

## **THE FIRM IN A FREE SOCIETY: FOLLOWING BASTIAT’S INSIGHTS**

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Frédéric Bastiat did not devote much attention to the problem of the firm, so taking an interest in his thoughts on the topic could seem strange. Yet, the foundations for a realistic theory of the firm (and, more generally, of the distribution of human activities) are found in chapter 14, “Wages,” of Bastiat’s classic book *Economic Harmonies*.<sup>1</sup> Further, the way that Bastiat lays the foundations are both original and profound. In this article, I will review Bastiat’s approach, develop it more fully, and draw some practical and theoretical conclusions about the nature of the firm.

### **FRÉDÉRIC BASTIAT AND THE FIRM**

The wage system particularly has been the object of the socialists’ attack. They have almost gone so far as to present it as something hardly less cruel than slavery or serfdom. In any case, they have viewed it as an oppressive and one-sided arrangement having only the semblance of

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<sup>1</sup>Frédéric Bastiat, “Wages,” chap. 14 in *Economic Harmonies*, trans. W. Hayden Boyers, ed. George B. du Huszar (Princeton, N.J.: D. Van Nostrand, 1964).

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liberty, as exploitation of the weak by the strong, as tyranny exercised by capital over labor.<sup>2</sup>

Here, Bastiat clearly explains the Marxist vision according to which wage-earners are exploited by capitalist entrepreneurs, and working relations are basically asymmetrical. Bastiat's own approach, on the other hand, is a dynamic analysis of the emergence of wages in a world of uncertainty.<sup>3</sup>

Interestingly, Bastiat's chapter on wages does not address precisely the issue of wages. Instead, Bastiat makes a comparison between the specific role of wages and other human phenomena. By so doing, he demonstrates that the existence and role of wages cannot be understood except by referring to a more general theory of human action in society. The process by which there is a differentiation of roles inside the firm is exactly the same as the process which induces people to buy and sell insurance or to pay and receive interest payments. Thus, Bastiat analyzes some of the reasons why individuals cooperate not only through exchange but also by creating associations.

One important reason for cooperation is the fact that different individuals hold different subjective expectations about the possibility of losses. When risk is viewed as too high, individuals may find it profitable to create a mutual insurance organization. Each member, by contract, agrees to bear a given portion of the damages incurred by other members. In such an organization, each member plays exactly the same role (except that each share is different from the other if the values of the insured properties are different). Such an organization is created because each member of the mutual fund prefers a low risk with a high subjective probability over a high risk with a lower probability. As Bastiat puts it, "Fixity is very attractive for people. However, when considering the nature of men and of their activities, it seems that fixity is not compatible with it."<sup>4</sup> Thus, individuals create associations in order to gain more fixity.

Bastiat's explanation is a real contribution to understanding human activities in society. He stresses that everyone, even socialists,

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<sup>2</sup>Bastiat, "Wages," p. 366.

<sup>3</sup>This uncertainty and its role in wage-earning is particularly stressed in G. Lane, "Bastiat, l'aversion pour l'incertitude et la loi de l'association," *Journal des économistes et des études humaines* 11 (June/September 2001), pp. 415–50.

<sup>4</sup>My translation.

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agrees about the benefits of associations as a means to share risks. But, he adds, “Indeed, the socialists give the name *association* exclusively to arrangements of this kind. As soon as speculation is introduced, they say, association disappears. I say that it is improved.”<sup>5</sup> Thus, according to socialists, as soon as a speculator—a profit-seeker—is introduced in an association, its very spirit and its very justification vanish.

