

**"Markets in the Firm"**  
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## **Introduction**

Why is it that major world economies appear to be enjoying a sustained period of solid growth without the emergence of growth-destroying, wage induced inflation? Inflation may occur as a result of other factors, but the wage-push dragon appears to have been slain.

It seems to be agreed that structural and continuous productivity improvement is the explanation (1), but why is this happening? The information technology revolution is often cited as the cause, as is fear of losing one's job. But neither of these explains or gets to the essence of the welcome transformation in workplace behavior. Certainly IT has contributed by causing a spectacular collapse of transaction costs. However, alleged fear of losing one's job is not supported by empirical analysis. (2)

In answer to the riddle the proposition presented here is that market principles have begun to penetrate the internal management of firms. When firms adopt internal markets, as opposed to being run as command and control collectives, the search by their personnel for higher incomes is tempered and constrained by firms' performance in external markets. When command and control operates, wage reviews are dominated by warlike standoffs between workers and management where each party attempts to capture the benefits of the firm for itself. Under command and control, external market signals relevant to the firm are ignored as the politics of envy, egotism and winner-takes-all corrupt decision-making and force staff costs up beyond the capacity of the firm to pay.

In societies dominated by command-and-control firms, the combined weight of thousands of firms paying more than their market performance can induce wage-led inflation. But under markets in the firm, remuneration is not artificially controlled by the managerial elite but rather is the outcome of thousands of small price and other market signals that individuals constantly transmit to one another. The result is increased income for internal staff, as their self-interested search for higher incomes is self-financed by leading to improved firm performance. This causes the productivity explosion. Firms that fail to share their market success with staff lose the staff upon which the success is built and ultimately collapse. In this model the internal market is as important to a firm's success as the external market.

## **Wage Push**

The debate over the Phillips curve—'the notion that there was a permanent trade-off between inflation and unemployment, so that policy makers could choose from a menu of alternative rates of inflation and unemployment; the higher the rate of inflation they were willing to tolerate, the lower the rate of unemployment they could achieve'—has continued since its debunking by Milton Friedman in 1967. (3) Friedman noted that it continues to be a popular idea particularly among lay and journalistic commentators. Friedman introduced the idea of the 'natural rate of unemployment' to which 'the level of

unemployment would tend whatever the rate of inflation' (4) and that to push unemployment below its natural rate required accelerating inflation.

It has since been argued that the natural rate of unemployment no longer applies. However, Edmund Phelps, one of the inventors of the natural-rate theory, retorts that 'The model's inventors never viewed the natural rate as a constant. It is simply an economic variable determined by non-monetary forces'. (5) Further, 'the real forces of enterprise and finance.....are the ultimate drivers of unemployment'.

Whatever the merits of the two theories, the general idea is that unemployment has a structural floor (even if shifting) below which it cannot fall without inducing growth-destroying, wage-push inflation. But if Phelps is right, the trick is to unlock the 'forces of enterprise and finance' that allow us all to seek as much work and income as we want without triggering wage-induced inflation.

Is this possible? Yes, if the principles of free exchange apply in the hitherto sacrosanct command and control zone: the internal operations of firms. Further, applying markets within firms is perhaps the final and full development of the non-monetary structural forces that could drive the natural rate of unemployment to zero. To explore this theme further requires a revisiting of the concept of the firm itself.

## **The Firm and Control**

The modern understanding of the firm starts with Ronald Coase's idea of transaction costs. Coase famously argued in 1937 that the firm exists because it provides a structure that contains transaction costs. However, it is less often noted that Coase argued that the containment of transaction costs was dependent on control exercised by an entrepreneur through the master-servant legal employment relationship. (6) It has been taken for granted that without this right of managers to control employees, transaction costs could not be contained.

