Beyond Master and Servant

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The New World of Non-Employment

During the twentieth century, when freedom's philosopher Friedrich Hayek was promoting the understanding of individual liberty and economic freedom, his position was being inadvertently undermined by a description of the operation of capitalism offered by an otherwise fellow traveller, the Nobel prize winning economist Ronald Coase.

This article demonstrates how particular explanations enunciated by Coase clash with some of Hayek's broad themes. Specifically, it shows how the principles of economic freedom have not been applied to the internal operations of firms in market economies. In effect firms, as described by Coase, are islands of command and control socialism dotting the seas of democratic, capitalist economies. The existing model of free, market-based economies is one in which the market is restricted to operating between firms and fails to operate inside firms.

This state of affairs is ensured through common law enforcement of employment, and reinforced by government and institutional practices. It finds its greatest manifestation in the management practices of firms. In its most grotesque form it is found naked in employment regulation and industrial relations systems.

It is slowly being recognised that markets must operate inside firms. How this is done is a cause of great anxiety, confusion, experimentation, failure – and, in some instances, success. What scares corporate heads, analysts and investors is that when free markets operate inside firms the complex actions of many individuals inside the firm create outcomes that no central corporate planner can predict. We therefore first need to look at what a firm is and how it creates and maintains its focus.

Hayek and Coase

Hayek's lifelong battle was as a proponent and defender of the classic liberal view that the free voluntary activity of many individuals making their own plans enables a complex social order to evolve.[1] This led him to focus on the role of government, or rather the limitation of the role of government. Before and after World War II, liberals were faced with massive central planning and social engineering machines that taxed market activity to create welfare states. It was not until politicians of the likes of Margaret Thatcher and Ronald Reagan began to translate Hayek's arguments into political action that the tide could be said to be turning. It was not until the fall of the Soviet empire that the idea of economic freedom of the individual appeared to win out over regulation by government central planners.

Coase's writings in the 1930s had a different focus. Coase observed how businesses operated, and he described what he found. Coase has had great influence, but for different reasons to Hayek. The interest in this article is on the observations on the operation of firms in his article 'The Nature of the Firm,' said to be one of the most influential works in the history of economics (Hazlett 1997). Coase both promoted understanding of what occurs in firms and also influenced how firms, in particular large corporations and government agencies, think of themselves and their internal structure and function.

Coase and Hayek have common ground in that they were both interested in the behavior of humans as economic units. However they studied economic behaviour from different perspectives. Both supported the market system, but whereas Hayek looked at the relationship between government and the economy, Coase studied the functioning of individual entities within the market.

In the 1930s Hayek was starting to lay out his argument about the damaging effects of government central planning on the freedom of individuals in market-based

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1 A useful source on Hayek's position is the educational resource package produced by the *Atlas Economic Research Foundation*, Sussex, UK, 1988.

economies. At the same time, Coase was explaining that the essential functioning element of capitalist activity (over and above the individual), the firm, exists solely because of the ability of the individual entrepreneur/ employer to centrally orchestrate the activities of the firm by controlling and limiting the freedom of individual employees. (Hayek's concept of individuals included firms acting as individual units.)

Hayek had to fight for the acceptance of his view. Coase's description of the firm, however, was taken at face value.

The outcome has been a dichotomy of intellectual debate and operational practice from those apparently 'on the same side,' over how best to make a capitalist economy produce the greatest sustainable and growing wealth for the population. On the one hand, Hayek's views are gaining the ascendancy over those of centralised bureaucracy. Yet amongst owners and managers of firms, Coase's picture has been interpreted (probably contrary to his own intentions) as an intellectual justification for stopping individual liberty at the door of the firm.

The very elements in a community who have the most to gain from the application of market ideas, the entrepreneurs, have been silently but compliantly supportive of opposing forces by refusing to apply the principle of individual freedom to the internal operations of their own firms. This criticism is not limited to private enterprise. The concept of a firm embraces all organisational models in free market societies, including public service delivery agencies, semi-government agencies and not-for-profit organisations as well as private for-profit businesses.

Coase and the firm

The most central and important observation of Coase, from which other observations flow, was his emphasis on transaction costs. Coase reasoned that interaction between players in the market does not happen costlessly; every transaction in an economy has a cost associated with it which has to be accounted for somewhere. As transactions become more complex and too difficult for single individuals to undertake, organisations form (firms) to manage and contain the transaction costs. As Coase said, 'the operation of a market costs something and ... by forming an organisation and allowing some authority [an entrepreneur] to direct resources, certain costs [transaction costs] are saved' (Coase 1937:40).