On the contrary, according to Bastiat, the speculator’s presence enhances the association’s capacity to meet its goals. Taking a dynamic view of the development of human activities, Bastiat thus imagines that some entrepreneur (or some company) comes to the group of mutual insurance members and tells them the following:

By providing for mutual insurance, you have tried to purchase your peace of mind. The price this precious asset costs you is the indeterminate assessment you set aside annually to cover your losses. But you never know in advance what this price will be; and, on the other hand, your peace of mind is never complete. Well, I am here to propose a different procedure. In consideration of a *fixed annual premium* that you will pay me, I will assume the risk for all losses. I will insure all of you, and here is the capital to guarantee my promises.<sup>6</sup>

From a practical point of view, it is likely that it is easier for one person (or the representatives of a company) to decide to meet the numerous members of the mutual fund rather than the reverse, and this is a logical implication of the theory of collective decision. However, from a theoretical point of view, it does not matter at all whether the negotiation between the entrepreneur and the mutual fund members has been initiated by one or the others. There is a fundamental symmetry in the arrangement, as in any contractual arrangement. The final arrangement ought to be the same whether an individual chooses to cooperate through contract with a group of individuals or whether several individuals decide in common to negotiate with him and to sign such an agreement.

In the real world, such as in starting a new business, neither the first nor the second situation prevail. Usually, the team of workers—which would be analogous to the mutual organization above—does

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<sup>5</sup>Bastiat, “Wages,” p. 363, emphasis in original.

<sup>6</sup>Bastiat, “Wages,” p. 364, emphasis in original.

not exist before the entrepreneur is present. Rather, a potential entrepreneur assembles the team of workers, according to his project, by hiring isolated workers who did not know each other. Likewise, the insurance entrepreneur establishes his project, and enrolls isolated insurees who did not know each other. But, once more, this is not a substantial aspect of the problem. In any case, the relations between all of them are exactly the same.

The association's members agree to pay a little more than their normal share in order to get perfect safety and peace of mind. According to socialists, says Bastiat, there is no more association since an intermediary has introduced himself between the associates. But, Bastiat argues, there is no fundamental change, except that the associates have found a way to remain in the association without having to care about its management.

As regards the entrepreneur, he provides two sorts of services. First, he takes away from the associates any remaining element of risk. Second, he takes care of the management of the association. Bastiat stresses the voluntary, and therefore beneficial, character of this contractual arrangement since, in any exchange, both parties to the exchange, given their differences in capacities and tastes, benefit from their specialization, which makes exchange possible. According to Bastiat, "The association thus transformed is in a position to improve in every way."<sup>7</sup>

Bastiat uses his insurance example to show how purely contractual arrangements make it possible for individuals to better organize social cooperation and to better manage life's inherent risks. He then generalizes this approach, making it applicable to all sorts of human activities. For example, he is able to explicate the role of wages, profits, and interests, and, by implication, the working of the firm.

It should be clear that while a firm is an association in the sense that Bastiat uses the term, it is not an association in the way that socialists use it. Thus, he writes,

[b]ecause of these same prejudices, this same ignorance, [socialists] rail constantly against *interest*, or else against *wages*, which are *fixed* forms, and therefore highly developed, for the payment of what is due to capital and labor.<sup>8</sup>

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<sup>7</sup>Bastiat, "Wages," p. 365.

<sup>8</sup>Bastiat, "Wages," p. 366.

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Further, it is because of the socialists' fallacious approach that wage-earners wanted to get rid of the wage system and to replace it by some sort of association, "as if *association* and *wages* were mutually exclusive."<sup>9</sup>

This mistrust in wages and in the wage system may seem overcome in our time, but, in fact, we just find it under other forms. It certainly inspires Marxists, since they describe the entrepreneur as someone who is in such a power position that he can extract part of the return which ought to be obtained by workers as a counterpart to their productive contribution to the firm output. The idea according to which only workers (wage-earners) are productive, whereas the entrepreneur is a sort of parasite which extracts resources from the community of workers, has, explicitly or implicitly, inspired all experiments and proposals about worker management. Further, this idea is present whenever one disagrees with what is his or her "fair share," an implication that wage-earners ought to receive a part of the profits of a firm.

