An Organizational Coase Theorem: Constitutional Constraints as Increasing in Exit Costs (or, Why Private Firms Aren't Democratic)

Collective action at impersonal scale involves losses to autonomy by definition because of the need to centralize some measure of authority. This stands as an important cost to collective action that varies in predictable ways depending on the extent of organizational choice available to members. By identifying characteristics at the fundamental institutional level linked to increases in self-determination relative to other organizational forms, I identify a structural tradeoff between exit costs and constitutional constraints with respect to the ideal of unanimity. Despite the long recognition of these institutional features as central to the processes of human social ordering, my analysis is centered in how each institutional solution to representative losses to collective decision making at scale reduces these losses relative to the other. As exit costs decrease, the losses to self-determination that collective action poses are increasingly resolved through individual choice, which makes the need for costly constitutional constraints fall in comparison. In a world of zero collective action costs, organizational choice would be infinite, and the initial distribution of organizations would always dynamically adjust to optimally reflect every individual's preferences. But because collective action costs are never zero, some measure of constitutional constraints are therefore always optimal in the governance of impersonal organizations due to the representative losses these organizations entail.

Eric Alston
Scholar in Residence, Finance Division
Faculty Director of the Hernando de Soto Capital Markets Program
Leeds School of Business
University of Colorado Boulder

I. Introduction

On what margins do our impersonal organizational forms pose representative losses? To a given extent, even voluntary association always poses some measure of losses in comparison to the dynamic autonomy that individual action provides. Self-determination and autonomy of the individual are well-understood and respected cultural values, although the extent to which societies champion this value as compared to others varies significantly worldwide. But if one posits that individual self-determination *is* a value worth social and therefore institutional pursuit, then the ubiquitous phenomenon of organization poses an interesting dilemma given the way in which it reduces autonomy. Unless one assumes perfect agreement among group members as to future decisions made on behalf of the group as a whole, voluntarily associating creates a relative likelihood that future decisions will be at odds with one's individual preferences, at least on a subset of margins. This tendency is heightened as one scales in terms of an organization's members, or the heterogeneity of governance preferences among a given organization's members. My analysis relies on the axiomatic recognition that collective action in impersonal modern organizations involves the centralization of authority for collective action in some members of the organization compared to others.

Collective action at scale tends to involve representative decision-making in both private and public organizations. Each organizational type has well-developed selection processes for those uniquely empowered to participate in collective decision-making, as well as measures to check and balance this authority. Democratic selection processes tend to prioritize representativeness within certain constitutional constraints on the unfettered exercise of majoritarian concentrations of power. But public governance systems themselves suffer from significant representative losses to the extent exit is costly or impossible, in contrast to many private organizations where membership is more voluntary. Each observed organizational choice in society can thus be understood to pose distinct losses to self-determination for their members.

But the fact that while some levels of representative losses occur in group decision-making at scale, there is nonetheless variance between organizations as to the extent of these representative losses means the institutions defining and governing organizations are of central relevance to the extent and form these losses take. Collective action is profoundly distinct from individual action because while one may be indecisive or "of two minds" about an issue prior to acting, the ability to perfectly hedge one's actions are typically limited to positions in abstract financial instruments. Collective action is the coordination of many independent minds. This makes the comparative representativeness of collective action necessarily at a loss to the (internal) unanimity that voluntary individual action entails. Unanimity thus stands as the representative ideal that would maximize self-determination in a world of costless collective action. In a world of unanimity with respect to our collective decisions and actions undertaken to implement them, a collective decision-making apparatus would be unnecessary. Unanimity thus stands as the collective action equivalent of a world of zero transaction costs.

Despite the obvious unattainability of unanimity in our collective action, there are efficiency arguments for why we should preference self-determination in organizational institutional design. There are also normative arguments for self-determination, independent of the utilitarian benefits to such organizational institutional design choices. For reasons of the non-ergodic nature of the world, self-determination is arguably an efficient default presumption for decision-making with respect to action. My analysis throughout makes the strong, though defensible, presumption that, ceteris paribus, more self-determination in governance is beneficial (utility-maximizing and/or normatively preferable). I ground this assumption through considering the unattainable ideal of collective action: unanimity. Given the assumption that more self-determination (or member representativeness) in organizational design is desirable, I explore the way different ubiquitous features of the institutions governing impersonal organizations at scale trade off in terms of their solutions to the representative losses that collective action at the impersonal scale inevitably poses.

While some of the most important organizations in society are integrally personal, such as one's family or community church, these associational forms where personal relationships define most of the important margins are less tractable to generalization at the level of institutional theorizing which animates my analysis, which is therefore limited to cases of impersonal associational ordering, organizations whose scalar benefits result in impersonal relationships among at least a subset of group members (i.e. no single member can personally know all other members). Throughout, my arguments in formal institutional design are on the margin - if taking as given a certain organizational purpose and characteristics of its members, what can we learn about the tradeoffs that different organizational forms pose in practice for the self-determination of their members? Another important presumption is that this analysis considers as given a certain level of group homogeneity/heterogeneity when analyzing the impersonal institutional features of exit costs, input into selection processes, and constitutional constraints. This does not belittle the importance of the individual characteristics of members as determinants of their preferences for governance, but instead situates the analysis squarely at the theoretical level at which comparative institutional features like exit costs and constitutional constraints can be compared.

Perhaps the most structural question for an individual when it comes to association is whether such association is voluntary, which is closely linked to the extent to which an individual can choose among organizations to be a member initially, as well as in an ongoing sense. Therefore, the first institutional feature of organizations of central relevance to self-determination requires a recognition of the polycentricity of organizational forms. This is because an organization's governance responds to the extent to which members have competitive organizational alternatives. An organization can certainly be described as to the extent to which it faces competition from similar organizations, but this is nonetheless properly understood as partly a feature of the larger polycentric system of which any organization is part. The extent to which an individual has organizational choice directly influences exit costs for membership in a given organization, and accordingly, observed institutional definition of the organization itself. To give but one example, subnational units compete with one another for residents to a greater extent than national governments, which claim exclusive jurisdiction over their citizens who face greater costs to emigrate than to move within their nation of residence.