The prevailing idea of the market economy, then, is one in which free transactions occur *between* firms but do not and cannot occur *within* firms. This limited view of markets dominated the theory and practice of management throughout the 20<sup>th</sup> century. Command and control management won great prestige between the 1920s and the 1970s (7), when the Taylorist or scientific approach to management prevailed. Taylorists held that it was possible to assess and formally structure every process and action required in a firm and that every employee subordinate to senior management would exercise thought and initiative only to the extent allowed by management. This approach achieved its apogee of sophistication under Elliot Jacques as late as the 1980s. (8) Jacques, a psychoanalyst by background undertook detailed studies of human behaviour in bureaucracies, and on that basis constructed a theory of management in which every function in a large organization could be scientifically analyzed for the 'time span management' required to facilitate the function. This made it possible to construct and apply a precise bureaucratic structure. Under it, staff remuneration and ambition were determined by the firm's bureaucracy, thus establishing order, control and harmony. Disharmony occurred only when staff sought to break free from the structure. Jacques' principles continue to be applied in some of the world's largest mining companies, the US military, and elsewhere. Interestingly, Jacques himself was careful to state that his principles did not apply to small business and in his own experience failed in the academic and education areas.

Coase's theory of the firm, and its development by Taylor, Jacques, and the bulk of the managerial theory profession reflected the experience of the social disorder that prevailed during much of the 20<sup>th</sup> century. Economic activity was conditioned by war and preparation for war. Firms existed to feed the military machines that were the agents of national security or ambition. (9) Quasi-military command and control was the natural approach to adopt in firms. Similarly, international conflict chimed with the crude idea that markets consisted of warring firms. Product development, marketing and price are part of the firm's armory. The firm is led by generals who devise strategies for defeating other firms. Winning is defined in terms of profit but also market share: by takeover as much as outcompeting. Managers are the generals; the employees are the footsoldiers who are expected to obey commands without question, an expectation embodied in employment law.

However, since the collapse of the Berlin Wall and the end of the Cold War, a more developed idea of markets has emerged. The idea that nations need to cooperate to survive and prosper is now broadly accepted. War, whether in the form of physical engagement between armies or of 'beggar-my-neighbour' protectionist trade policies, is viewed as destructive of prosperity. The role of the firm is likewise being reassessed, however slowly.

### **The firm is a market (?)**

The internal dynamic of firms is starting to reflect that of markets. As early as the 1950s, significant breaks from the command and control model emerged, some of which were spectacularly successful and long-lasting. The ever wider acceptance of markets is driving management to preoccupy itself with interlocking systems of interdependence up and down supply chains and often in partnership with businesses once thought of as competitors. In this market paradigm no firm sees itself as an island. Cooperation becomes at least as important as competition. Here are some examples.

#### *Franchising*

The modern form of franchising, developed by Ray Kroc, the genius behind McDonalds, demonstrated that a large, complex business could be developed that was not at its core a system of command and control but instead a form of market. (10) Under franchising, the personnel management bureaucracy is dissolved into small and discrete parts. Most McDonalds stores are independent business run by an owner-operator. McDonalds bring to the franchisee a package that includes product creation, marketing and many other disciplined arrangements. The franchisee and franchisor enter into a commercial agreement after full and exhaustive negotiations. McDonalds looks after the supply chain to bring product to each store. Interestingly, McDonalds does not have written agreements with its suppliers. Marketing and advertising is largely controlled by subcommittees of the franchisees.

Key interlocking features in which McDonalds mirror markets are:

- The principles and legalities of the commercial contract at will or contract *for* services is key. Offer, consideration and acceptance are the essence of the franchise agreement and dominate the McDonalds structure. The employment contract *of*

service, which involves the ‘employer’ having a ‘right to control’ an ‘employee’, applies only between the franchisee and the store staff.

- Price signals have been driven deep into the McDonalds organization and are the key operational triggers governing the franchise. A franchisee’s income is the profit of the store and the franchisor’s income is a percentage of the turnover of the franchisee’s business.
- Trust. With no written contracts between McDonalds and its suppliers, relationships are dependent on reliable cooperation to ensure consumer satisfaction. McDonalds must understand the suppliers’ problems. The supplier must understand the product required by McDonalds. The parties spontaneously cooperate because they need to achieve mutually beneficial outcomes.