### THE FIRMS AS A SYSTEM OF COOPERATION

Following Bastiat's example—Bastiat, by the way, can be considered as a precursor of the modern theorists of contracts and agency problems—let us assume that a team of workers does exist. It can transform into a capitalist firm by two means:

- An entrepreneur offers a new set of contracts by which he specializes in organizing the team and taking care of risk.
- Workers decide to become wage-earners so they hire the services of an entrepreneur who, according to the contract between them, only gets a residual income (i.e., the part of value added which is not absorbed by wages and interests).

In any case, the firm newly created, through the transformation of the team of workers, is nothing other than a set of contracts. As such, its creation is necessarily beneficial to all, as is any contract which has been freely agreed upon by contractors. By substituting a more complex set of contracts (the firm) for a simpler set of contracts (the team of workers), those who voluntarily contract reveal that they consider the new set as beneficial for all of them.

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<sup>9</sup>Bastiat, "Wages," p. 367.

It is true that, in some cases, they may make the wrong choice and later regret it, but this is not the issue. At the time they accept the new set of contracts, they believe it to be beneficial. The fact that, throughout history, humans have regularly selected the set of contracts known as a firm, rather than selecting other sets of contracts, is evidence that they have learned from experience that the firm is the most efficient set of contracts.

Bastiat identified two justifications for this differentiation in roles: a better organization of the productive process, and a better distribution of risk-taking. Let us consider them successively.

### ***Organization by a Manager***

In order to better analyze the improvements thus introduced by firms, let us first focus on the problem of personal capacities and specializations by considering a purely imaginary situation in which there is no uncertainty about the final production of a team of workers. Let us also assume that we are initially in a pure exchange economy without any economic organization. Each individual is endowed with primary resources and his own productive capacities (his mind). He transforms the resources he owns or the ones he got by exchange, and he sells any output that he does not invest or consume himself. His customer, in turn, transforms what he bought, and consumes, invests, or sells the output. For instance, to build a car, one worker would build a chassis, and then sell it to some other worker. The second worker would add a body, and sell the product to a third worker who would add an engine, and so forth until the entire car is produced.

But to increase productivity and, therefore, the income of each member of this productive chain, a team organization is probably desirable. We will distinguish between two basic cases, one in which self-organization by the workers is possible, and another where such self-organization is not possible.

### **When Self-Organization is Possible**

Self-organization is possible if the production process is simple and the team is small. The members of the team organize themselves, allocating a specific task to each according to their respective abilities.

However a problem will appear as soon as the common product of the team has to be allocated. If the allocation is decided after the production has taken place, there is a great probability that producers will disagree about the share each is to receive. Let us assume that

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they somehow reach agreement about distribution, such as via some voting process. In order to maintain peaceful relations within the team, all members accept it, although it may create an unfair distribution of wealth. There also exists the possibility that the decisions about the distribution are brought about via coercion: the strong members coerce the weaker ones, as is the case under socialist production. The possibility of such an outcome under this type of decision process may lead people to be more reluctant to engage in team production, and therefore reduce the overall productive capacity of the society.

The best way to obtain a peaceful and agreed-upon distribution of the total return is for the team members to contractually agree on the rules before production takes place. Thus, economic calculation is possible and distributional risks are eliminated. This solution is beneficial for people because, as Bastiat wrote, men like fixity. While the cost of fixity may, in some cases, outweigh its benefits, in which case men will not buy it, in the present case, the cost is presumed to be smaller than the benefit, making it worthwhile to accept it. In fact, in this case, the costs are mainly negotiation costs. The members of the team have to discover supplies and demands for the various possible qualifications of members. The shares will finally depend on the contribution of each member of the team and on the relative scarcity of his precise ability; there is no reason to believe that such productive contributions will be equal, so there is no reason to expect all shares to be equal.