But for all major associational relations, exit costs are typically non-zero. This is often by voluntary design, which has an important implication. In many cases of where choice of membership in an organization is voluntary, this choice involves the voluntary self-assumption of barriers to exit. This suggests that exit costs, despite the relationship between agency in membership in a given organization with respect to ability to exit to alternative organizations, are not optimally zero in regard to optimal self-determination within organizational forms. Higher exit costs resolve certain intertemporal commitment problems that are especially salient in contexts where group members lack sufficient personal knowledge about all group members. Furthermore, having some measure of stake in the organization improves organization's members governance incentives in many (although not all!) contexts. The Schumpeterian argument that some gains to joint production need to be left over to ensure innovation can be mapped to organizational choice as well, which suggests some surplus to joint effort may be social-welfare-enhancing more generally. But if exit costs are ideally non-zero, which suggest less than perfect competition in organizations in a given space, this raises the possibility of negative consequences resultant from the exercise of concentrated governance authority that is part and parcel of impersonal modern organizations.

This risk for abuse of authority, or outcomes sufficiently at odds with members' preferences, increases as the extent of organizational choice available to someone decreases, which makes the importance of other safeguards than competition on the extent to which outcomes with a group can diverge past a certain point of any one member's autonomy. In political ordering, these are classically called constitutional constraints, which most importantly define the selection and retention processes for those specially empowered to govern, as well as limitations on the extent to which group action can extend into individuals' spheres of autonomy. With respect to input into selection processes, the rules associated with group membership, decision-making, and action are all of central interest when it comes to the extent to which a given organization poses representative losses to a given individual member. These all greatly influence the scope of group members who will be represented, and the constraints on the incentives of the governors to decide and act in the interest of the governed.

As important, though, are the substantive and procedural constraints with respect to the rights of individual group members as against other members as well as uniquely empowered governors themselves. My argument throughout hinges on recognizing as emergent institutional phenomena the limitations on the scope of collective decision-making authority and the exercise of executive authority in impersonal organizations' secondary rules. Bills of rights and guarantees to a certain level of fairness in process and substance before the law are each hallmark institutional solutions to the problems of representative losses before the action of monolithic governance organizations at their modern scale. Constitutional constraints can be understood as reducing the scope and magnitude of downstream losses resultant to any one organization member from the exercise of collective decision-making processes. Constitutional constraints, even though binding against one's ability to fully obtain benefits in future outcomes as against other organization members, facilitate commitment credibility through increasing risk-averse participants' knowledge that certain outcomes are not subject to the processes of collective decision-making and action to which all participants are adhering. These constraints therefore reduce the risky tails of the probability distribution(s) surrounding possible outcomes in an organization's pursuit of its purpose that members care about.

Attenuated agency and representative losses are unavoidable in all impersonal organizations, which makes some measure of institutional response to these representative losses likely to emerge in these organizations. But the polycentric context in which an organization plays a role itself greatly shapes the collective action costs and related level of organizational choice they face when it comes to a given sphere of joint production. As set against the ideal of zero collective action costs where all action in pursuit of a collective goal would be individual and voluntary, the different institutional responses to representative losses vary predictably as a function of the extent of exit costs (organizational choice) an individual has. Put more directly, in cases where exit costs are low, the benefits of centralized decision-making outweigh the costs to individual autonomy that centralized authority entails because individuals can leave freely for another organizational context that better reflects their governance and performance preferences. In contrast, in cases where exit costs are high and organizational choice approaches zero, the costs of centralized exercise of collective decision-making and action authority creates increasing losses to individual autonomy, which necessitates the institutional solution of constitutional constraints on the exercise of this centralized authority. In sum, in organizational contexts where there are utilitarian or normative benefits to individual autonomy, the need for constitutional constraints increases as exit costs increase. This can be understood as a "power law" within the complex system that is modern human social ordering at scale.

II. Comparing Impersonal Organizations' Institutional Features

I have already referenced both an organizational design efficiency argument for self-determination, as well as an independent normative argument for self-determination. Regarding the efficiency of self-determination, individuals are argued to command local knowledge that makes them best situated to determine outcomes to which they are subject, and individuals empowered with their own autonomy are arguably more productive at tasks they have voluntarily chosen, ceteris paribus. But beyond the gains to organizational output that result from self-determination, the principle also has intrinsic value that derives from our value as individual human beings. Each of these channels of benefits motivate the realization of self-determination within our associational forms. But the simple reality remains that we can do much more when we specialize and produce collectively, such that the benefits of collectively choosing a purpose and acting toward it exceed the costs of organization and determination that our collective action necessarily creates (Buchanan and Tullock 1962; Olson 1965). Importantly, the analysis here is silent as to the optimal choice of purposes for our organizations, as well as the optimal balance of organizations that maximize realization of our collectively chosen purposes subject to the input of labor and capital toward them. Instead, the analysis considers how specific features of institutional contexts can predict the type of organizations that predominate, as well as the institutional remedies designed to limit expected losses to the self-determination of members that are therefore likely to result.

Beyond the obvious question of why we act collectively if doing so poses costs, a more specific comparative question emerges – what does a given balance of organizational forms in a particular context tell us about the means by and extent to which self-determination is occurring? Democratic ordering is often held up as an ideal for representative governance, but if this is indeed the case, why aren't more of our organizational forms governed democratically? At a minimum, if losses to self-determination are greater, ceteris paribus, in more centralized organizations, the prevalence of centralized governance in private organizational contexts poses a dilemma. The logic I spell out here suggests this is because a competitive equilibrium of relatively centralized organizations provides greater benefits on net to social actors than a single relatively decentralized organizational structure. Because the decision-making processes defining collective action are themselves costly, choice in organizational form itself presents a margin by which distinct competitive gains and losses are wrought (Graham et al 2015; Lo et al 2016; Aghion et al 2017).