McDonalds developed a process that has subsequently been accepted and applied with such enthusiasm that franchising is one of the fastest growing practices in developed economies. It is most common in the retail sector, with franchisees typically occupying discrete physically sites. However, in some cases franchisees consist of departments in mega-stores. Banks, usually thought of as command-and-control organizations, now frequently franchise their retail bank branches.

The fast-growing home-services industry is mostly franchise-based. Home gardening, cleaning and ironing rounds are run by individuals under franchise contract arrangements organized by marketing and sales coordination businesses. An active market in the buying and selling of franchise rounds usually exists. In one large retail franchising chain, when the franchisor got into financial difficulty it was bought out by the franchisees. Now each franchisee is subject to the contractual requirements of a franchisor in whom they each own shares.

In all these examples, free contracts and price signals operate at the heart of the organization. Transaction costs are successfully managed, but not by the employment mechanism that Coase observed.

### *Koch Industries*

Koch Industries is another example of markets operating in the firm. This debt-free, privately owned conglomerate, with annual sales of \$US35 billion and rated as the 18<sup>th</sup> largest business in the USA, has consciously sought to apply market principles to its internal management for more than 30 years. The Chairman, Charles Koch, claims that this explains the firm’s phenomenal growth and continuing success. Further, the firm has documented and patented its Market Based Management (MBM) system, making possible a solid understanding of its operational practice. (11)

Significantly, Koch Industries operates in traditional ‘old economy’ areas such as oil and gas refining and transport, cattle production, petrochemicals and finance. Its management structure relies on internal markets to allocate internal resources. It seeks to replicate individual economic rights inside the firm. For example, it likens the idea of property rights to its allocation of decision rights to staff members.

Koch Industries’ management training manual *Models Collections* (12) explores the mental constructs that are necessary to successfully operate in markets and seeks to have its staff apply them in their working relationships. The mental models include

mutual respect, patience, trust, attention to people's needs and the elimination of arrogance.

In introducing markets into the firm, Koch Industries has split itself into 'profit and cost centres' that are expected to survive by offering services to each other ultimately without monopoly privileges. This approach can be applied to a remarkable number of the firm's activities, such as non-safety related maintenance, many human resource services, transport, accounts, debt control, marketing, recruitment, design and planning.

The approach has even been applied to the Office of the Chairman and CEO. Koch Industries documents show how under the old regime the Office of the Chairman produced and distributed reports within the organization. After the introduction of MBM, the Office had to market its reports to divisions within the organization. Many divisions refused to buy them. To retain its viability, the Office had to find out what kind of information the firm's divisions required. This caused it to refocus its activities so that the content, quality and quantity of its reports reflected the needs of its internal clients.

A key feature of Koch Industries is the conscious attempt to drive price signals as deep into the organization as possible. Developing 'free trade' between Koch's profit and cost centres can effectively destroy the protective barriers and prevent the 'turf wars' that are features of all command and control structures. This internal commerce lays bare the hidden transaction costs always buried within command and control. The regular salary of Koch staff is an income floor underpinning limitless potential income constrained only by the performance of the profit and cost centre in which one works.

Koch Industries is unique in the degree, sophistication and depth of thought it has invested in planning, applying, and documenting markets in the firm. It admits it hasn't discovered how to apply the principles of MBM into every corner of its operation and that some functions continue to operate under command and control structures. This is true particularly of safety and other areas where government regulations seem to demand command-like compliance.

Koch Industries shows that markets in the firm can succeed under normal commercial criteria. By documenting its efforts to apply markets inside the firm, it facilitates study of the idea in one of its forms. Many other firms adopt elements of internal markets but don't apply the tag.