Coase extended this understanding by observing the factors which cause firms to be held together. He drew on the practices of entrepreneurs and managers and observed their capacity to control and direct the people working in the firm. This control and direction is legally underpinned by the existence of the common law master and servant employment relationship. Coase reasoned that if the entrepreneur did not have the legal 'right to control' the people working in the firm, then transaction costs could not be contained and (presumably) the firm could not exist.

> 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 (Coase 1937:53).

In this manner Coase tied the existence of firms to the maintenance of internal control through the master/servant, employer/employee legal relationship. In so doing he postulated a direct interdependence between the very existence of markets and the legal right of one human to control another human.

The legal concept of 'employment control' holds that the employee is a physical and psychological appendage of the employer.

It is important to appreciate the distinction between the ordinary idea of employment, that of a simple work-for-pay relationship, and the legal definition of employment. The legal concept, dating from medieval times, hinges on the 'right to control' an employee/servant by an employer/master (Phillips 1997). Under common law definitions, the legal concept of 'employment control' holds that the employee is a physical and psychological appendage of the employer – unable, unwilling or not allowed to act in an independent manner. In short, the legal right of an individual to act freely is removed when common law employment exists. This removal of individual liberty to act and individual freedom to choose when being 'employed' inside the firm is, according to Coase's understanding, essential to the operation of markets in capitalist economies.

At this point we see the clash between Coase's observations and Hayek's insistence on liberty in society. Hayek says that for markets to operate, the freedom of the individual must prevail over direction imposed by central (government) authorities. But Coase's observation in 1937 was that for markets to operate, the freedom of the individual must be subservient to that of the central (corporate/entrepreneur) authority.

> Order will emerge and prevail and economic activity will be at its most robust when individuals are free to act for themselves.

This subjugation of liberty at work is a key legal tool used by governments seeking to use the market as an instrument of social control. For example, control of firms through employment regulation is only constitutionally possible if a master-servant relationship is found to exist in the work environment. Anti-discrimination legislation seeks, in part, to manipulate social behaviour by imposing legal sanctions on employers/masters for failing to control inappropriate behaviour of their employees/servants. Gaming and liquor control legislation has as a presumption that these activities are controlled through licensed operators who are masters/employers (Phillips 1997).

Scientific Planning

The idea that the removal of individual liberty was essential to the existence of firms had a natural fit with dominant management theory and practice of the 1920s to the 1960s. Coase had observed accurately! In particular, during this period mass production was organised around the principles of 'scientific' management, or 'Taylorism', which endorsed the separation of 'thinkers' (management) from 'doers' (labour) (Cowen and Parker 1997:23). Management acted for and on behalf of the entrepreneur under the delegated legal authority of the employer to direct and control the working lives and actions of the employees.

Although in decline, this concept continues to dominate and direct current management theory, thinking and practice. The concept of labour not having a brain fits well with the arrogant, self-important view of the elite establishment, who sought (and seek) to command and control societies. The social control bureaucrats have common ground with command and control entrepreneurs and managers.

Hayek disagreed fundamentally with the establishment elite who sought to use the principles of natural science to design the world of human action. He used the term 'scientism' to describe the flawed approach of this social engineering elite. However the 'scientific' approach to management was based on the same principles of social engineering, but applied *inside* the firm, and passed without apparent comment.

'Control' and the firm

Coase's explanations of transaction cost problems are valid and remain a key to realising why and how firms operate and underpin economic activity. However it is not correct to believe that systems of internal organisational control are exclusively dependent on the subjugation of human liberty through common law master-servant employment regimes. Employment subjection is but one control model, and if principles of liberty and freedom are applied to the firm, 'employment' should be seen as a brutish and debilitating form of control. As a model for control, employment was not the best in 1937, nor should it be the preferred model in 1998 or beyond.

Hayek is more accurate. Order will emerge and prevail and economic activity will be at its most robust when individuals are free to act for themselves. Just as Hayek argued for limitation of government, so do parallel arguments hold valid for the limitation of management. Central control of the individual by either a government or corporate elite is inferior to organisational methods which focus on liberty and the release of individual creativity and activity – in societies and in firms.

Contractual Control

Arguing for the freedom of the individual in the firm is not an argument for the release of chaos. Just as those who desire top-driven control of society do not understand Hayek's arguments, the command and control corporate elite fail to understand that order will prevail and performance will be improved when the individual is released from legal master-servant 'control' regimes.