Formal impersonal organization requires the articulation of secondary rules to define individual roles within an organization's hierarchy for collective decision-making and action (Hart et al 2012). The act of constituting an organization requires identifying the characteristics that qualify or determine membership. As an organization scales, representative authority for collective governance provides important economizing benefits but also creates costs that need unique resolution (Alston et al 2021), either through monitoring, mechanism design, or separating competencies between different organizational units, although these are all second-best remedies confronting the concentration of authority that governance at scale requires. As importantly, authority for collective decision-making demands qualifying criteria for individual members' empowerment in the processes of governance, as well as a process by which selection occurs from among qualified group members. Thus, modern impersonal organizations involve considerable centralization of authority, which has required institutional solutions to check and balance this authority or reduce the incentive problems it creates. This emphasizes how some measure of concentration of authority is inevitable in impersonal organizations, yet how the remedies to address this concentration of authority vary considerably, especially between public and private organizations, a distinction which my analysis sheds light on directly.

While representative losses are by definition costly compared to the ideal of unanimity, the costs of institutional choices designed to reduce these representative losses are to an important extent exogenous to the choice set of an organization's decisionmakers. Past a certain point, a CEO can no more change the industry of the firm whose leadership they assume than a president can violate deeply held constitutional norms on the part of their constituents. Nonetheless, the latter example of democratic ordering with constitutional constraints and separated governance authorities is more costly by design – the decision-making is slow, incremental, and subject to considerable administrative and judicial interpretation and reinterpretation over the course of implementation. But in organizational contexts whose purpose tends toward more concentrated production, whether territorial provision of security services or other network industries, the choice of organizational purpose begets economies of scale or other constraints that cut against a plurality of organizations competing to provide similar to identical outputs. For some governance contexts, concentrated or monopoly provision of an organizational output is optimal. This creates the need to minimize the costs of such organizational provision, which has been argued to be sub-optimal from a consumer and social welfare perspective.[1]

My approach here develops the institutional tradeoffs underlying the Coaseian insight that organizational choice greatly shapes observed economic (and social) outcomes. But just as the bureaucratic costs of transacting within the firm limited the ultimate size of the firm itself, the choice of purpose underlying a particular form of organization can greatly shape the feasible institutional contours of that organization (Alston et al 2021). For example, modern mineral

[1] Some measure of market power is necessary to obtain profits which are arguably linked to innovation and reinvestment (whether directly or indirectly), but the study of network industries directly indicates that the optimal industrial organization of some markets is determined exogenously to the participants of those markets.

extraction at economically viable scale requires a certain level of capital investment and labor applied to the purpose of extraction. Similarly, public governance of a geographically large territory presents a set of constraints on the means of viable governance that make exit more costly (Alston 2018), which has direct implications for the optimal form of governance in terms of reducing representative losses. If exit to competitive governance alternatives is impossible, constraints on process and substance may be the next best institutional solution. It is this structural tradeoff in organizational choice that is the central concern of my analysis.

As a caveat to my analysis of impersonal institutionally-defined organizations, self-determination in highly personal groups or organizations is likely to be higher, because of the integral nature of these associations to our pursuit of our individual objectives, as well as the flexibility these arrangements have compared to those given more formal definition into institutions. Nonetheless, the idiosyncrasies of personal associations, while certainly tractable to rigorous analysis under the assumptions of institutional and organizational theory (Becker 1998, Greif 2006), do not lend themselves to as generalizable comparisons between the institutional choice presented to individuals for expression of their preferences within a given organization. For impersonal organizations, though, which are integral components of modern liberal societies, their very nature as institutional scalars of the more personal associations in life means their characteristics are defined in contract and law (Alston 2022b). This makes such impersonal associational forms tractable to specific institutional comparison and rigorous analytical, theoretical, and empirical analysis (Alston et al 2018). As importantly, these comparative institutional tradeoffs can reveal the structural forces that are significant determinants of observed outcomes with respect to associational choice in any society, which is a core motivation of my analysis throughout.

At the level of generality of this analysis, I do not focus centrally on specific institutional choices that, for example, create higher or lower exit costs from a particular organization, but will instead discuss institutional features that are themselves intrinsically related to the autonomy and representativity that one experiences because of the impersonal associations to which they belong. Of course, the specific means by which democratic electoral processes occur are of central relevance to determining the margins of representative benefits and losses occurring to any potential voter (Alston 2022c), but my analysis here is taking place at least one structural layer deeper. The need for the check on representative collective decision-making that democratic electoral capability provides is itself a function of the extent of organizational competition available. Before deciding what form democratic electoral processes take, the question of whether these processes are even a competitively viable governance choice is necessarily precedent. If firms could do so costlessly, they would likely organize democratically, but the informational and incentive problems these organizational governance choices create mean the competitively viable organizational choice is high degrees of centralization in practice.[2] If competition provides sufficient self-determination to organization members who remain voluntarily, this is lower cost than the relatively cumbersome apparatus of democratic selection and retention of representative decision-makers.

[2] Interestingly, though, as informational and communication costs have fallen in the digital age, more decentralized forms of private governance have begun to emerge, whether using traditional analog methods of governance (like Zappos) or harnessing technological innovations like blockchain (Alston 2020).

Importantly, the level of organizational choice in a given sphere of joint production resultant from collective decision-making is endogenous to the larger complex system of which any organization is a part. Therefore, my analysis does not proceed by claiming the structural forces that determine a given level of exit costs or constitutional constraints are typically within the choice set of human institutional designers. Instead, in the vast majority of cases, my analysis suggests that a given level of centralized decision-making in a highly competitive industry, or a given level of constitutionally-constrained government over a large and heterogeneous territory and constituency, is relatively fixed with respect to the choice set of individuals empowered to change institutions at any given point.[3] Nonetheless, the structural features of the organizational context, whether a publicly-traded firm or a constitutional republic, display an observable regularity with respect to the institutional features I identify here. In complexity theory, observable features across many complex systems that display a distributional regularity in relation to another feature that is at odds with observed normal or Poisson distributions have been deemed "power laws" (Bentley and Maschner at 153-54). Given that the highly polycentric human social orders we observe today are undeniably complex systems, the relationship I draw out here between unanimity, exit costs, and constitutional constraints can be understood as developing the intuition for and finally identifying an "institutional power law[4]".