### *Information technology*

Even a cursory study of the IT industry reveals the huge role played by internal market signals. Attend any IT trade fair and the shop floor gossip is as much about remuneration rates, performance bonus and share schemes as it is about products and technology. IT people have adopted a convention of complete openness about remuneration. This transparency of normally private information is vital to enable participants to assess their value in the market, so encouraging inter-firm mobility and risk taking.

### *Other models*

In Australia, the domestic housing construction industry has long been structured around independent contracting arrangements. Marketing, design and housing development companies are, in the construction phase, specialist commercial-contract organizers. Houses are not built by employees of the firms; instead, this is done by an army of

plumbers, carpenters and other tradespeople under individual commercial contracts with the development firms. The process is efficient, cheap, orderly, fast, and delivers quality.

Also in Australia a unique form of labour hire has emerged in which personnel supplied to firms are not employees but independent contractors on individual, daily-hire commercial contracts. The principles of offer and acceptance of contract underpin the relationships. The hire agency acts as an administrator of contracts facilitating transaction management.

Many other individual examples exist but few are documented other than in the 1997 publication from the IEA, *Markets in the Firm: A Market Process Approach to Management*.

### **Policy Implications**

If the application of markets in the firm is the structural shift that, at least in part, explains the end of wage-induced inflation, it offers policy-makers a paradigm that can promote sustained non-wage-inflationary growth.

Questions need to be addressed. How does government policy and practice promote or prevent markets operating inside firms? Should government be active or passive in determining firms' internal management?

Presently government largely promotes command and control. Employment law has as a core intent the suppression of competition and the protection of both management and the managed (13) : a point rarely recognized by economists. By contrast, commercial law is about the maintenance of competition. As the behavioural patterns inside firms move away from employment and toward commercial principles, policy-makers could study and understand how these two opposite legal paradigms impact inside firms, affecting the performance both of firms and ultimately of the economy as a whole. For example, how would anti-dismissal laws operate if the workforce consisted principally of independent contractors rather than employees? Could labour-market distortions caused by equal opportunity and anti-discrimination law be resolved if commercial practices replaced employment? Much social regulation presupposes the master-servant relationship and operates by limiting the employer's 'right of control'. Introducing markets into the workplace could empower individuals to achieve individual and collective goals by increasing the scope for direct negotiation between free contractors.

Overall, the detailed linkage between the firm, the market and the law and Coase's theory of the firm warrants reconsideration in light of more than 60 years' experience and several decades of comparative world peace. Policy settings need to reflect a deep appreciation of the inter-connection of legal concepts and legal policy, with the economic behaviour of people, firms and societies.

There is no longer any serious intellectual resistance to the market economy, understood as an arena in which firms compete and cooperate on the basis of free contractual arrangements. Applying market principles to the internal operations of firms is the next logical step, but one we have hardly started to consciously think about taking.

## References

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“We can best approach the question of what constitutes a firm in practice....by considering the legal relationship normally called that of master and servant or employer and employee..... The master must have the right to control the servant’s work. We can thus see that it is the fact of direction which is the essence of the legal concept of employer and employee just as it was in the economic concept (of the firm) which was developed above”
- 7) *Markets in the Firm. A Market process Approach to Management*. Institute of Economic Affairs. London 1997.
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- 11) *Introduction to Market Based Management*. By W Gable and J Ellig. Pub Center for Market Processes. George Mason University Virginia. 1993.
- 12) *Market Based Management Models Collection*. Copyright Koch Industries 1999.
- 13) *The Dependent Contractor: A study of the legal problems of countervailing power*” by HW Arthurs. 1965 University of Toronto Law Journal 89.  
In commenting on workers legal status Arthurs says; “If viewed as ‘independent contractors’ rather than ‘employees’ they lack the legal status which is prerequisite of the right to bargain collectively under labour relations legislation. As businessmen, they cannot legally employ collective tactics to buy or sell or otherwise stabilize conditions, because of the combines legislation. They are prisoners of the regime of competition.”

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