A Brief Glance at Governance Token

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Governance token plays a vital role in distributing control of a blockchain project to its user community, also called "on-chain governance."

In the decentralized world of blockchain, projects are often looking for ways to distribute a greater amount of power and responsibility to their users. But in order for that to work, they need to employ a method that guarantees only users who are seriously committed to the success of the project participate in it.

One way to achieve that is to create a special type of collectively managed organization known as a decentralized autonomous organization (DAO) and require participants to invest their own money in exchange for voting powers to ensure they all act honestly and the DAO prevails. Usually under this setup, those who invest more money have greater voting power over those who don't.

A type of utility token known as a "governance token" is then issued to users to represent each person's stake in the DAO.

Distributing control among stakeholders in this way is called "on-chain governance." The powers denoted by the governance tokens may include traditional management roles and the authority to change the project's protocol, i.e. its foundation in code. Sometimes users' votes are weighted proportionally to the size of their holdings of the governance token.

To ensure that the holders of governance tokens have an interest in the good health of the project long term, protocols often channel a share of network transaction fees into the wallets of the token holders. The tokens may also carry non-governance rights, like the right to be exchanged for certain other tokens at predefined rates.

For example, the Terra network uses a governance token called luna. Luna is traded on digital

exchanges, just like a regular cryptocurrency, but one of its core functions is to enable its holders to participate in votes on the network policy. A vote by luna holders precipitated a move to "burn" tens of millions of luna tokens in 2021 and mint millions of new TerraUSD stablecoins. The pros and cons of the decision were hotly debated among luna holders in the run-up to the vote. A whole community can act something like an enormous committee in this way, strictly organized by the impersonal mechanism of the protocol's smart contracts.

Governance tokens, therefore, get some of their value from the fact they confer certain powers to their holders. That may contribute to their sizable valuations: Luna ended 2021 trading at more than $80. In this way, they differ from conventional cryptocurrencies like bitcoin, which functions more like traditional money as a store of value and medium of exchange.

DAOs typically use governance tokens to structure their decisions. These entities are designed to avoid centralized management altogether by giving power exclusively to stakeholders.