III. Unanimity as Eliminating the Need for Organizational Choice

The unattainable organizational ideal with respect to self-determination is unanimity. If unanimous agreement as to each group decision were possible, and not prohibitively costly to reach where possible, this would directly suggest no loss to individual self-determination. Put differently, if someone joins a group where they agree with every single decision made and action taken, there is by definition no loss in self-determination occurring as compared to how they would individually act; membership is truly voluntary in such a far-fetched hypothetical. Indeed, in such a context of perfectly unanimous agreement, the question of leaving becomes moot, for why would one voluntarily leave an association where every action undertaken was in perfect harmony with one's own desires? Hopefully, this hyperbolic example underscores how unrealistic unanimity is in human organizations. While not impossible, the costliness of obtaining unanimity makes it a rare decision rule in comparative contexts, also requiring a decision rule for the default outcome in cases where unanimity cannot be reached.[5] Perfect unanimity is an organizational corollary to a world of zero transaction costs – even if perfect

[3] In certain special "constitutional moments" much more of the institutional choice set is up for grabs (Alston et al 2018, Chs. 7&8). This is not to argue that the scope of institutional change available to a given set of governors is not an important determinant of performance, but instead that some measure of institutional change for an organization is always outside the decision set of its governors at any given point in time (Alston et al 2021).

[4] Over the distribution of exit costs (organizational choice) subject to a chosen joint output of collective action (purpose of an organization), this chosen joint output defines an optimal level of organizational scale and hence competition (and exit costs), which in turns defines the level of centralization of authority that can be achieved due to the specific collective action costs this centralization creates. {F (Purpose) -> Exit Costs -> Optimal Const. Constraint Level}

[5] Twelve-member jury trials in the United States stand as a salient example of this. Despite the fact that the stringent bar to conviction itself conditions prosecutorial incentives to only bring cases with a sufficient likelihood of conviction in the first place, hung juries occur between 8 to 13% of the time, depending on whether the jury is hung on the most serious count, all counts, or any one of the counts charged (Hannaford-Agor et al 2002).

agreement as to purpose were possible among a group's members, the apparatus needed to define tasks and coordinate complex sequential and combinatorial output is costly. Eventually, the costs of unified governance exceed their benefits, which is viewed as the canonical boundary limiting the extent of the firm (Coase 1937).[6]

In many governance contexts, unanimity is unattainable, due to the simple reality that governance exists in great part to resolve intended and unintended disputes among group members (Alston 2022a), either resultant from their independent actions (crime and torts) or disagreements due to obligations emergent from their voluntary associations (contracts). In a sense, the questions that least matter for a given group are those over which there is total unanimity, and indeed perfect unanimity would require no organizational governance whatsoever as all action in furtherance of an agreed-upon purpose would be obvious and voluntarily individually undertaken. An apparatus for collective decision-making is thus centrally concerned with resolving areas of disagreement among group members about the right collective action to where those whose interests are less represented in a particular decision nonetheless value the ongoing benefits of collective action sufficiently to abide by the decisions of the group. The specific institutional definition of the apparatus of collective decision-making and subsequent action has direct consequences for the balance of costs created by a given organization's hierarchy.[7] While the balance of costs has implications for firm performance (Bloom et al 2010), effective leadership traits (Alston et al 2021), and resilience (Prendergast 2002), the research in this area of organizational design suggests that while some measure of deconcentration of decision rights within the firm hierarchy is due to exogenous factors, there is some measure of deconcentration of decision rights that is within the decision set of firm managers. This directly indicates that the more competitive an industry in which a firm is situated, the more elastic a firm's governance choices need to be with respect to competitors' choices. To the extent labor commands bargaining power, or relative deconcentration of decision rights yields productive benefits, more organizational competition is likely to result in greater self-determination for organization members.[8]

The high costs of unanimity effectively ensure that some measure of group action poses potential losses with respect to any one member's individual preferences. Revealed preferences suggest two ways to understand someone remaining in an organization where exit costs are not so large as to prevent leaving altogether: either one values the net results of collective association absolutely, or does so relative to all other possible associational forms. In reality, these motives are likely both present in good measure when it comes to conditioning associational choices –

---

[6] Other notable organizational boundaries have been identified, perhaps most significantly by Williamson (1983), including how certain types of asset-specific investment create unique incentive problems when they span organizational boundaries, creating firm integration in certain contexts. See Alston et al (2021) at 4-7 for a review of this literature.

[7] In some organizations, like research universities, decision rights are highly deconcentrated, and coordination costs are central to the success of the ability of the organization's leadership to progress in furtherance of the organization's purpose. In other organizations, like sports teams or private firms, decision rights tend to remain centralized, with agency costs becoming more prevalent relative to coordination costs (Alston et al 2021).

[8] Of course, there are many industries where concentrated governance authority is relatively more efficient, given the nature of the firm's production. My arguments throughout at the general organizational theoretical level are on the margin, taking as given an organization's output (and therefore, its set of competitors and the exit costs the organization's members therefore face).

one decides both upon the specific expected benefits of a given associational choice in isolation, as well as the opportunity cost of that choice as compared to available alternatives. Despite the importance of that which our organizations are trying in practice to achieve for their members through their collective output, this analysis is instead limited in a relative sense to the institutional structure of organizations as compared to one another. Taking as given an individual's preferences for associational outcomes, they are nonetheless confronted with considerable associational choice in modern society, such that the relative institutional margins of organizations present a competitive margin for individual choice (Alston 2020). Of course, our choice as to national government is considerably more limited than our choice of insurance company or university, such that the extent of competition an organization faces in attracting members is a significant determinant of which institutional features are likely to facilitate or hinder self-determination.

