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PETER AKOS BOD AND JOHN B. HALL

## **Toward an Autonomy Preference Theory of the East European Firm**

Developments in recent years necessitate a new theory of the firm. Existing theories of the firm operating in a market economy, advanced by Scitovsky (1943), Baumol (1959), and Williamson (1964), narrowly preserve the importance of profit maximization and are thus inadequate for explaining the real-life functioning of the firm operating in the reformed Hungarian economy. Contributions by Ward (1958) and Kornai (1980), aimed toward advancing an understanding of the self-managed or state-owned firm in a planned economy, provide at best limited insights into the functioning of the contemporary Hungarian firm in a transitional economic environment, that is, one shifting from a planned toward a mixed-market economy. The task of this essay is to lay the groundwork and advance a theory of the East European firm whose logic is influenced by reform policies. The Hungarian firm functioning in the Hungarian reform environment is taken as an example. In the last twenty-one years, applied reform measures have created a unique economic environment in Hungary to which Hungarian firms have adapted. The result is that Hungarian firms have developed an internal logic uncharacteristic both of capitalist firms operating in a market system and of the state-owned enterprises (SOEs) in a traditional Soviet-type or even a self-managed system.

Presented first in this essay are the unique features of the Hungarian firm functioning in its special economic environment, one characterized by distorted financial signals. This is followed by an examination of the range of contributions toward the theory of the firm, in both market and planned economies. Shortcomings of this theory in explaining the behavior of the Hungarian firm are emphasized. Finally, the unique features and logic of the Hungarian firm are elaborated and formalized into descriptive models that take into account the complexity of the reformed economic environment and, especially, the role of

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banking and finance. Included are brief suggestions for improving the performance of these firms.

### **Facts and Tendencies**

The level of monetization of the Hungarian economy is still inadequate to achieve economic efficiency and to allocate resources effectively even though more than two decades have passed since the New Economic Mechanism (NEM) was promulgated in January 1968 and over ten years have passed since the phase of renewed marketization began in 1978. The use of money, credit, and capital market instruments is still surprisingly limited even after so many years of official reform. Their limited development is exemplified by the following indicators (see Bod 1988):

—Forty percent of the companies in the socialized sector, that is, the state-owned enterprises and large-scale industrial cooperatives, do not use bank loans, either for short-term operations or to finance investment;

—Business investments are mainly, and increasingly so in recent years, financed through internal financial resources. Consequently, the share of bank loans in corporate finance is surprisingly low and is not increasing;

—At the same time, there are indications of a seemingly irrational demand for bank loans. A certain group of firms manifests an insatiable demand for credit at interest rates of 20 to 24 percent, while the average industrial profit rate is close to 12 percent. To be sure, expensive credit can be used rationally if investments financed from them will yield returns that exceed the rate of interest. However, in too many cases credit-financed investments fail to yield even normal profits. Thus there is a tendency, at least in this particular circle of firms, to invest even when the interest cost of the investment is higher than the expected or realized rate of return on the investment;

—Debts to banks are concentrated. According to a personal communication from the biggest Hungarian commercial bank, the thirty biggest industrial debtors represent approximately half of the total outstanding assets, and a significant part of these loans is regarded as inactive. This credit structure gives rise to a situation in which the bank has only a limited capacity to finance other profitable and healthy applicants, while both the bank and its group of problem debtors are dependently tied to each other. The second, and equally important, dimension of the problem is that regardless of what interest rates and profit margins would prescribe in a model monetized economy, both the bank and the firms are motivated by nonmonetary considerations, and their interface will unavoidably tend to become political;

—Despite the availability of bank-guaranteed bonds and a nascent bond market, most companies prefer to channel internal savings to physical stock building or in-company fixed capital formation, i.e., into excess productive capacities. The tendency to plough back profits is especially striking in industries with low demand and next-to-zero profits.

When regarding these characteristics of the credit market, we find a contradictory picture. Under the reformed economic system, some firms refrain from using bank loans or have no access to credit on a commercial basis. Other firms overuse credits, thus following behavioral patterns that are different from those based on sound business principles.

This ambiguous situation and its mistaken perception played a key role in the so-called liquidity crisis in Hungary in the first part of 1988. Excess purchasing power concomitant with inflationary pressure building up from mid-1987 in the Hungarian corporate sector were the events preceding the National Bank's tightening of the money supply in 1988. Under the newly created two-tier banking system, the Hungarian National Bank decided to impose severe refinancing conditions for state-controlled commercial banks in order to lessen the stock of short-term loans to nonfinancial enterprises. The idea was to decrease the amount of excess money in circulation and thus release inflationary pressure that was building up in the economy.