Internal control of a firm, and indeed any organisation, is comparatively simple when the thinking is shifted from the need to control people as humans (common law employment) to the need to control the direction of business through commercial contracts. Commercial contracts require the entity needing services or products to know, understand and plan its own needs, to translate those needs into contractual understandings and seek others who can fill those needs. When firms grasp the same commercial contractual understandings that operate between their business and other businesses and apply them to the internal people dynamics of their own business, the pathway to contractual control of firms becomes apparent. This truth applies to government and private organisational models.

But in looking to such understandings being applied to people in the firm, the argument seems to return to the transaction cost problem originally identified by Coase. It has become an accepted paradigm that the transaction costs associated with applying commercial contracts to labour will always exceed the marginal benefit. This paradigm, however, is wrong. Commercial labour contracts can work despite the transaction costs. Success is dependent upon the nature of the contracts and the quality of the administrative systems used. This in turn substantially relies on people interaction systems, aided to some extent by technological progress.

The failure to understand the application of commercial contracts to people in the work situation comes from several factors. These include a poor understanding of commercial contracts, poor understanding of their own business, lack of imagination and lack of developed systems to manage contractual arrangements. In addition, government, legal, institutional and social structures present significant blockages to firms that wish to move from employment command and control structures to commercial contractual control of the internal operations of the firm. The law, institutions and attitudes far too frequently drag firms that want to break free from command-and-control structures back into debilitating employment structures – even though common sense tells the players inside the firm that 'employment' is producing inferior results.

The Accountability Problem

An important reason for why firms stick to command and control, common law employment regimes is the way employment helps management to avoid performance accountability. Command and control employment regimes deliver to people working in firms systems which avoid accountability being imposed on the individual. When things go wrong – for example workplace accidents – individuals can say it is 'the system' which has failed and not individuals. Individuals at all levels are able to hide behind the corporate veil.

Corporations are peculiar beasts. If they are wholly owned or controlled by a single individual or small group of individuals, the ultimate entrepreneur-controller can normally be identified. Media, retail and manufacturing barons come readily to mind. In these instances, command-and-control legal employment systems could be seen to fit the nature of the organisation. More commonly, however, corporations have divested control through public or private listings into structures in which the power of any individual is frustrated by competing individuals. No one individual controls the corporation. 'Management' assumes the authority of the entrepreneur, but is really nothing more than a collective of employees. Corporate control is effectively undertaken by this elite controlling other employees. This is even more obvious in the case of government instrumentalities and public service structures, where ownership is diffused among the collective public.

The avoidance systems that follow are well entrenched and developed, particularly in large firms. The larger an organisation becomes, the more removed is the entrepreneur/employer from daily decision making. Top-driven command systems develop in which the employer's authority is legally delegated down the line to managers. Managers act on behalf of the employer as if they were the employer. In truth, managers (delegated employers) are employees and have more self-interest in common with other employees than they do with the actual employer.

The primary human dynamic which functions as a consequence is that all employees, whether managers or otherwise, seek to ensure that they cannot be accountable, because at law they remain 'servants' – employees not responsible for their own actions. They are controlled. This causes the top of the management pyramid to distrust lower and middle management and operationally constrict their freedom. The outcome is the strangulation of creativity and performance.

The international mining giant Rio Tinto (then called CRA Limited) recognised the accountability problem in their own organisation in the 1980s (CRA 1995). In a harsh analysis they said of themselves that 'The tap-root of sluggish organisational functioning has to do with the withered sense of accountability ...' (CRA 1995:5). Rio Tinto began a reorganisation program which has at its core the driving down of accountability to each appropriate level. Managers (employees) are held accountable within the work descriptions. The centre is limited in its ability to override managers' authority (Swain 1995).

Good contracts are not 'employment' contracts

Good commercial contracts are simple. They

- are clear, up front and understood by both parties;
- express the intent of equal parties;
- bind both parties to agreed action;
- impose pre-agreed sanctions for breaches;

- cannot be changed without the agreement of both parties;
- do not have to be written and are most often verbal;

and most importantly

- have short lives.

These simple elements of commercial contracts sustain normal commercial transactions and contain transaction costs. The contractual principles are readily applicable to people engagement.

Support for these principles should not be confused with the 'employment contracts' which are currently and commonly attempted but which are really a bastardisation of commercial contractual understandings. 'Employment contracts,' by their nature, describe agreements within the structure of master and servant, delineating legal relationships between non-equals. They are a reworking of form rather than a change of substance. These 'contracts' frequently contain hidden and undisclosed requirements and most often give the 'employer' the right to change the contractual terms without agreement from the 'employee.' These are not in reality contracts, but master-servant control agreements written in a modified language.