But beyond this tailoring as to individual preferences, choice in private organizations creates an additional benefit with respect to governance, for competition has itself been recognized as exerting a beneficial discipline on organizational governance. On net, the more organizations available to an individual that therefore provide more representative governance, the more dynamic the space in which organizations are competing for members through which to achieve their intended purpose. This level of choice in organizations can be understood as synonymous with the exit costs an individual faces – infinite exit costs imply no organizational choice, whereas zero exit costs define the other theoretical endpoint where organizations are ephemeral groups of individuals voluntarily and costlessly coordinating their individual actions. Between these two theoretical endpoints lie all human organizations, each posing some measure of exit costs to their members, but varying importantly as to the extent to which they do so.

IV. Exit costs

Competition in organizational forms is in part a function of the public institutional environment delineating the means to form these organizations. Fundamental amongst the organizations linked to the benefits of competitive access are economic organizations (like corporations) and political organizations (like parties). Thus, extent of choice available to individuals in terms of associational forms in society is in part among the institutional choice set of government itself, and restraint of this choice set is often part of how illiberal regimes control rents in society among members of a dominant elite coalition (North et al 2010). This suggests that the rents from control of access to associational forms are diminishing in competition; more competition results in a greater share of the surplus from collective action flowing to the consumers of that output, whether they be organization members or no. This is the political economic logic by which North et al argued that competitive access to organizational forms operated to increase social welfare in the nations that managed to the achieve the requisite set of doorstep conditions. As an additional example, the history of access to the corporate form indicates how when forming a corporation required a special act of the state legislature, this proved a powerful means of disbursing economic rents in exchange for the continued political support of comparatively monopolistic organizations who benefited from the privileged access to comparatively beneficial institutional definition (Alston 2022). Of course, for the vast majority of social actors, input into the rules governing access to associational forms is sufficiently costly that the level of choice in organizations in a particular context is largely fixed from their perspective, despite being endogenous to the greater polycentric system of organizations.

A given level of organizational choice being fixed for most social actors, whether due to a political economy or structural factors that limit the optimal number of organizations, means that exit costs vary significantly for individuals depending on the society in which they live and the type of organization in question. Given the narrative thus far, the supposition that lower exit costs are always better would be forgivable, due to the benefits that result in competitive access to these forms. Instead, however, it is likely that the theoretical endpoint of zero exit costs is actually suboptimal from the perspective of most impersonal organizations' ability to coordinate members' actions in pursuit of their collective output. This concern is often shorthanded as "no skin in the game", which indicates the way in which having a stake in an organization and the outcomes it is pursuing is beneficial for the organization itself in terms of member's incentives to participate in governance with an eye to medium to long run outcomes (Alston 2020). This can resolve intertemporal commitment problems to the extent other organization members also know other members have symmetric or a minimum level of stake in outcomes, which can shape incentives in beneficial ways (Buterin et al 2020). At its most extreme, if someone cannot exit a given group the stakes associated with every governance decision are necessarily higher than contexts where they can leave, albeit at some cost. Put differently, if exit is always less costly than participation in the processes of representative governance, this can significantly alter the dynamics of governance itself, when only a group with an outsized interest in governance outcomes participates compared to a much larger whole.

Nonetheless, the discussion thus far has emphasized the benefits of organizational choice in terms of competitive governance and tailoring membership to individual choice as enhancing representativeness. This means exit costs, all else equal, tend to decrease the representativeness of the organization as they increase. Therefore, exit costs above a certain level create discrete problems associated with a lack of choice in organizations. Because collective action at impersonal scale tends to involve some measure of concentration of authority in terms of representative decision-making and implementing these collective decisions, this creates a direct risk for the abuse of this authority. In firms, this problem is classically those cases where the interests of management depart from those of shareholders. In public governance, this includes a much greater scope for abuse, due directly to the greater scope of human action over which public governance asserts jurisdiction. Furthermore, as highlighted previously, the credible threat of exit on the part of an organization's members constrains the scope of governance choice available to those organization members uniquely empowered to define and exercise it.

A world of zero exit costs is one where all organizational membership would be voluntary, and organizational choice infinite. In this organizational equivalent to a zero transaction cost world, collective action would be unanimous and spontaneous, because every unit of collective action would perfectly reflect all its members interests, due to the ability to costlessly exit to an infinite number of other organizations.[9] Yet the process of collective

[9] In such a world, organization would itself be evanescent, and would only reflect voluntary coordinated action in pursuit of a purpose shared unanimously. Such organizations would of necessity be costless because they would require no apparatus for collective decision making, let alone defined constraints on the individuals deciding and acting on behalf of the larger whole.

decision-making and action at scale is itself costly, which suggests a much more discrete number of organizations in practice. Similarly, the ability to exit from one organization is always costly to some extent in terms of transition or switching costs. In a world of finite organizational choice, with switching itself being intrinsically costly, exit costs are *always* non-zero. But when coupled with some intertemporal benefits to organizations from formally creating exit costs to align members incentives and ensure one another's commitment credibility, this indicates that exit costs in organizational choice are even higher than the non-zero level I argue for in the preceding sentence.

Exit costs perhaps most clearly vary along the lines I outline here when one considers the distinction between private and public ordering. Private ordering of necessity facilitates pluralism compared to the geographic monopolization of governance that public ordering ubiquitously entails. Without illiberal public barriers to forming organizations, the relatively open entry in contexts of private ordering creates the threat of Schumpeterian competition, a constraint even when an entrant has not entered. This is the canonical case of market competition but also holds true for other associations, like sports leagues, churches, and non-profits. In contrast, public ordering has more difficulty accommodating pluralism. First, the uniformity of law compared to the selection available through organizational choice directly implies representative losses for a subset of those governed, if one accepts the presumption that governance choices over which there is sufficient agreement do not warrant the costs of public institutional definition. Furthermore, there are a variety of problems with the scale of public governance surrounding the ability of smaller groups to organize and obtain concentrated benefits at the cost of dispersed costs across the much larger whole.[10] Thus, as jurisdictional reach increases, and available alternatives diminish as one scales geospatially, this makes exit costs increase to where for many individuals, certain governance organizations to which they "belong" do not provide a meaningful opportunity for exit. This makes the challenge of ensuring some measure of self-determination is nonetheless retained as a central question in organizational design.[11]

