problems.<sup>5</sup>

### **C. Cultural and Economic Rationales for Organizational Conservatism**

Overall, the analysis above demonstrates that reward systems are complex, which provides a good reason for formateurs to adopt “off the shelf” reward and recruiting systems. Both the templates chosen for reward systems and the teams assembled reflect the aims and constraints of their founders, rather than history or broad collective objectives, *per se*. The constraints include technological and cultural factors, which are not entirely predictable. Although formateurs can influence both technological and cultural developments, neither is completely within their control, because both are consequences of complex networks of social relationships and dynamics that are beyond the complete understanding or control of any single person or organization.

Acknowledgement of the partly “spontaneous” and unintentional nature of productive internal and external cultures has implications for the formateur’s choice of organizational design. It implies, for example, that new pecuniary reward systems and new recruiting methods may have unintended consequences on an organization’s ability to attract and retain productive team members. For example, the evidence surveyed by Frey and Jegen (2001) suggests that increases in explicitly conditional forms of motivation often reduce (crowds out) self-motivation. In principle, the unintended effects of changes in reward systems on internal culture can be positive or negative, but even if the unintended effects (prediction errors) are symmetrically distributed around zero, rather than biased toward undermining the organization’s supporting culture, risk aversion on the part of formateurs implies that fewer organizational experiments take place.

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<sup>5</sup> See Iannaccone (1992, 1998) or Wintrobe (2006) for overviews of how norms of various kinds can be encouraged (or exploited) in order to solve free rider and coordination problems in organized groups. Most economists recognize the importance of incentive systems within organizations, but tend to focus only on pecuniary ones. See, for example, Holmstrom and Milgrom (1994).

“Institutional conservatism” in such cases is an entirely rational response to the problem of “unanticipated consequences” by risk-averse formeteurs (and their successors). “If it ain’t broke, don’t fix it.”

### *Economic Support for Institutional Conservatism*

Rational institutional conservatism is further supported by advantages associated with being “conventional.” Stable internal routines, theories, and norms can be passed on to successive generations of team members at a relatively low cost, as current team members teach new members the methods for getting along and succeeding within the organization. The use of routine “off the shelf” methods of reward and assignments of responsibility within an organization allows personnel to be easily shifted among teams within large organizations. The use of commonplace reward systems allows new team members to be recruited from other organizations and employed with lower training and acculturation costs than is possible when differences among internal reward systems are large.

In settings in which a number of organizations compete to attract the services of team members, team members will naturally tend to join the teams offering the highest (risk-adjusted) rewards and exit from those providing the lowest (risk-adjusted) rewards. Organizations that offer too little to current and potential team members will not be viable, because they will not be able to retain or attract team members. Conversely, teams cannot promise to pay too much, because the system of rewards cannot be greater than the team’s total production without reducing the viability of the organization. Competitive pressures, thus, reinforce other practical advantages associated with the use of conventional reward systems. The greater is the competition for team members, the narrower is the range of feasible reward systems.

Such economies of conventionalism reinforce tendencies for convergence of internal incentive regimes and provide additional support for institutional conservatism and stability. Together, the common interests of formeteurs and competitive pressures imply that very similar solutions to intra-firm incentive and governance problems tend to be widely used in culturally linked regions and applied for long periods of time.

The convergence and stability of reward systems do not, however, imply that every formeteur regards his or her organizational form to be the best that can be imagined or that formeteurs are extremely risk averse. Nor do they imply that the results are socially optimal in some sense. For example, excessive conservatism may be induced by a prisoner’s dilemma–like social dilemma that

increases the stability of prevailing practices beyond optimal levels. Individual formeteurs may not be able adopt more “efficient” practices without losing team members or customers to their more conventional rivals, even though all formeteurs and team members would be better off with revised practices.

With or without such social dilemmas, however, it remains the case that the formeteurs adopt the most cost-effective reward systems that are feasible for them, and that considerable convergence among reward systems tends to take place. Stable patterns of rewards simply imply that the anticipated cost of significant reforms exceed their benefits for formeteurs, given prevailing practices and norms in the communities in which the organizations operate. Fishing clubs will use similar nets to catch similar fish in similar places. Pear harvesting coops will use similar ladders and baskets. Cherry picking firms will use similar harvesting techniques and pay similar wages to their employees based on similar performance criteria.

#### **D. Why Organizations Have Governments**

Institutional conservatism and convergence do not imply that experimentation ceases or that organizations become completely rigid, although they do imply that standing routines tend to be relied on, experiments tend to be relatively small, and the routines employed tend to be similar within organizations pursuing similar goals.