At that time, the commercial banks were rather uncooperative. Their directors argued that any financial squeeze would discriminate against those companies relying on credit. Such companies appeared to be of two types. One type was the low-profit, generally large, highly indebted firm whose mere existence would be threatened by a denial of further loans. The remainder were mostly adequately managed, cost-sensitive ventures relying on external financing to help their activities develop. Business logic would require that the credit squeeze be imposed mainly on the former type of customer. However, this was impossible for political reasons. Besides, banks tended to be captives of their huge clients. Among the second type of firm, credit withdrawal could have been effectuated but only at the cost of punishing future customers, the very firms that behaved in the way reformers had been advocating for years. In any event, the least hurt were the traditionally credit-averse firms.

Critics of the credit-squeeze policy argued that the state should implement budgetary cuts, since the main responsibility for excess money in the economy rests with the budget. An interesting twist is that the heavily indebted, large firms have traditionally been the prime beneficiaries of state subsidies, with the state giving out investment subsidies contingent, as a rule, on partial self-financing or bank credit. The banks, on the other hand, have appeared willing to provide long-term loans to big companies that received state backing.

The 1988 liquidity crisis sheds some light on the rather limited explanatory power of accepted economic theories. Firms in Hungary obviously do not behave in a manner described by mainstream microeconomics or its recent refinements, and this should not be of any great surprise to students of the Centrally Planned Economies (CPEs). Even Hungary, as perhaps the most reformed CPE, is still a far distance from a Western-type monetized, market economy. On the other hand, no adequate description can be given of the contemporary Hungarian economy within the framework of an economic theory in which a passive role of money is postulated.

### **Schools and Theories**

Existing theories of the firm need to be challenged since the economy that we are examining falls between established paradigms. The Hungarian economy is an economy in transition from a planned to a mixed-market economy. If and when Hungary has a full-blown market economy, the behavioral assumptions of market economies should then, of course, hold true. Yet such reasoning cannot serve as an escape for those concerned with real policy issues. As the aforementioned liquidity crisis case indicates, policy makers and advisers have to address urgent issues, and quickly. In addition, a paradigm shift could take a rather long time, and without a workable theory to rely on, such a transformation would likely take that much longer. Moreover, these seemingly esoteric problems may offer lessons of a more general character in those cases falling between or outside of the existing theoretical frameworks that have been developed to analyze either a planned or a market economy and might also serve to reveal something new about the nature of social institutions.

A firm in a capitalist economy will behave, and be forced to behave, in compliance with the rules and norms of that system. So will a traditional Soviet-type production unit in a traditional CPE. Yet even if persons comprising either of these social institutions totally comply with the given norms, it would be farfetched for us to think of these norms as being their own. That is the sense in which the "real" nature of any institution can hope to emerge under "in-between" conditions. In any event, though, while we attempt better to understand the behavior of economic agents under the transitional Hungarian setting, we can also ponder the general nature of industrial organizations.

Theories developed earlier do help to shed some light on the Hungarian case. Among the modification or refinements of the neoclassical theory of the firms, Scitovsky's observation (1952) of the trade-off between profits and leisure deserves mention. While Scitovsky defined the firm as being controlled by the owner, the psychological factors that may weaken the owner's profit drive must be all the more true in the case of a socialist enterprise in which corporate executives do not legally own their firm. Thus the strategic behavior of the managerial stratum, undisputedly the most influential constituent of the postreform firm in Hungary, may be determined on the one hand by the relative value of enterprise profits earned and shared, and on the other by the importance of a pleasant life and leisure within the utility function of corporate managers.

No research has ever been able to record profit maximization in social-sector enterprises. Therefore, Baumol's (1959) explanation concerning a revenue-maximizing firm operating subject to profit constraints may also hold for the managerial firm under a reformed planned economy. What observations in the 1950s and 1960s revealed was a clear tendency for socialist firms to grow. Therefore, Marris's (1964) theory about a growth-maximizing firm

operating under a security constraint appears to be the best description borrowed from theorizing on the topic of the contemporary capitalist economy suited to Hungarian conditions.