Thus, a series of bilateral contracts and exchanges has been replaced by a system of cooperation based on a set of contracts. Members of the team can sell their labor services, rather than their output, to a collective entity. In exchange, each member receives a previously-agreed-upon share of the common output. The institutional change to a more complex and abstract set of contracts allows for an overall improvement in productivity. An individual producer's share of the common production can be called a wage, but referring to this person as a wage earner instead of as a productive team member is only a specification of his more general status: he is a producer who acts and trades.

### **When Self-Organization is Impossible**

Self-organization may, in practice, become impossible if producers are numerous and if the productive process is complex. In such a case, the team members (the wage-earners) will have an interest in

looking for an organizer, as Bastiat suggested. We may call this organizer a manager, but it would be premature to call him an entrepreneur, since we have assumed for the time being that there is no uncertainty. According to their respective comparative advantages, the producers of the firm specialize either in this general management task or in another more specific productive task; thus, a differentiation of roles is introduced in the firm.

However, it would be wrong to interpret this differentiation as an asymmetry. The manager is not at the top of some hierarchical organization, giving orders to people with a lower status. The members of the organization engage in different tasks; there would, after all, be no sense in a contract between identical co-contractors. However, these differences do not and can not imply any asymmetry; all members of the organization are equal in the sense that they have equal rights.

In the case of the firm, the manager and the other workers sign contracts with the abstract entity called the firm—which is the collectivity of members—and they are all linked by the same type of relations. From this point of view, we may as well say that the manager hires the other workers or say that the workers hire a manager. It is not substantial to the understanding of the working of the firm to decide who hires whom. In fact, it may be preferable not to use such terms term as “to hire.” Rather, we may be more satisfied with saying that the individuals are contractors, they are partners in exchange, and they get part of the output. We may imagine that, historically, in one case, the manager looks for workers and “hires” them and that, in another case, the workers look for a manager and “hire” him, but the result is exactly the same. There is an agreement between all of them for a given specialization of each one.

When the firm exists because all agreed to their respective contracts, workers sell their services to the organizer, who, in turn, sells the output on the market, pays the wages, and keeps his share of the output. The important point here is that such a set of contracts never constitutes a command system. Semantic confusion is introduced when one says that the manager or, later on, the entrepreneur, “hires” the workers, when, in fact, he buys their services. A similar confusion exists when one says that there is a hierarchy in the firm, with the manager giving orders to the workers. A hierarchy would imply a command system in which relations are unilateral.

Such a unilateral command system is the case with relations between the men of the state and citizens. The former give orders to the

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latter, and use coercion to ensure that they are obeyed. Clearly, this can never be the case if relations are based on free contracts, as occurs in the firm. From this point of view, it is fallacious to describe a firm as an organization structured by a hierarchy. A firm's managers are not at the top of some hierarchy; they just have a different and more complex role than other participants.

In any contract, there is a necessity for each contractor to make sure that others fulfill their specific obligations. Let us consider what happens when workers sell their services to a manager. The workers have the easy task of making certain that the manager pays the wages which have been agreed upon. The manager, on the other hand, has the far more difficult task of monitoring the workers, who may be many and have varied skills, to ensure that they are performing according to their agreement. Thus, the manager spends far more time ensuring compliance of the workers than the workers spend ensuring compliance of the manager. This differentiation of roles and monitoring tasks gives the impression that there is a hierarchy. Again, let us be clear, the manager is not a commander-in-chief of an army of workers. A well-functioning capitalist firm incorporates monitoring procedures, but no hierarchical relations. It could even be said that the capitalist firm has been invented because it is not a hierarchical system.

Stressing this feature of the capitalist firm makes clear that such a firm is not essentially hierarchical, so it is inappropriate to define it as such. However, concrete appearances are not always as clear-cut as that. In reality, a contract can never stipulate all of the duties of a wage earner, so some broad language is likely to be included in the contract, such as saying that the wage-earner will follow the instructions of the firm's owner or manager. This opens the door to possible misunderstandings or refusals to engage in particular actions under particular circumstances.