As external circumstances change, organizations that have routines for adjusting their team’s production to take advantage of the new circumstances will tend to do better than organizations that do not. For example, changes in the location of fish or fruits caused by seasonal or long-term changes in weather may require fishing clubs, pear-harvesting cooperatives, and cherry-picking firms to change their methods of team production. Seeking new fish may require new fishing gear, new times of day for fishing, or new fishing strategies. Harvesting new fruits from new orchards may involve larger or smaller trees, or heavier, lighter, more perishable types of fruit, and more travel. Changes in the supplies of particular ores or demands for particular metals may similarly induce blacksmiths and smelters to search for new sources of ore and to refine their alloys.

The fact that various forms of team production become more or less viable as external circumstances change has a number of important implications about organizational design, one of which is relevant for the purposes of the first half of this chapter and another of which is important for the remainder of the book.

Regarding the first, dynamic circumstances provide another explanation for the use of complex reward systems. Inducing changes in team production often requires changing the organization's reward system. Multidimensional reward systems can more be easily adjusted to encourage personnel to shift among tasks than single-dimensional compensation schemes, because there are more margins for adjustment and it is unlikely that all the dimensions of compensation are constrained by useful internal norms. The pear-harvesting cooperative and cherry-picking firm may provide long-distance harvesters with somewhat generous travel reimbursements (new shoes), better equipment, or create new prizes for those who have walked the most miles in the service of their organization. Such rewards may encourage team members to volunteer for work in new locations, without undermining other useful aspects of family-, seniority- or loyalty-based reward systems.

Regarding the second, it bears noting that organizations with flexible reward systems can induce their teams to be more effective in new circumstances only if they have procedures for recognizing new circumstances and adjusting their methods of team production to take advantage of the new circumstances. A fishing club, pear harvesting cooperative, or cherry picking firm that simply returns to the same pond or orchards after all the fish and fruit are gone will simply not survive. They must also be able to recognize innovations in "best practices" in order to take advantage of innovations in reward systems and team production.

Organizations that are able to detect relevant changes in circumstances and make modest adjustments to their standing policies tend to be more successful than those that cannot. They survive in more environments, because they are quicker to adjust to changing circumstances and better able to make adjustments than those without routines for recognizing new circumstances and responding to those changes. In other words, durable organizations have governments, because the present is not entirely stable, the future is not completely knowable, and the best methods of team production vary with circumstances.

Paradoxically, survivorship, institutional convergence, and rational institutional conservatism imply that organizations cannot be entirely rigid in the medium and long term, except in completely unchanging and understood circumstances.

## **E. Organizational Governance**

The standing procedures for making policy decisions within organizations have attracted far less attention by economists and other rational choice analysts than have the internal incentive systems analyzed in the first half of the chapter. For example, Williamson's widely read books and articles on

corporate governance (1967, 1996, 2002) implicitly assumes that the institutions for choosing policies are already in place, essentially automatic, and well-functioning. The same can be said about Alchian and Demsetz' (1972) analysis of team production, Vicker's (1985) analysis of delegation, and Laffont and Tirole's (1993) game-theoretic analysis of relationships among firms and between government regulators and firms.

A partial defense of that neglect is that an organization's government is often an instance of team production and delegation. In most cases an organization's standing policies are jointly produced by several team members that have been delegated authority to make various policy decisions. Information is collected about internal and external circumstances, the information analyzed, alternatives evaluated, and decisions made. In only the simplest of organizations and circumstances is all this done by a single individual. As a consequence, those participating in organizational governance normally have "artificial" incentives that are largely determined by the organization's standing system of rewards, because the usual problems of team production have to be overcome to create an effective organizational government.

However, just as an organization is more than an incentive system, its government is more than just another team.

The "outputs" of an organization's government are very different from those of other teams. Its outputs are decisions that substantially create the organization itself and revise it through time. It determines whether teams will be organized to pick cherries, pears, or apples. Once teams are organized and production is underway, it determines whether to continue or not; and whether to change direction or not. A pear harvesting cooperative may switch to grapes or olives. A fishing firm may shift from fishing to shipping, and, if it does so, the policy choices of its governing body will substantially determine which ships head to which port cities, and who and what is on board its ships. The decisions of the ruling body of a regional government determines what will be taxed, who will collect the taxes, and also how future decisions about taxation will be made.