For all of the strengths of these explanations, they do not seem to have influenced Hungarian scholars and decision makers much since the introduction of the NEM. Instead, firms and their managers in Hungarian economic thinking appeared to have acquired a mythical capacity for economic rationality. What did have some influence on established views were the early lessons of the Yugoslav self-managed firm. Ward's (1958) Illyrian firm, under strong pressure from workers as co-owners, can be supposed to increase wages at the cost of capital investments, while managers tend to exercise an insufficient counterbalancing effect. Therefore, under the Hungarian NEM of 1968, government regulations were introduced to control prices—a rational step in light of the expected tendencies of firms to raise prices in order to finance wage and bonus increases and to tie the hands of managers in the allocation of revenues between investment and workers' incomes.

Regulations made the ploughing back of depreciation obligatory and determined the relative share of various enterprise funds in after-tax profits. In other words, practically all firms had to allocate the same percentage of net profits to a sharing fund to pay bonuses; a development fund for financing capital investments and stockpiling materials; a sociocultural fund, mainly for housing purposes; and a reserve fund to be used for ameliorating business-cycle effects and unforeseeable contingencies. These uniform, nationwide regulators were, of course, blatantly irrational from a microeconomic point of view since they did not permit the implementation of such strategies as the regrouping of depreciation of new fields of business. On top of this, uniform resource sharing could not effectively account for scarcity of individual factors of production at various enterprises. Whether or not a particular firm wanted to invest, it had to.

However, in reality Hungarian firms have not been as eager to increase wages as to increase fixed capital formation. While a certain wage-push has always been present, the paramount desire of corporate executives has manifested itself in strong investment cycles in the economy. This is an indication that the Hungarian firm is closer to the firm described by Williamson (1964) or Marris (1964) than to Ward's (1958) Illyrian firm. As experience has accumulated, economists have lost part of their belief in unspoiled rationality of real, existing firms and their executives but retained some of it in the *in abstracto* firms. This seeming schizophrenia is not hard to understand. Although there do indeed exist incompetent or unimaginative managers, the unfavorable consequences of the still top-heavy, state-dominated economy have urged greater support for managers and entrepreneurship.

Kornai (1980) provided a powerful and new explanation. He attributed a strong systemic role to the managers of productive units in his analysis of the self-reproducing nature of shortage in centrally planned economies. Kornai's

managers are supposed to be strongly motivated by their identification with the organization for which they are responsible. Moreover, their goals are attached to the status of the firm. Therefore, the main concern of the managers lies with the growth and expansion of their institution. Expansionism is the rule of the game, as other institutions also vie for scarce resources, i.e., inputs. Revenues and profits do not really count, in Kornai's view, because the budget constraint of the socialist firm is soft.

*Economics of Shortage* initiated a debate on the role of money in planned economies. One of the most disputed factors in Kornai's model is the passive nature of money. Yet monetary incentives have never been insignificant, as Sóos (1986) so eloquently argues, not even in the orthodox Stalinist model. That there thus appear weaknesses in Kornai's model is a point of critical importance. Since 1979, the Hungarian economy has not experienced significant economic growth. Stagnating as well as nonexpansionary corporate strategies are also observable. While the importance placed on growth in revenues and increasing organizational size may be present in the utility function of the managers, in a slow-growth economy highly expansionary business strategies can only be effected through attacks, buyouts, mergers, and other similar expansionary actions. Yet surveys and case studies (Bod 1987, 1988) confirm that a great number of managers have consented to the nonexpansionary rules of a new game. These are not only indicators of the survival of soft-budget-constraint-induced growth orientation among executives but also indicators of cautious business calculations. For instance, Hungary's bank officials complain that World Bank (WB) credits have not remedied any problems. Credit quotas cannot be fully tapped without special incentives because enterprise decision makers find the WB conditions too restrictive as a result of their tendency toward intensive bank supervision and high interest rates. While Kornai's theory may be valid under the explicit and implicit assumptions of this model, it fails the test of a comparison of its predictions with contemporary Hungarian reality.

An additional and important fact is that too wide a gap exists between the institutional model of shortage and the evolving set of market institutions of Hungary, or even of China and the Soviet Union for that matter. Roughly speaking, two-thirds of the necessary market institutions came into existence in Hungary by the end of 1988, supposing that one can numerically determine the requisites of a market economy. This is not to belittle the significance of the missing institutions—such as convertible currency—nor to pretend that the present Hungarian economy, as it exists, manifests signs of market behavior. However, current policy questions, e.g., those connected with the unexpected outcomes of a credit squeeze in a half-monetized economy, cannot possibly be answered by a model that assumes away the very institutions in question.