V. Constraining the Powerful ("Watching the Watchmen")

As the scale and scope of an organization increases, and the scope of organizational choice available to potential and current members decreases, this means that the application of the organization's institutions becomes less avoidable and more uniform. This heightens the potential for representative losses, which creates the need for additional restraints on the exercise of concentrated collective decision-making authority to avoid this class of collective action costs. These needs have been the most salient in the case of public governance, such that these constraints are most classically labelled constitutional. Despite the label of a constitution fitting

[10] This tendency is only exacerbated by finding like the one that interest groups narrowly specialize and dominate an area (Browne 1990) as opposed to cancelling out one another's interests in a moderating process.
[11] I would remind the reader that there are functional benefits to increasing the representativeness of organizations, all else equal, as well as normative arguments as to why it is desirable to do so, separate from the utilitarian arguments. Assuming a certain level of demand for these benefits on the part of an organization's designers, or a given constituency, is an assumption motivating my analysis, which ultimately spells out the tradeoffs that institutional design choices pose for self-determination.

oddly with many private organizations,[12] what I am describing here are integral components of modern public constitutions, even though the institutions of input into selection processes and restraints on the scope of executive authority appear in nearly all organizational contexts to some extent. My analysis highlights how the level of need for these types of constitutional constraints varies depending on the extent to which exit is costly for organization members.

a. Selection, Retention and Punishment of the Governors

Of the two emergent constitutional constraints that I identify for ensuring that a measure of self-determination is retained when acting collectively at monolithic impersonal scale, the first surrounds input into the selection processes of governors, as well as means to punish said governors, either through penalties or removal from the position in a subsequent selection process. Democracy is the quintessential example of input by the governed into the processes governing them, but this is not the only means by which the governed can have input. Governments vary in terms of their electoral structures considerably, just as private associational forms ranging from private companies to public corporations display considerable variance in terms of the selection processes for those engaged in the governance of the organization.

As important as input into selection is the process by which specially empowered organization members are disciplined. Thus, while shareholders might not necessarily directly select firm managers, they can engage in processes that ultimately culminate in the removal of management. Nonetheless, the creation of a special set of governors with the unique ability to punish other governors is itself sufficiently challenging and costly institutionally that some systems limit the punishment governors can receive, especially during their time in office. The refrain of "who watches the watchmen?" clearly indicates that creating a unique set of adjudicators and punishers does nothing to solve the recursive problem of vesting this special authority (and its potential for abuse) somewhere. This problem is so acute when it comes to the exercise of public executive authority that while in office many executives are insulated (at least partially) from the typical processes of criminal oversight that apply to ordinary citizens. In such cases, the process of reelection is viewed as an important restraint on the incentives of the incumbent.[13] Put most simply, the threat of discipline conditions the incentives of those subject to the discipline, and to the extent this discipline was defined through the processes of collective action subject to some measure of input from organization members, should enhance representativeness accordingly. Unfortunately, though, well-defined processes of selection and discipline of the governors by group members writ large are likely insufficient when it comes to reducing the losses to self-determination that collective action at scale poses, which raises the second category of institutional solution to this problem.

b. Constitutional Constraints on the Substance and Process of Collective Action

[12] Nonetheless, one area of private constitutional consulting surrounds defining a "constitution" for extremely wealthy families due to the need to define areas of authority over different familial business concerns, as well as the ongoing equitable division of wealth and authority over said division. (McCain 2006; Stone 2009)

[13] Of course, another structural limitation surrounds the number of terms someone can serve in a position of governance for a group. This limitation trades off with electoral discipline, for outgoing executives have been argued to pursue a wider range of goals more consistent with their independent preferences as compared to periods when they are subject to an election (Besley and Case 1995; Murray et al 2018).

Even when subject to electoral discipline, as the scope of governance authority increases (directly alongside exit costs), so too does the need to procedurally and substantively constrain the scope of collective action for group members subject to the decisions of governors. In the public governance contexts animating this discussion of organizations with high exit costs, constitutions frequently delimit the areas subject to legislative authority at a given level of government, often reserving those undefined areas[14] to subsidiary, and presumably more representative, levels of government, due to the smaller scale and lower exit costs that by definition characterize subsidiary governance units, ceteris paribus.

Nonetheless, constraining the scope of legislative authority and defining appropriate spheres of authority between superior and subsidiary units of governance authority may not provide sufficient insulation against the exercise of authority by those specially empowered to govern. An additional constraint that has thus emerged in impersonal public governance involves the articulation of a core set of areas that each member is entitled to as against the collection decisions and actions of the organization's members. In the context of public governance, these are individual rights accorded to all citizens, and provide an additional bulwark against the representative losses that impersonal public governance at scale necessarily imposes. By definition, the removal of certain areas of individual autonomy from being subject to the decisions of the collective increases self-determination compared to contexts where such authority is unconstrained.

The analysis of institutional responses to the representative losses posed by heightened exit costs has thus far focused on the "who" and the "what" of collective decision-making and action at scale. As important, however, is the "how". This has led to a recognition of the institutional importance of procedural transparency, clarity, and uniformity. Classically known in the United States as due process, this surrounds the concept that every organization member is entitled to a process of collective action with respect to them and their interests that displays certain normatively preferable characteristics. While a comprehensive treatment of due process as defined in United States jurisprudence is well beyond the scope of this analysis, this example emphasizes how ongoing constraints on the process by which collective decision-making and action occurs are an increasingly necessary institutional component to reduce the extent of representative losses to which any one organization member is subject.

The realm of pure institutional theory, including my discourse thus far, can lend the unfortunate impression that institutional mechanism design is perfectly attainable in practice. But the need for additional stopgaps may well spring eternal due to the representative problems associated with impersonal social ordering. As but one example, in the United States the convicted have the equivalent of a "last chance" under some state and federal law. The fundamental fairness doctrine surrounds how in certain cases where procedural and narrowly defined substantive avenues to a new trial are not available to a convicted criminal, there is nonetheless an argument that can be made to the court that the record in its entirety betrays a fundamental unfairness to the convicted to where justice demands that a new trial be had. The ubiquity of the incompleteness of our law also extends to contracts (Williamson 1985;

[14] In constitutional design parlance, this is known as the residual authority to legislate, and is one of the most important design choices when it comes to delimiting the scope of legislative authority between different levels of government.