As a consequence, there are informational, bargaining, and collective choice aspects to organizational governance that are absent or much smaller for other teams within large organizations.

*“Natural” Organizational Governance*

In most cases, formeteurs also choose standing procedures for making and revising policies at the same time that they create their new organizations, because they recognize that their initial policy decisions are provisional, rather than final.

The “natural” first form of organizational governance is the one (implicitly) assumed by most economists and also by many political theorists. Formeteurs may simply retain their initial authority to make and revise all major policy decisions after their organizations are up and running. Such “authoritarian” decisionmaking procedures have many advantages for formeteurs and their organizations. Formeteurs often have a superior understanding of organizational possibilities, which justifies their initial investment of time and attention to assemble a team and devise methods for advance particular goals. Formeteurs know their own goals better than others are likely to and normatively have leadership skills that allow them to form and motivate groups at lower costs than others. Leadership skills often include a relatively large informational base and the ability to persuade others that it is in their interest to defer to the formeteur’s direction.

In the medium and long run, however, as demonstrated below, it is often in the interest of formeteurs to relinquish part or all of their initial control over their organization’s policies. There are cases in which sharing policymaking authority can improve organizational governance, and many other cases in which limiting or sharing their policymaking authority can advance other formeteur goals. Voluntary transfers of policymaking authority are partly driven by informational and time allocation problems that emerge as an enterprise increases in scale and complexity and partly by other practical advantages that can be realized by shifting and trading authority within their organizations.

For example, formeteurs of contemporary commercial enterprises often give up part of their control over their organization in exchange for investments by those who purchase voting shares. By “going public,” formeteurs become “shareholders in” rather than “owners of” their enterprise. Such trades of authority for money often increase the resources available to their organizations, albeit at the cost of reduced control over their organizations. Similar transactions often took place between European kings and parliaments in the period between 1400 and 1900, as developed below in Part II of the book, and analogous transactions took place between local rulers and “free towns” in the late medieval period. No threats of violence were necessary for such shifts of authority to occur.

It bears noting that both delegation and markets for authority tend to produce divided forms of organizational governance. Authority for making policies may be shared among formeteurs and other stakeholders or specific policies may be under the control of different subsets of an organization's government. In many, perhaps most, cases the form of divided government adopted is a variation of the "king and council" template for governance. The king and council template divides policymaking authority between a chief executive (the king) and a committee of more or less equals (a council, board of directors, or parliament), who jointly make policy decisions.

The remainder of this chapter focuses on the informational advantages of governance based on the king and council template. Other advantages and opportunities for trading policymaking authority within that template are developed in chapters 3–6.

## **F. The Formeteur-Ruler's Informational Problems and Institutional Solutions**

Consider the case in which a single formeteur initially chooses to run his or her organization as an autocrat. This is not the only possible type of formeteur or initial form of government, but it is a natural place to start and it is widely assumed in rational choice analyses of economic and political institutions. The formeteur is clearly in the best position to know his or her own interests, and has a reasonably clear idea about how an organization can be created to advance those interests. As a single actor, he or she avoids the collective choice dilemmas noted by Olson (1965) and the potential intransitivity problems of collective decisionmaking noted by Arrow (1963).

Wintrobe (1998) argues that all such autocrats face several kinds of information problems, many of which are consequences of their control over organizational rewards and punishments.

First, an autocrat faces the same information problems as an ordinary person. An autocrat must decide how much information to gather about every dimension of choice and every causal chain that may affect his or her assessments of alternatives. He or she must decide which information sources are reliable and how much of the information gathered to share with others. A formeteur, however, has greater need for accurate information than other persons in his organization, because the scope of an authoritarian formeteur's policymaking authority is initially much wider than that of other members of the organization. There are alternatives that must be accurately assessed if he or she is to make policy decisions that effectively advance his or her own interests. In unstable settings, autocrats will also require useful information about changes in the internal operation of his or her organization and in the external environment in order to make effective use of the team assembled.

The organization itself may also be revised, as its weaknesses and strengths and new opportunities are revealed through time.

Second, an autocrat confronts a series of information problems that are consequences of his or her authority to allocate organizational resources and to adjust the internal system of rewards. The information provided by others within the organization tends to be intentionally biased whenever there are potential benefits from manipulating the autocrat's assessment of alternatives or people within the organization. Personal careers can often be advanced by exaggerating one's loyalty and performance relative to other rivals within the organization. "Cherry polishers" do not simply seek the boss's favor, but hope to profit from that favor. Wintrobe (1998: ch. 2) refers to this aspect of a rule maker's informational problem as the "dictator's dilemma." Persons who assure the autocrat that he or she is right in every case may increase the ruler's confidence (and gain his or her ear), but will not increase the accuracy of his or her policy decisions.