In conclusion, the applicability of the aforementioned models and theories of the neoclassical tradition are not yet valid, while the Kornai model of the traditional Soviet-type firm has never been valid.

## Toward a Relevant Theory

All of the theories mentioned above contain an element of holism. In fact, the mere use of the term "firm" implies that there exists something that behaves as a whole. The concept of the firm is basic in neoclassical economics. As Braff (1969) so succinctly states: "The private business firm occupies a central position in a market economy. . . . The range of problems the business firm must solve covers a broad spectrum. It must make a product selection, arrange to finance the investment necessary to produce and market the product(s); in addition, it must plan, organize, and administer on a continuing basis."

Yet who is to "plan, organize, and administer"? Certainly not all persons constituting the social organization called the private business firm. Such administrative rights belong to the owner(s) or, since the separation of ownership from control, to the owners plus the managers.

Conversely, an SOE should in no way be regarded as a social whole since its owners are not clearly recognizable, though they clearly stand outside of the organization. In real life the owner may become totally spiritual, and managers *de facto* owners. Therefore, any analysis of real-life economies with a huge, let alone a dominant, SOE sector must define the *de facto* status of the firms in question.

In present-day Hungary, the unqualified use of the term "firm" may still be misleading if it conceals the differences in types of firms. According to our classification, Type 1 firms include private and semiprivate firms and real cooperatives, all together accounting for no more than one-fifth of GDP. Their pricing, inventory accumulation, borrowing, and similar behavior resembles the descriptions of classical microeconomic rationality, with some qualifications. Their limited use of bank loans, for example, appears to be a result of the inadequacy of supply-side incentives because local banks and thrift institutions have been slow to recover from the previous antimonetary period stretching from the late 1940s through to the late 1960s.

On the opposite side of the spectrum we find the Type 2 firms. Here we must note that Professor Kornai made the error of assuming these firms as the dominant, if not exclusive, type of firm and not as just one of three types. He used what we call the Type 2 firm as a building block in his general theory of shortage. We estimate that these types of firms account for no more than one-half of national assets and 30 percent of GDP.

We characterize Type 2 firms as large-scale budgetary or quasi-budgetary institutions such as railways, the postal service, public utilities, and defense-related industries. The managers of such firms are literally executives, that is, their independence is both *de facto* and *de jure* limited. For this group, money is not a real factor of production. Money's availability does not necessarily imply that managers can increase wages or start capital investments or even choose to invest outside of the firm. Excess monies of Type 2 firms may also be diverted by supervising agencies. Thus spare money is, quite naturally, invested into

concrete objects such as machines, inventories, office buildings, and the like. Classical monetary variables hardly function in this circle. For example, a drastically increased interest rate would not necessarily weaken their expansionary ambitions, especially if investments eventually were determined somewhere up in the hierarchy. In this case, authorities would likely find funds to complete construction projects. Nor is there a tendency for an increase in voluntary, internal savings. If authorities were to learn about savings, they would likely respond by withdrawing subsidies. The scope of Type 2 firms is not determined by legal status only. In the permissive mid-1970s, several large-scale industrial companies behaved as if they were budgetary institutions, while a stricter economic policy regime later forced some of these industrial organizations to assume performance patterns conforming more closely to international business standards.

Finally, Type 3 firms, which are of central concern for this essay, would include the average industrial, agricultural, and service firms. Together they account now for some 30 percent of GDP. They have a significant degree of autonomy, and their eventual choice of corporate strategy tends to depend largely on the personality of the leading manager of the firm. This subjective factor appears to be of greater importance for the Type 3 firms than for an average business corporation operating under the pressures of a capitalist market. However, case studies reveal certain common strategic features as well as systemic differences between capitalist and Type 3 firms.

Attitudes toward reliance on external financing, for example, disclose interesting parallels with those of the typical capitalist firm. Type 3 firms in Hungary begin investing by first using the cheapest form of financing—their internal financial resources derived from after-tax profits and depreciation. Once this source has been depleted, they continue investing by raising capital on the bond or stock markets. But, strangely enough, Type 3 SOEs do not pay a dividend; instead they pay a profit tax, and firms that earn no profits pay no taxes. The more expensive short-term loans are their final resort.