For example, contractual duties are more loosely defined in Latin countries than in Anglo-Saxon countries. This may allow Anglo-Saxon workers more leeway in refusing to take actions not explicitly covered in the contract, while leaving Latino wage-earners feeling that they must follow orders and have less say over their contracts. Nonetheless, such contractual specifications (or lack thereof) do not transform the nature of the firm, namely, the fact that it is a set of contracts between individuals who benefit from the same rights.

### *Uncertainty*

Let us leave now the purely hypothetical case of a firm without uncertainty. Since men like fixity, they are ready to pay for the services consisting of suppressing uncertainty. As is well known, the entrepreneur is precisely the one who absorbs the uncertainty. Since the value of the firm's future production is uncertain, the entrepreneur promises to the wage-earners a fixed wage which is less than the expected value of their production. By the same token, the wage-earners are paying the entrepreneur to absorb the uncertainty. If the market value of the production is higher than the costs, the entrepreneur earns a profit; if it is lower than the costs, the entrepreneur suffers a loss. The wage-earners earn the same wage in either case.

The wage-earners could decide in advance, without knowing the total market value of their combined output, the share of the total output that is to be received by each worker. However, history has repeatedly shown that workers usually prefer to transfer the uncertainty to someone who specializes in the provision of certainty, in the same way as an insurer is paid for providing a safety service. As with any voluntary contractual arrangement, such a contract is beneficial for both parties. The workers buy more safety at the expense of a possible lower gain (but also, possibly, a lower loss) and the person who absorbs the uncertainty gets a more or less important return by selling safety services.

It is not necessary that the manager be the same as the person who absorbs the uncertainty, but there are two good reasons for them to be the same person. First, few would be willing to absorb the uncertainty without the ability to monitor the production process. Second, the manager has more incentive to efficiently control the production process and to innovate if his returns depend on his own decisions.

Since the entrepreneur plays both roles, what we said previously about the relations between the wage-earners and the manager still holds. The entrepreneur does not become a chief in a hierarchical structure merely because, in addition to his role as manager, he absorbs the uncertainty. In no case is a firm built along the lines of a command system; it remains a set of contracts under any circumstances. The entrepreneur, who is both a manager and a sort of insurance company, is also a capital-owner, as had been well emphasized by Bastiat. After all, in order to be acceptable as insurer, an entrepreneur must own capital, making it possible to guarantee that he will honor his contracts, and attracting confidence from the other contractors.

Saying that the entrepreneur is the owner of the firm means that he owns part of the present means of production and rights on future profits. As an owner, he can sell the firm, i.e., sell a complex set composed of capital goods, the specific organization he has implemented, the specific contracts he has signed, and so forth.

### **SOME IMPLICATIONS OF THE ANALYSIS OF THE FIRM**

The traditional definition of the firm as a set of contracts is important and correct. Numerous consequences can be derived from this very definition.

#### ***Differentiation and Asymmetry***

As was already stressed, contracts exist because people are different. But differentiation does not mean asymmetry, which can only exist in a command system in which some people can coerce others. Relations are unilateral in a command system, bilateral in a contractual system. According to Mises, “There are two different kinds of social cooperation: cooperation by virtue of contract and coordination, and cooperation by virtue of command and subordination or hegemony.”<sup>10</sup>

As we know, individual goals are all different and cannot be compared. This has important implications to the free society, and to the coercive society. Since there is no way to engage in inter-personal utility comparisons, it is impossible to claim that any voluntary relationship is asymmetrical, or that it benefits one party more than it benefits another. On the other hand, when individuals are parties to transactions via coercion rather than voluntary choice, it is quite clear that one side gains and the other side loses. In comparing these two situations, it is clear that there cannot be asymmetries in a capitalist firm.