The larger the organization and more complex the goals and operating environment, the more difficult such informational problems tend to be and the more costly are mistakes that could have been avoided with better information. Two quite different informational settings are analyzed below.

### *Why Well-Informed Formeteurs Benefit from Advisory Councils*

Consider first a shrewd fairly well-informed formeteur-ruler with unbiased expectations about the consequences of alternative policies and therefore about the relative merits of policy alternatives. Such formeteurs will not make systematic policy errors and will choose policies that maximize the (average) effectiveness of their organizations and, thereby, their own expected utility. Yet a formeteur, like any other person, will economize on information and devote his time and attention to collecting and processing information only up to the point where his expected marginal benefits equal its marginal cost. Statistical theory implies that the smaller the data set on which estimates are based and the less sophisticated and thorough the analysis, the greater the errors tend to be, other things being equal.

In most cases, the sum of the information possessed by an organization's team members includes much that is not and cannot be known by even a well-informed formeteur. Team members, for example, often know a good deal more about the specifics of production than the formeteur. Members of a pear-harvesting coop or cherry-picking firm often know details about particular orchards or trees that the formeteur does not. For example, pears or cherries on the northeast side of particularly trees may be juicier than those on the northwest side at some locations or during

some times of the year. Taking account of this information would improve harvests and/or increase profits, although that information cannot be accessed directly by the formeteur.

In small organizations, useful information and recommendations may simply be collected from all team members. In larger organizations, an “advisory council” may be recruited by choosing members randomly from the organization’s team (or citizenry). Such “citizen advisors” tend to be less informed overall than the formeteur-ruler, because such persons lack an encompassing interest in the organization. Advice from such councils, however, may still be useful, because team members have different personal experiences and expertise. Insofar as the information (samples) of the formeteur and members of the advisory council are independent of one another, their predictions about future events are also independent and may be approximately unbiased. Elementary statistics implies that an appropriately weighted average of several unbiased estimates is a better estimator (more accurate) than any single estimate. There are also many cases in which the unweighted average or median estimate of a group is more accurate than the estimate of the member with the largest data set. This information-aggregating effect implies that a council of non-expert advisors that makes recommendations on the basis of majority opinion or consensus can be a cost-effective method of assessing the merits of alternatives, because it produces relatively accurate median forecasts and recommendations.<sup>6</sup>

In areas in which specialized knowledge is useful, the formeteur can improve the quality of the advice obtained by assembling a panel of especially well-informed individuals, whose more complete understanding of the organization and its operating environment makes their forecasts less prone to error than the typical member of the organization. Such expert councilors may have a comparative advantage at gathering and processing information relative to other team members for many reasons. They may simply have greater talent for assembling and processing information, or may have devoted much time and energy to acquiring large information sets and skills for analyzing them. Such experts, by definition, have relatively greater speed or accuracy as information processors

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<sup>6</sup> This aggregation effect of the use of majority rule is often referred to as the jury theorem or Condorcet’s jury theorem. Nitzan and Paroush (1985), Wit (1998), McLennan (1998), and Congleton (2007b) shows that a council that uses majority rule to select recommendations tends to be far less error prone than individual members of the council. Large committees would make essentially no mistakes if individual members are even slightly more likely to be right than wrong in their recommendations and voted on the basis of their private information.

That consulting with a “council of wise men” can improve decisionmaking is, of course, not a new idea. The idea that a committee of experts possesses more information than a group of ordinary people (who often possess more information than a single expert) is mentioned, for example, by Aristotle in book 3 of *the Politics*, which has been widely read for centuries.

than the average member of the organization and can also provide the formeteur with more accurate assessments of the merits of alternative policy decisions.

For example, the formeteurs of the pear-harvesting coops and cherry-picking firms might send out “orchard spotters” to assess the quality of the fruit available at various orchards in the area on a particular day. A committee of experienced fruit harvesters may listen to the spotter reports and offer their informed opinions about which orchard is likely to provide the best harvest. Similarly, the formeteur-ruler of a trading enterprise that wants to establish a new trading post may direct his advisors to sample the opinions of well-traveled persons, and to recommend a few places where a trading post can profitably be established. The leader of a team of roving bandits may send out scouts to bring back information about the availability and cost of acquiring goods in new territories. His “war council” may use that information to make suggestions about where and when to launch the team’s next raids.