Williamson 2003; Moore and Hart 2007) such that the need for default rules and force majeure clauses also stand as examples of how all our institutional remedies are incomplete. But as exit costs increase, and those to whom the policies of an organization apply grow in number and diversity, the need for such failsafe measures grows with respect to the collective action costs this creates, for incompleteness is not decreasing in the scope of the institutional forms defining human action. A single discrete exchange is necessarily more complete than an agreement to exchange over time, and the decisions for an isolated fishing community can typically contemplate more of the events likely to emerge under its governance than can a complex modern government overseeing the affairs of millions, if not billions of its citizens.

Thus, the more an organization scales (whether rightfully or wrongfully!) to monopolize the field of organizational choice in the area in which it is competing for members, the more incomplete institutional remedies become, and the more representative losses are likely to occur on the margins, either for discrete groups or for the polity as a whole. This makes the institutional remedies to the incentive problems and concentrations of power that public governance at scale involves more costly, less effective, and more incomplete than smaller organizations subject to greater competition and with lower exit costs for members. In sum, constitutionally constraining the comparatively leviathan nature of public government creates a more costly governance regime because this is the best obtainable outcome as one scales in terms of number of constituents and/or diversity of constituents' governance preferences.

Moreover, the greater the scope of governance authority, the greater the need for dynamism with respect to governance. While conservatives and progressives might argue over the appropriate locus for updating our institutions (incremental common law versus centralized regulatory authority, respectively), few scholars of political ordering would deny the near-constant need for our rules to adapt to the ever-changing nature of a non-ergodic world. As the scope of governance authority increases, so too does the need for updating, and so too does the cost.[15] All of this points to comparatively greater costs and representative losses, all else equal, to relatively less choice in organizations. But the purpose of public or centralized monolithic governance may well be worth the costs, as the advocates of public goods or network industries (with constantly declining marginal costs) would stridently argue. In such cases, my analysis indicates that selection processes of governors and constraints on the scope of collective action become more important to reduce representative losses.

The optimal scope and magnitude of purpose for a given organization is well beyond the scope of my analysis. But the descriptive analysis thus far, grounded in principles of constitutional design, institutional and organizational analysis, and public choice theory, has an important implication for our understanding for the structural tradeoffs that define rule-based social ordering. If unanimity is the unattainable ideal, and exit costs are (optimally) never zero, then some measure of constitutional constraints are always necessary to reduce losses to self-

[15] This is decidedly not an implicit argument that smaller is always better. Holding constant the purpose (or output) of a given organization, as scope and magnitude of an organization's purpose increases, the more that scale economies are also likely to predominate, whether in terms of private network industries or public governance. My argument instead relies on the readily defensible claim that the complexity and cost of the Environmental Protection Agency's governance is orders of magnitude greater than that of a local wildlife area, even if both are publicly-defined-and-budgeted agencies whose purpose as organizations is similar on important margins.

determination that collective action mechanically poses. Of course, the effect on the margin is as important, which directly indicates that as organizational choice decreases (and exit costs increase) constraints on governance increase in importance. This operates through two discrete channels that I have identified: (i) a decrease in exit costs means this individual response to representative losses is less prevalent, enhancing the relative need for other, more costly institutional measures to preserve autonomy; and (ii) the potential for abuse of authority increases as this authority concentrates, which happens mechanically as organizational choice decreases. In a world of non-zero exit costs, some measure of constitutional constraints are therefore always optimal.

VI. Conclusion

My analysis explores the emergent and interrelated nature of institutional features related to the representative nature of our organizations for collective choice and action. In a complex system, everything is endogenous to the point where identification of discrete causal processes is extremely difficult (and limited in predictive scope), if not impossible. Human social orders at the scale they have attained in modernity are no different, which means the rule-based structures we have devised to overcome collective action problems at modern scale are themselves a complex system. Nonetheless, such complex orders are tractable to analysis through identification of their discrete features and certain regularities among the relationships between those features. If certain discrete features of complex orders display a sufficient regularity with respect to one another, these can be deemed "power laws" of complex systems. If polycentric modern human orders, defined by many organizations and even more institutions as they are, can be deemed a complex system, then my analysis here can be understood as identifying a power law within such systems related to unanimity, representative losses, and the way in which organizational competition and constitutional constraints emerge to deal with these unavoidable costs of collective action. When distributed over exit costs, choice in organizational purpose (joint output) defines a given level of choice for organization members that in turn creates an increasing need for constitutional constraints as the given choice in organizational purpose approaches the infinite end of the distribution of exit costs.

My analysis hinges on the recognition that unanimity as first best from an individual and mechanism design perspective is also therefore unattainable because collective action itself has positive costs. More controversially, perhaps, I argue that low exit costs are second best compared to the third best of constitutionally constrained monopolistic organizations. This is because the positive institutional costs required to achieve less imperfect representation are greater than the costs to representation achieved on net through individual membership choice from among competing organizations. However, as exit costs increase (and organizational choice decreases) process and substance constraints on government action and the selection of governors increasingly become the solely attainable third best. But the fact that exit costs are understood as optimally non-zero suggests that constitutional constraints are also always optimal to some degree. If much of the fruits of voluntary exchange at scale can be attributed to economic institutions that resolve commitment credibility problems within the shadow of impersonal enforcement, this suggests an important downside margin by which zero exit costs would be socially suboptimal due to the inability to enforce commitments intertemporally. This provides an emergent logic for the constitutional constraint of the powerful as operating to create net social welfare gains from the credibility their commitments have under the rule of law as compared to not (Wallis 2021).

In the face of the unattainability of unanimity, comparatively centralized unchecked governance processes that compete with one another are more effective than comparatively decentralized constrained governance processes that enjoy high concentrations of the share of governance authority. But given many organizations' structure of governance is greatly determined by broader forces of territorial or demographic cleavages, this means organizations vary as to the extent and form of institutional remedies they provide to improve self-determination for individual members of the organization. And because collective action is costly due to the unattainability of unanimity, all such action poses representative losses compared to individual action. Nonetheless, in contexts of comparatively free organizational entry, the relative predominance of unconstrained centralized decision-making suggests that the benefits of this competitive organizational equilibrium exceed those provided under a more decentralized organizational equilibrium with less competition between organizations.