In short, Type 3 firms in Hungary tend to follow the textbook case of corporate finance until they reach a point at which they begin to depart from the behavioral description. What is unique to Type 3 firms in the transitional Hungarian economy is that these companies may continue to invest beyond a point where the cost of external financing exceeds the expected returns from an investment. But in reality there exists a countervailing force because the increasing liquidity risk causes firms to stop borrowing for investment purposes. Here Edwards's (1987) understanding of the importance of firms' liquidity is especially useful: "In all companies in all countries, liquidity is paramount over profitability: an unprofitable company may be capable, by borrowing and using its reserve, of turning its financial situation around; but an illiquid company can be made bankrupt by its creditors and its liquidity crisis can produce a rapid descent towards company death."

Edwards's considerations do hold for the average Type 3 Hungarian business

firm. The firm's preference for liquidity is, of course, explained under the assumption of a fully monetized economy. In order to grow and flourish, firms need liquid capital to invest, while insolvency will bring about the demise of a firm.

In the half-monetized Hungarian economy, money in and of itself is not enough to determine a firm's success or bankruptcy. However, SOEs operating in a market environment have to earn profits in order to survive and continue functioning. This is where money begins to count. The importance of the firm's survival provides the basis for the quasi-business attitudes of Hungarian managers to external financing.

First, Hungarian managers invest their internal revenues. Firms operating in comfortable positions stemming from the benefits of oligopolistic or monopolistic market structures or those firms following an easy life may stop at this point. This is one explanation for the high percentage of self-financing companies in Hungary. However, if the growth ambitions of the managers are higher, then external financing has to be sought from government or bank sources, although the consequence of such borrowing is a certain loss of autonomy.

If the move toward external financing is taken, there remain two likely strategies. One strategy is that external capital is raised only to the extent that it does not provoke the suppliers of capital to scrutinize the borrower's position. If, however, autonomy has already been lost to external agents, e.g., to state authorities in connection with government-financed development programs, a second strategy comes into play. The goal then becomes the acquisition of the maximum possible amount of external resources in order to increase production and size and, concomitantly, socioeconomic power and prestige even at the price of sacrificing profits. The consequence is that Type 3 firms tend to cluster according to whether they chose a cautious or aggressive investment strategy. The widespread incidence of these strategies explains why some profitable companies refrain from applying for external financing while at the same time a huge stock of bad debts has accumulated at other firms. One can thus rephrase the statement on the strategic behavior of the business firm in a reformed socialist economy such as Hungary's. In short, enterprise management autonomy is paramount over profitability or growth.

## Conclusions

Managers of SOEs endeavor not to lose their grip over their autonomy, whether to a planning bureaucracy or to competitive market forces. Under the NEM, enterprise executives have effectively set themselves free from many of the controls of national planning, an achievement reform-minded economists and the managers themselves have always welcomed. On the other hand, managers cannot be expected to be fully enthusiastic about marketization if it is to increase market competition and the owner's control. This is an important lesson derived from the on-going program for promoting marketization in Hungary—a lesson

that should be of interest to students of both comparative economics and industrial organization. The case analyzed in this essay is not at all esoteric. On the contrary, management's values and behavior can be modeled under clearly defined circumstances, namely, in the practical absence of owners, but all in an environment with a market character.

As we have argued in this essay, Hungary's managers aspire to maximize neither profits, nor growth rates, nor the range of their bureaucratic grasp. If anything, managers make decisions regarding their firms in the interest of maximizing, or at the very least of preserving, their own autonomy. This can be achieved in a variety of ways. Hungarian managers tend to work hard to make profits, provided a certain level of profitability is necessary for them to keep their jobs and enjoy a special social status and to feel that they have room to maneuver. If growth rates promise secured survival, then growthmanship will become the dominant management style. Executives of SOEs seem to be flexible in responding to social norms. What they do seem to desire is freedom from control. Some may trade it off for profit or growth, but most can afford to choose their level of autonomy. This may be a general aspiration of managers, an aspiration suppressed by the norms of both the normal capitalist market system and the normal Soviet-type economy but not by the Hungarian post-Soviet transitional system.

However, what is to be understood as autonomy could also be interpreted as managerial slack. Freedom from government intervention could simply mean leading the easy life. Freedom from market pressure could also be taken to mean unearned monopoly profits. Thus in the transitional Hungarian case, the main task must be—though it may sound un-reform-like—to strengthen the grip on the managers. The modalities are not objects of discussion here but can be summarized in two types of external checks: those from above, by creating real owners to personify the profit motive; and those from the side, by increasing market competition for products and factors, including managerial positions.

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