### *Competition for Membership in Advisory Councils*

The value of the information and advice produced by advisory councils will often be far greater than the cost of the advisory team’s compensation, because the reward systems for such information gathering and processing teams—advisory committees—will normally be a combination of status, privileges, and money, roughly in that order. Many advisors will be pleased to provide free information to the formeteur, simply because they value the approval and thanks of ambitious men and women. And, of course, advisory councils can be quite small, which tends to enhance the prestige associated with membership.

Team production of advice often produces economies in information gathering and analysis that are analogous to other forms of team production. Recruiting the right men and woman to such teams can also increase an advisory council’s productivity. Comparative advantage at information collection, processing, and advice giving can be increased through various artificial incentive systems.

The formeteur may, for example, construct contests for council membership that reward analytical skills and policy-relevant information acquisition with relatively high status and/or salaries. Contemporary research suggests that such contests can be extremely effective methods for inducing investments in useful information and analytical skills. The sum of the investments by the purchasers of lottery tickets is normally greater than the sum of the rewards given out, which is, of course, what makes lotteries profitable (Tullock 1980, Hehenkamp et al. 2004). Compensation in the form of

*positional goods* can also be quite inexpensive for the proprietor, yet encourage substantial efforts by prospective councilors (Tullock 1965, Hirsch 1976, Frank 1985, and Congleton 1989). Moreover, being councilor to a successful formeteur may also produce new “consulting” opportunities as well as status through reputation effects.

Thus, one widely used informational technology for collecting and filtering information is the advisory council. This solution requires recruiting and motivating a team that specializes in collecting and processing information that is useful for the formeteur’s decisionmaking. Such teams may also be charged with proposing new policies that may advance the formeteur’s interests. In such cases, the advisory council is given some agenda control over the alternatives considered by the formeteur-ruler.

### *The Dilemma of Experts*

Motivational problems for council members are fairly limited in environments in which the proprietor is sufficiently informed about policy consequences to make his or her own unbiased estimates of the facts or policy consequences. In such cases, the formeteur-ruler can reject obviously manipulative estimates and recommendations by the council (and individual council members) as implausible “outliers” and punish the conspirators for their “disloyalty,” that is, for placing their own interests above his. A cherry spotter’s claim that the “the cherry trees in the next village are a three hundred feet tall with tons of cherries on every branch” can easily be rejected by a formeteur that knows something about cherry trees, without traveling to the recommended village.

The motivation problems become more difficult as one shifts from settings in which the formeteur-ruler and councilors have small samples of essentially complete information to ones in which the formeteur and potential councilors all remain completely ignorant about some relevant dimensions or possible consequences. For example, the formeteur may not have traveled or studied extensively and so may be largely ignorant about orchards, trading posts, and rival bands of bandits in other territories. His potential councilors may include individuals that have traveled more widely and know more languages, but even such sophisticated travelers will not have visited every possible orchard in every possible territory. Some kinds of fruit trees will remain entirely unknown. In such circumstances, completely unbiased estimation about the best type of orchard or method of harvest may not be possible for the formeteur-ruler or his councilors (Congleton 2001, 2007).

Knowledge problems of this sort increase the potential advantage of additional information, but also increase the risk of manipulation. To profit from the advisory councils in areas in which the

formeteur-ruler is essentially ignorant, the organization of the council must overcome the “dilemma of experts,” the difficulty of taking advice from knowledgeable persons whose information cannot be readily appraised by the person receiving it and which may or may not be biased.

The dilemma of experts would not be a problem if members of the advisory committee were indifferent about the formeteur’s subsequent policy and personnel decisions, and so simply passed on their best advice, but this is not always the case. A few orchard spotters may prefer one kind of fruit or location to others. Bandit scouts and war councils may have grudges against particular communities or persons. Trading-post experts may have friends who own real estate in one of the areas of interest or prefer some climates to others. Such personal interests may cause advisors to provide overly optimistic assessments of some opportunities and overly pessimistic ones about others that are less personally advantageous.

In the previous “rational expectations” case, the formeteur had his own independent and unbiased estimates that could be used to reject opinions and advice that were clearly outliers, but in settings in which ignorance, rather than small samples, is the main informational problem, he does not. Relatively short-term forecasts and advice can often be directly checked as events unfold, but even short-run decisions based on bad advice can be disastrous for an organization during difficult times.