'Employment contracts' are really a bastardisation of commercial contractual understandings.

The Problem of Permanency

Two interrelated barriers that flow from a poor understanding of contracts block the application of individual liberty in the firm. One is the social contract imposed on firms by employment regulation. The other is the desire of management for stability in people engagement. Both can be summarised in one word: permanency.

Permanency is an unnatural state of affairs in market operations. Each time an individual purchases an item from a shop the contract comes and goes quickly. A single purchase does not create a contractual obligation on the buyer to undertake repeat purchases, or on the seller to continue to offer items for sale. Even in large businesses dependent on the supply of raw materials, long term contracts are not necessarily signed. Long term contracts drive down competition and ultimately limit supply. Businesses learn to keep their options open for suppliers. What drives the market is the commercially interdependent needs of all parties, governed by offer and acceptance of contract subject to availability, service, quality and price.

The desire for and imposition of permanency in people engagement within firms is destructive of the market and breeds a culture of complacency and non-performance. In effect, the desire for permanency reflects a desire for the removal of individual liberty. The perversions of human behaviour that Hayek predicted would occur with top-driven command and control economies, likewise occur with top-driven command and control firms.

The harsh but liberating reality of markets is that nothing is permanent. What markets have are ongoing (but changing) needs. The satisfaction of ongoing needs can create an illusion of permanency; however, this is critically different to a permanency created by legal dictate. This reality must be accepted and embraced by all parties for the lift in liberty and performance it delivers. In attempting to create permanency, market realities are removed. When markets are prevented from operating inside firms, the inevitable corruptions develop of internal monopolies, accountability avoidance and protection of misbehaviour, all leading to diminution of performance.

The Market Prevails

Ultimately, the only way to overcome problems resulting from employment regimes that deny individual freedom is to fix the problem at the root. Markets must be invited to operate inside firms. This can only be fully achieved by removing the master-servant employment model and replacing people engagement arrangements with the very thing that drives economic activity: the common, well known, everyday understanding of commercial contracts.

This would perhaps interest Coase. He would be interested in the concept of markets in the firm and the firm being internally driven by commercial contracts. As he recently said of the impact of new technologies on contract methodologies, 'So that's what I'm interested in now. By improving the way the market works, you can produce immense benefits ... Without the ability to make efficient contracts, you can't use these new [technologies]' (Hazlett 1997:30).

Creating systems for the cost-effective management of people engagement contracts inside firms is the key to understanding markets in the firm. However, if transaction costs cannot be kept below the benefits, then 'master and servant' is forced to prevail in the firm and Coase's original analysis remains valid.

In the existing legal environment, many operational models exist where management thinking attempts to conduct human relations outside the master-servant model, but is constrained by the legal framework. The working of markets inside firms will and does vary from circumstance to circumstance. Some legally supported models have emerged.

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In one example in Australia, a model of transaction cost management in people engagement, was created in the *Odco* High Court judgements.[2] In this Odco system, people (workers) are supplied to user businesses through the medium of a contracts administration agency.

- No contract exists between the worker and the business where the worker works.
- Engagement is daily hire and at law no master and servant 'employment' exists.
- The workers exercise legal 'control' of themselves.
- The contracts can be changed daily for every worker.
- The user business does not 'control' the worker but controls the business results through the terms of contract which it is prepared to accept.
- The system operates on offer and acceptance of contract.
- The transaction costs are known and contained in the negotiable fee the administrator charges the user business.

Through Odco arrangements, businesses have the external market penetrating their internal operations, possible because the transaction cost problem is managed.

Other legally supported models of non-employment exist where the contractual relationship is direct between the user business and the non-employee. In these models, the user business must develop its own internal systems for contract management to keep the transaction costs within affordable levels. This is the challenge facing government and local councils in compulsory competitive tendering.

Conclusion

For the full flowering of human creativity and productivity, the individual must be delivered both legal and actual liberty. In the market place this is achieved through commercial contracts. When the market is restricted to operating between firms and fails to operate inside firms, firms and in turn market-based economies will underperform.

Legally defined 'employment' is by its nature and operation concerned with the suppression of human liberty. As a method for the achievement of great things with people, in firms and societies, 'employment' is a poor model. *Policy*

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2 The Odco Judgements involved six judicial considerations. The primary judgement is that of the trial judge, Mr Justice Woodward, in the action *Odco v BWIU & Ors*, No VG151 of 1988, in the Federal Court of Australia (unreported), 24 August 1989.