A similar argument may be made concerning information asymmetries. Different individuals choose to get different information, and people enter into various forms of associations because they have different knowledge. For instance, a wage-earner transfers to the entrepreneur the uncertainty about the demand for his own work, because the entrepreneur better knows how to meet this demand. Thus, merely

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<sup>10</sup>Ludwig von Mises, *Human Action: A Treatise on Economics*, 4th ed. (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996), p. 196.

to observe that different individuals possess different information does not imply asymmetries in their relationship.

### **The Goal of the Firm**

Microeconomics textbooks often state that “profit is the goal of a firm.” This same statement is also made by socialists who attack the firm under the pretext that a firm’s very existence tends to create beneficial results only for a small set of individuals, namely, the owners. However, the textbooks and socialists are in error.

A firm, being a set of contracts, cannot have a goal, since only individuals have intentional activities. Further, the individuals who sign contracts have different and even diverging goals. The entrepreneur may look for profit, but also seek other goals, such as prestige, influence, or satisfaction of curiosity. Wage-earners probably look for high wages, but are also likely to be interested in a pleasant working environment, insurance benefits, or an easy commute. Not only do we not know these various goals, we don’t need to know them. Traditional microeconomic analysis uses a simplistic approach with a single, arbitrary variable (the maximization of profit) as the goal of a firm. An alternate approach, used by Bastiat and Mises, assumes that each individual participant’s goal is personal utility maximization, which may or may not be consistent with profit maximization of the firm. Such an approach is logically superior to the mathematical approaches in modern textbooks.

There is a plurality of goals in a firm because there is a plurality of individuals whose goals are diverging, or even antithetical to each other. One fundamental role of the entrepreneur, as an organizer of social cooperation, is to make these goals consistent with each other. In fact, it seems clear that a firm cannot work efficiently if this diversity of goals is not taken into consideration.

### **Decision-Making In A Firm**

While socialist societies create hierarchical organizations (wrongly called firms), and family-based societies are hierarchical, a capitalist organization is not hierarchical. In the capitalist firm, the owner and managers are not giving orders to wage-earners; rather, they are fulfilling their own differentiated role as organizers, for the mutual benefit of all—wage-earners as well as entrepreneurs. Some wage-earners

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and some entrepreneurs are good at their respective roles, and others are bad. In such a mix, some outcomes may create the illusion of a command society, but this does not make it so.

Further, because no contract can specify every possible circumstance, someone has to decide how to face new situations. When facing some new challenge, the entrepreneur, being the organizer of the work in the firm, is the one who decides what the worker has to do. The worker can argue that the decision does not correspond to the terms of the contract and, at the limit, can quit.

Deciding to leave the firm is more or less easy. It depends, for instance, on the expectation of finding a new job on the labor market, on one's compensation, and a variety of other individual factors. It may also depend on the institutional characteristics of the firm. If, for instance, a firm benefits from a monopoly privilege and a wage-earner's job is very specialized (train driver, professor of economics, etc.), he may have difficulties in finding a new job. Thus, a worker's expectations of finding other employment may have an impact on that worker's belief in the existence of a hierarchy in the firm.

However, the existence of orders coming from the top and going to the lower levels is not a *substantial* characteristic of a firm. The fact is that there are firms in which orders are never given. Even if a more or less great number of managers behave as if they were in a command system, a capitalist firm cannot be defined or described by the existence of orders and hierarchy. Analyzing the nature of the firm requires the analysis to look for a firm's substance, rather than to merely consider the incidental features of some firms.

### **The Act of Will and the Differentiation of Interests**

While the preceding analysis of the firm constitutes an answer to many of the usual prejudices about the respective interests of wage-earners and entrepreneurs, the leftists also offer a static and biased approach. Because they do not understand the wealth-creating process or the coordinating role of the firm, they consider that what the entrepreneur gets is at the expense of the wage-earners.

Further, when they object to the idea of profit maximization as the only goal of a firm, they do so for incorrect reasons. Rather than recognize the myriad goals by participants in a firm, they are happy to attribute an act of will to a collective entity, such as a firm. Once they attribute this collective entity with a will, they argue that it should

take into account the interests of both those who earn wages and those who earn profits.