### *Beyond the Kitchen Cabinet: Advantages of Representative Advisory Councils*

A common method of addressing the dilemma of the expert in settings in which significant formeteur-ruler ignorance exists is to assemble a small loyal group of advisors—a council of loyal wisemen, who have demonstrated that their interests are aligned with those of the formeteur and whose recommendations on past matters have been sound. In small- and medium-sized organizations, such advisors might, for example, be assembled from the formeteur’s family members, friends, and long-term employees whose interests are often well aligned with those of the formeteur. Such “kitchen cabinets,” however, may exhibit considerable ignorance about matters beyond their own organization (or the royal court).

A council whose membership extends beyond the organization has informational advantages over kitchen cabinets, because “outsiders” have a larger sample of information and include more kinds or dimensions of information than “insiders” could or would be inclined to assemble on their own. The more extensive information sets of councils of outsiders reflect their broader range of talents, interests, and experiences. Many of these informational advantages reflect systematic

differences in backgrounds (education, profession, and/or family) that can be easily recognized by the formateur, while others reflect chance events that provide outsiders with unique experiences and acquaintances (travel, talent, and friends) that cannot be so easily appraised.

The informational advantages of a council of outsiders, however, come at the price of greater motivational problems. In many cases, biased (manipulatory) advice can reduce the effectiveness of outsider councils to levels below that of insider councils. This partly explains why kitchen cabinets are so common, especially in cases in which outside information is not particularly valuable or can be acquired without relying on outsiders.

In cases in which outside information is especially valuable and tends to be available only from outside experts, an advisory council that includes outsiders can provide more useful advice than a “kitchen cabinet,” even if agency problems cannot be completely eliminated. For example, both our illustrative pear-harvesting cooperative and cherry-picking firm may benefit from the advice of a panel of agronomists and marketing experts, even if their advice cannot be entirely trusted.

One institutional method for reducing the agency problems associated with outsider councilors is to assemble “representative councils” with predictable biases. By including members with opposing personal interests, one hears arguments on all sides of an issue, and can be reasonably assured that points of agreement are unbiased assessments. The members of such councils can be assembled, for example, by having various economic and ideological interest groups (regional authorities, guilds, landowners, banks, labor unions, clergy, and so on) propose members for the advisory council. The problem of manipulation (biased advice) can be further reduced by including insiders as well as outsiders on the advisory council, which allows outsider assessments to be evaluated by insiders before being applied. Such “representative” councils allow that policy assessments to be based on a broader information base than possible from groups of insiders, while at the same time increasing the likelihood that the median or average of the analyses and advice given is well informed and unbiased.<sup>7</sup>

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<sup>7</sup> Gilligan and Krehbiel (1989), Krehbiel (1991), and Banks and Weingast (1992), among others, provide a careful game-theoretic analysis of the informational aspects of heterogeneous committees and agencies. Although their main focus is essentially the opposite of that explored here, their analytical results are consistent with the arguments developed above, namely that advisory committees function best when all interests are represented. See Balla and Wright (2001) for a useful overview of this literature as it relates to advisory committees and for evidence that such representative advisory committees are used in contemporary governments.

The advice of such representative councils may still be problematic if the council as a whole has policy interests that differ systematically from those of the formateur-ruler.

## **G. Why Well-Informed Formeteur Partnerships Employ a Chief Executive**

The informational problems of a formeteur-ruler and advantages of advice from committees suggests that organizations founded by small groups of formeteurs may be better able to make policy decisions than those founded by a single formeteur. Formeteur partnerships can function as a committee of experts by themselves, and so they can potentially draw on more information and use it more effectively than an otherwise similar single formeteur. It is thus not surprising that many organizations are founded by small teams of formeteurs, who form partnerships of various kinds. (Our illustrative pear-harvesting cooperative may have been formed in this way.)

Even a small group of formeteurs, however, may not be able realize their potential informational advantages, because the individual formeteur-partners lack a fully encompassing interest in their organization's operation. Each partner receives only a fraction of the organization's surplus or profits. As a consequence, each tends to under-invest in their joint enterprise. For example, each member farmer of a small pear-harvesting cooperative tends to be more interested in his or her own orchard's success than in the cooperative's overall production and profits. As a consequence, the partners collectively under-invest in the cooperative's activities, which reduces their partnership's ability to reduce member costs and increase their sales by negotiating with suppliers or running joint advertising campaigns.