The essence of my argument surrounding relative representative losses flows from the fact that organizational choice is wrought individually but constitutional constraints are defined collectively and applied uniformly. The former allows for a degree of contextual tailoring solely at the cost of the individual, whereas the latter requires affirmative expenditure to define and enforce, in addition to the losses on fit dimensions that a uniform protection against excessive governance action entails. Furthermore, the threat of exit itself exerts a beneficial discipline on governance. My argument here is not meant to assail the value of democratic or constitutional constraints, but instead to argue that their emergence is inevitable in the face of the representative losses that high exit costs (or a lack of organizational competition) create.

My argument can be understood as a Coase theorem of organizations: in a world of zero collective action costs, organizational choice would be infinite, and the initial distribution of organizations would always dynamically adjust to optimally reflect every individual's preferences (that could best be achieved through collective as opposed to individual action). But because organizational choice is finite (and exit costs are always non-zero), some measure of substantive and procedural constraints on an organization's decision-makers is always optimal. These classically include input into the selection processes for an organization's governors, and constitutional constraints on the substance and procedures of collective decision-making and action. Constitutional constraints can therefore be understood as the (third) best institutional means of preserving a measure of self-determination before the inevitable consequences of collective action at impersonal scale in contexts where exit costs are sufficiently high.

Citations

Aghion, P., Bloom, N., Lucking, B., Sadun, R. and Van Reenen, J., "Turbulence, firm decentralization and growth in bad time," NBER Working Paper No. w23354, 2017.

Alston, E. "Constitutions and Blockchains: Competitive Governance of Fundamental Rule Sets." *Case Western Journal of Law, Technology and the Internet*. 11(1): 2020.

Alston, E. "DAOs' Resilience as Constituted by Shared Norms and Pluralistic Governance." Working Paper. 2022a.

Alston, E. "Demand for Constitutional Decentralization." Working Paper, 2018.

Alston, E. "Norms, Institutions and Digital Veils of Ignorance: Do Network Protocols Need Trust Anyway?" Working Paper (under submission at *Regulation & Governance*). 2022b.

Alston, E. "Piercing the Veil of Political Altruism, or, Why Political Rules Are Weird." *Austrian Economics in the 21st Century: Economic History and Austrian Economics* (2022c).

Alston, E, L. Alston and B. Mueller. "Leadership and Organizations." NBER Working Paper No. w28927, 2021.

Alston, E., L. Alston, B. Mueller and T. Nonnenmacher. *Institutional and Organizational Analysis: Concepts and Applications*. Cambridge University Press: 2018.

Becker, G. "Family Economics and Macro Behavior." *American Economic Review*. Vol. 78, Iss. 1, (Mar 1988).

Bentley, R., and H. Maschner. *Complexity theory*. AltiMira Press, 2008.

Besley, T., and A. Case. "Does electoral accountability affect economic policy choices? Evidence from gubernatorial term limits." *The Quarterly Journal of Economics* 110, no. 3 (1995): 769-798.

Bloom, N., Sadun, R. and Van Reenen, J., "Does product market competition lead firms to decentralize?" *American Economic Review*, *100*(2) (2010), 434-38.

Browne, W. "Organized interests and their issue niches: A search for pluralism in a policy domain." *The Journal of Politics* 52, no. 2 (1990): 477-509.

Buchanan, J. and G. Tullock. 1962. *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor, MI: University of Michigan Press.

Buterin, V., D. Reijsbergen, S. Leonardos, and G. Piliouras. "Incentives in Ethereum's hybrid Casper protocol." *International Journal of Network Management* 30, no. 5 (2020): e2098.

Graham, J.R., Harvey, C.R. and Puri, M., "Capital allocation and delegation of decision-making authority within firms," *Journal of Financial Economics*, 115(3), (2015), 449-470.

Greif, A. "Family structure, institutions, and growth: the origins and implications of western corporations." *American economic review* 96, no. 2 (2006): 308-312.

P. Hannaford-Agor, V. Hans, N. Mott, G. Munsterman, "Are Hung Juries a Problem?." National Institute of Justice. 2002.

Hart, H.L.A., J. Raz, and L. Green. *The concept of law*. Oxford University Press, 2012.

Lo, D., Dessein, W., Ghosh, M. and Lafontaine, F., “Price delegation and performance pay: Evidence from industrial sales forces,” *Journal of Law, Economics, and Organization*, 32(3) (2016), 508-544.

McClain, L. "Family constitutions and the (new) constitution of the family." *Fordham L. Rev.* 75 (2006): 833.

Moore, J., and O. Hart. "Incomplete Contracts and Ownership: Some New Thoughts." *American Economic Review* 97, no. 2 (2007): 182-186.

Murray, C., E. Alston, and M. Wiebusch. "Presidential term limits and the international community." In *The Politics of Presidential Term Limits*, pp. 557-584. Oxford University Press.

North, D., J. Wallis, and B. Weingast. *Violence and social orders: A conceptual framework for interpreting recorded human history*. Cambridge University Press, 2009.

Olson, M. 1965. *The Logic of Collective Action*. Cambridge, MA: Harvard University Press.

Prendergast, C., “The tenuous trade-off between risk and incentives,” *Journal of political Economy, 110*(5) (2002), 1071-1102.

Stone, E. "Private trust companies—oases for wealth planning." *Trusts & Trustees* 15, no. 10 (2009): 802-805.

Wallis, J. Leviathan denied: Rules, governments, and social dynamics. Book Manuscript, 2021.

Williamson, O. "Assessing contract." *Journal of Law, Economics, & Organization* 1, no. 1 (1985): 177-208.

Williamson, Oliver E. "Examining economic organization through the lens of contract." *Industrial and Corporate Change* 12, no. 4 (2003): 917-942.