From this wrong interpretation of the very nature of the firm come all sorts of fashionable ideas, for instance, those who argue that “social logic” should supercede “financial logic.” Likewise, there are those who argue that firm governance should consist of decision processes that include stake-holders as well as share-holders. While they correctly recognize that people in different roles have different interests, they fail to recognize that the capitalist firm has its particular organization precisely *because* of these different interests. It is, after all, the voluntary capitalist structure that allows all these interests to be made compatible with each other. This joining of interests is completely ignored by all fashionable streams of thought, as well as by political decision-makers.

### **Differentiation and Symmetry of Rights**

Let us return to the previously mentioned problem of differentiation and symmetry of rights. In a contractual arrangement, individuals may have different goals and bring different capacities, but they have the same rights so there is no asymmetry. However, as regards the working of firms, language often creates confusion. When symmetry exists in a social reality—as is the case with voluntary contracts—then the same symmetry has to exist in language. However, the language employed when discussing firms is more or less contaminated by Marxian-type concepts.

For instance, if one says that “an employer hires an employee,” one ought also to say that “an employee hires an employer,” since both parties are equal and voluntary participants, and each is in a position to accept or reject the other. Likewise, if one says that “an employer fires an employee” when the employer terminates a voluntary agreement, one ought also to say that “an employee fires an employer” when the employee terminates the voluntary agreement. However, these second sets are not used in conjunction with these first sets, so the usually employed language suggests that the employer can unilaterally determine whether an agreement exists (to hire) or whether an agreement is terminated (to fire).

Many labor laws are predicated on the idea that there is an inescapable asymmetry between the employer and the employee. To rectify this supposed imbalance, many such laws make it more difficult for

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employers to fire wage-earners than it is for wage-earners to fire their employer (to quit their jobs). While different people possess different capacities to act—it may be easy or hard for a worker to get another job, and it may be easy or hard for an employer to get another worker—this does not imply any asymmetry in rights. All parties *can* act to engage in a contract, to not engage in a contract, or to terminate a contract.

One may even argue that because the entrepreneur has to bear some specific constraints, those who believe in the existence of contractual asymmetries should really give the entrepreneur the additional protection. If a firm fails, the entrepreneur loses his past investment in time and savings, whereas wage earners take their accumulated human capital with them. If ever someone had to be protected—which, obviously, is not the case—why would it not be the entrepreneur since, after all, he bears the uncertainty? The wage-earners have traded away uncertainty for fixity, so their main potential claim to needing protection is gone.

In reality, the specific protection of wage-earners cannot meet any rational explanation. It is nothing but the result of the working of majoritarian democracy. Wage-earners are more numerous than entrepreneurs, and they vote to create a legal system which, at least they believe, works in favor of their interests. However, in many countries, excessive regulations and taxes have made it impossible for potential wage-earners and entrepreneurs to sign labor contracts, which is the real cause of unemployment. Because these existing laws make it more difficult for a wage-earner to find a new job after leaving a previous one, additional labor laws get passed to increase the protection of wage-earners against firing. This, in turn, further reduces the incentives for entrepreneurs to engage in contractual relationships with wage-earners, and unemployment is increased, not decreased.

### **Profit Sharing**

A correct understanding of the nature of the firm leads to the rejection of proposals that mandate worker participation or profit sharing. Since the distribution of roles in the capitalist firm is done according to comparative advantage, the participation by workers in strategic decisions is one which reduces overall efficiency unnecessarily.

Further, since wage-earners traded away the uncertainty of profit for the certainty of wages, profit-sharing with wage-earners is also a

contradiction. It would be analogous to stockholders sharing profits with bondholders (lenders); bondholders chose to be bondholders to ensure a lower risk. If wage-earners (and bondholders) want to share in the profit, they need to share in the absorption of uncertainty by buying shares of stock on the market.