Formeteur-partnerships cannot always solve their informational and managerial free-riding problems by simply ruling as a committee.<sup>8</sup>

A natural solution to the "committee government dilemma" faced by formeteur partners is to delegate responsibility for managing their organization on a day-to-day basis to a single person, a chief executive officer (CEO), senior partner, king, high priest, or prime minister. Such CEOs directly participate in the day-to-day execution of policy and so acquire relatively complete and detailed knowledge of the process of implementing policy within the organization. The CEO's informational advantage allows him (or her) to understand the effects of alternative day-to-day policies better than other members of the partnership, and so is able to make more-informed decisions. In this case, however, the "king" (CEO) will serve at the pleasure of the "council" (formeteur partners), who will retain considerable policymaking authority for themselves, including veto power over major initiatives.

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<sup>8</sup> Such free-rider and agency problems partially explain the existence of partnership law, which attempts to assure that partners do their duties and receive what is properly due to them. Partnership law extends back to at least Roman times (Weber 2003).

The previous analysis of reward systems implies that the formeteur-partners will use cost-minimizing combinations of pecuniary and nonpecuniary rewards to align the interests of their chief executive officer's with formeteur interests. The effectiveness of that reward systems can usually be improved by selecting CEOs who are relatively easy to motivate and have the talent to be effective managers. In other words, the chief executive is chosen only partly for his or her managerial ability. His or her own norms and desire for approval, respect, status, fame, and financial resources are equally important, because these reduce the cost of solving principal-agent problems.<sup>9</sup>

Selection procedures are also important because selection procedures can also induce competition for the post of CEO. Insofar as the selection process sufficiently open and CEO compensation is sufficiently generous to produce competition for the post of chief executive, many talented individuals will invest in acquiring the skills and knowledge to be an effective CEO. The latter also provides some redundancy in advice and information sources, which further reduces monitoring costs for the council of formeteur-partners.<sup>10</sup>

For such reasons, organizations founded by small groups of formeteurs also tend to use the king and council template for organizational governance, although formeteur-partners will adopt a quite different initial distribution of policymaking authority than that used by a single formeteur. The council will normally retain broad policymaking authority, including veto power over major policy changes and also over changes in the organization's distribution of policymaking authority. They will also retain the authority to replace their current chief executive officer when selection errors are made and/or when their reward system fails to align the CEO's interest with their own.

### *Delegation to a "King and Council" by Very Large Groups of Formeteurs*

When a large group of formeteurs (or organizations) forms a new organization, day-to-day management and considerable policymaking authority may be delegated to an organizational government for more or less similar reasons.

It is very costly for the members of large cooperatives, stock companies, partnerships, and polities to meet and debate policy alternatives every time a decision has to be made. Such meetings

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<sup>9</sup> Brennan and Hamlin (2000) discuss how selection can be used to find the right persons to fill positions in organizations in which monitoring is difficult and contracts are incomplete. Their discussion addresses problems in democratic design, but their logic clearly applies to other organizations as well.

<sup>10</sup> It bears noting that modern elections for presidents require candidates to reveal their policy preference, personal propensities, and managerial talents to the persons selecting them. Contests for the CEOs of large organizations are similar in many respects, although less public.

are very time consuming and inconvenient. Moreover, informational “free riding” tends to be a greater problem for large groups than for small ones. Consequently, one of the first collective decisions by the founders of a large cooperative or small town is normally to delegate significant policymaking authority to a cooperative or town government.<sup>11</sup> As in other organizational choice, there will be templates for cooperative and town governance that have survived the test of time, and large groups of formeteurs will normally choose from among preexisting forms, rather than invent a new one whole cloth.

For reasons similar to those developed above for the single formeteur and small number of formeteur cases, large founding groups are thus likely to adopt some version of the king and council template: an chief operating officer and board of directors, a mayor and town council, a president or prime minister and a parliament. Such forms of government tend to produce better policy decisions than others, including meetings of the community of formeteurs as a whole, by solving a variety of informational and incentive problems and reducing decision costs. Both the king and the council are likely to be selected by the formeteurs through some process of collective choice (direct or indirect elections) and some veto power over the government will normally be retained by the founders.

In the large number of formeteurs case, the use of divided forms of the king and council template also tends to reduce losses from selection errors, that is, from the failure to select the best persons to serve as managers and monitors under a particular existing reward system. In undivided governments, a single mistake in selecting an “organizational autocrat” can clearly be very costly. By dividing policymaking authority between a king and a council, this risk is reduced, because the policies adopted by such systems tend to be weighted averages of the institutionally induced interests of the “king” and “council.” The institutionally induced interests reflect the process through which these officials are selected and renewed, the reward systems in place, and the division of policy making authority between them. Consultation and compromise will be necessary for major decisions within such divided governments, which tends to reduce errors<sup>12</sup>

<sup>11</sup> Buchanan and Tullock (1962) use rational choice models to explore how particular governmental structures might be selected by such large groups. The focus of their analysis is political governments, rather than organizations in general, but many of their results are relevant for the present setting. For example, their results on voting rules are clearly relevant for the large group of formeteur setting. They do not mention the king and council template in their analysis, but they also suggest that divided governments (bicameralism) can be more likely to advance common interests better than undivided ones (unicameralism).

<sup>12</sup> In commercial enterprises, the formeteurs are often modeled as shareholders, who are assumed

Continued on next page...

The use of the “king and council” template also encourages error correction, because it increases the likelihood that more or less honest accounts of the organization’s activities are made available to the entire body of formeteurs. The founders may ask the council to report on the chief executive and the chief executive to report on the council on the occasions when they meet as a body. The natural inclination of the officeholders of each branch of government is to tout their own achievements and attribute all mistakes to the other. By combining the two reports, a reasonably complete overview can be achieved, albeit one with higher variance than would be ideal.<sup>13</sup>

Such informational and control advantages, reinforced by institutional conservatism, also explain why the king and council template is widely used to delegate authority within large organizations. A CEO may choose to create his or her own council of advisors. He or she may also delegate policymaking authority in particular policy areas to individual managers who are monitored and/or advised by committees of experts. The number of advisory councils can also be adjusted, and specialized advisory councils of various sizes can be created to analyze particular subjects or policy areas. The result tends to create hierarchical forms of organizational governance with “top levels” constraining the choices of “lower levels” through specific delegations of authority and control over selection and reward systems.

## **H. Overview: Formeteur Interests and Organizational Design**

This chapter has provided a theory of organizations that explain (a) why durable organizations have governments, (b) why most organizations use some form of the “king and council” template for governance, (c) why most organizations use mixed forms of conditional incentives to solve team production problems within the organization, and why (d) internal incentive systems and organizational policy tend to be somewhat flexible at the margin, although (e) core policies tend to be fundamentally stable and similar among organizations. An organization’s system of governance and its reward system tend to be stable, because organizations tend to make better decisions and be better able to retain and train their teams when they have “institutionalized” their reward and governance systems. The analysis also demonstrates (f) that decisionmaking authority within an

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to have a uniform interest. Within such large organizations, conditional contracts are also used to align the interests of CEOs with their formeteurs. See, for example, Gibbons and Murphy (1990) or Holmstrom and Milgrom (1994). That literature, while shedding a good deal of light on CEO compensation practices, tends to neglect divided governance within the firm and policymaking aspects of governmental decisions, although it acknowledges that contract “solutions” tend to be incomplete.

<sup>13</sup> Persson and Tabellini (1997), for example, demonstrate that divided government tend to increase information flows to principals.

organization can be distributed in a number of ways and argues that (g) the initial division of authority varies systematically with the origin of the organization.

As in other aspects of organizational design, formeteurs choose the institutions of governance. They do so based on their assessment of the performance of those institutions in other organizations about which they are familiar. The governmental templates that attract their interest tend to collect and use information relatively efficiently and to produce decisions that increase the viability of their organization, while advancing formeteur interests. This is not to say that the templates for creating organizational governments create completely robust organizations or advance formeteur interests perfectly, but it is to say that obviously ineffective and non-robust procedures for making policy decisions tend to disappear from the menu of governmental forms that attracts the attention of formeteurs.

Single formeteurs are inclined to adopt “king-dominated” forms of the king and council template of governance, partly for informational reasons. They will have standing councils of advisors, who make proposals for improving policy in areas of interest to the organization, which the formeteur will consider and choose whether to accept or reject. Formeteur partnerships, in contrast, will tend to adopt “council-dominated” forms of the king and council template in which day-to-day decisions are delegated to their CEO, but the authority to veto power major policy decision is retained by the partners. More evenly divided forms of the king and council template may be adopted in cases in which organizations are founded by a large number of formeteurs.

The analysis of the second half of chapter 2 suggests that informational advantages of the king and council template are sufficient to explain the use of this template for governance by a broad range of organizations throughout recorded history. Additional rationales for using the king and council template are developed in the chapters 3–5, in which long-term organizational viability and territorial governance are analyzed.