When governments mandate profit-sharing, they are changing the relationship of each individual to the firm, and changing the extent to which each individual absorbs the uncertainty associated with the firm. As such, it is foolish to legally mandate profit-sharing.

Still, voluntary contractors must be free to adopt any sort of contract. Thus, for instance, some entrepreneurs and employees may decide that employees will receive both a fixed wage and some participation in profits. This is often done with stock options, which are used to create incentives for those who engage in strategic decisions to make good decisions. Indeed, stock options are sometimes considered by stockholders as a good way to monitor the managers.

At the same time, though, it is obvious that holding shares of stock would be unlikely to modify the behavior of an unskilled or low quality worker in a big firm. After all, the decisions or actions by such an individual worker are unlikely to have any real impact on the stock price, so no incentive for better individual performance is created. This is the reason why stock options are generally only offered to a limited number of wage earners—generally only to those whose actions can have an effect on the stock price.

### ***The Nature of the Firm***

Explaining the limits between the firm and the outside market is a traditional problem (which could be called the “Coase problem”). If the market is “efficient” (as most economists believe), why does the firm exist? After all, it is well established that economic planning cannot work at the worldwide level, or at a national level, so why should it work at the firm level?

Alas, the very question is based on the assumption that the firm is a non-market organization that engages in planning. However, this approach to the nature of the firm is flawed; the firm is not a planning system, i.e., a system in which those who have power give orders to others and in which there are no prices. Rather, a firm is a system of contracts and, as such, it is a market system.

In understanding the workings of various human systems, reference to the market is inappropriate, since a market exists as long as

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any sort of exchange exists. Rather, one ought to focus on questions such as the following: Are there free and voluntary contracts, or is there coercion? How are property rights defined and enforced? Are property titles tradable?

A free society is not a market economy; rather, it is a society of legitimate rights and free contracts. As is well known, coordination between individuals is made through the price system, the use of traditions, and general rules. In the pure exchange economy, individuals do not need anything else. In many other cases, though, some process of voluntary organization has to be added, and is considered an improvement. In such cases, coordination implies cooperation through some process of collective decision.<sup>11</sup> This process is collective in the limited sense that concerned individuals explicitly agree about some common rules or ways to behave and act. It does not mean that the organization by itself thinks and acts.

Such is the case with associations (condominiums, mutual funds, etc.). By entering freely into an association, a team, or a firm, an individual agrees not only to pay his fee or to sell his services, but also to cooperate with others according to some specific rules which exist or which are to be developed.

In a firm, as in an association, individuals share something in common, which may give the impression that the organization has its own life, goals, and existence. As an example, what is called a “firm culture” is not an objective reality, but is the result of more or less common perceptions. In fact, it may even be more correct to say that there exists not only one single culture in a firm, but several cultures.<sup>12</sup> Whenever this feeling of sharing something in common fades away, individuals may end their agreement and “leave” or, let us say, “fire” the firm.

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<sup>11</sup>Thus, cooperation is only one form of coordination, a form which implies the explicit organization of inter-individual relations, either under a hierarchical or non-hierarchical structure. The other form could be named “spontaneous order,” as suggested by Friedrich Hayek.

<sup>12</sup>For example, the folks in the mailroom, the cafeteria servers, the marketing staff, the accountants, and the assembly line workers may all share common perceptions among their own group, but not with all other groups in the firm.

## CONCLUSION

As Bastiat stressed so well, socialists favor associations because they view associations as collective entities that possess the will to act. As such, socialists celebrate associations as being a superior alternative to capitalism. Further, they often use associations as unofficial parts of the state through which they can gain subsidies and privileges for themselves and their pet projects

Libertarians are certainly in favor of voluntary associations, since libertarians understand human nature, and know that individuals are social beings. But they also know, as Bastiat made so clear, that firms are the most perfect forms of associations.

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