The Triumph of the Firm

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Henri Szeps, the actor, is a neighbour of mine. As an actor he usually signs a contract which specifies a given amount of pay per performance; his income is certain, so long as the show goes on, but a sell-out audience makes no difference to his pay. Henri recently returned from a very successful run of his one-man show, "I Am Not A Dentist," in Melbourne. Unusually, Henri is both the actor, the script-writer, and the producer of this show. As such, he bears the risk of the show folding and he reaps the rewards of sell-out crowds, such as he enjoyed in Melbourne. We drank to his success.

As an actor, Henri is usually employed by the producer and submits to the director. His wage is reasonably insensitive to the box office take. The contract will usually specify a specific cast, performing at specific locations, for specific periods, for specific pay. But there is an alternative form of employment for stage actors. A repertory company will have longer-term contracts: the actors become employees of the company for the interim, taking whatever parts in whatever plays at whatever venues on whatever dates as management decrees. In the theatre, the short-term contract is the norm, while the repertory company — and the actor-producer — is unusual.

When we look beyond the theatre to industry at large, we see that the opposite is true and one sort of arrangement predominates. It exhibits long-term contracts with at least some of its suppliers, owners who direct employees lower in the hierarchy in production and who bear the risks of high or low returns, and a size of organisation which takes advantage of economies of scale, with the need for coordination at larger sizes. It is the firm.

What are the reasons for the existence of the firm? Why not the theatre's short-term arrangements? Over the past twenty years or more, economists have turned to asking questions about the meaning and purpose of the firm, and have come up with answers that have helped advance our understanding of the firm and its management. They have focussed on organisational factors rather than the technological factors which have provided a rationale for the firm in standard microeconomic theory.

With downsizing and outsourcing, not to mention privatisation, there has been a recent focus of attention on the size and extent of the firm. Perhaps not coincidentally this interest has been accompanied by renewed involvement on the part of economic theorists on the economic theory of the firm, which previously had almost entirely been seen as a "black box", the producing counterpart to the consuming household.

What have economic theorists ever done for the real world? you may be asking. Well, Maynard Keynes for one, in a celebrated passage in his *General Theory*, spoke of

0. I should like to mention my late wife, Hazel Church, and Robin Stonecash, both of whom gave me useful comments.

economic theorists in these terms:

> ... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. [p. 383]

So the ideas generated by economic theorists have a way — especially if taken up by influential members of the profession — of entering the political agenda. (This is certainly true of the move to privatise government-owned enterprises.) Here we explore four economic rationales for the existence of the firm.

Why are there so few worker-owned firms? What is the appropriate scale or scope of a firm? Why are conglomerates apparently going the way of the dinosaurs? These questions are a few that economists have been asking in the past twenty years. We provide a brief overview of economists' ideas about the firm, and how our understanding of the theoretical underpinnings of the firm have developed and illuminated the questions above.

A moment's thought will reveal one's mental image of "the firm": an owner-manager who hires labour, buys new materials, buys or hires equipment, and coordinates the transformation of these inputs into goods and services which are sold, usually for profit, after all costs have been accounted for, including the opportunity costs of capital. Of course, it may be that the owners have hired managers to make day-to-day decisions, and it may be that such people have their own goals — such as a higher market share — which are not entirely congruent with those of the owners, who may be more interested in short-term profits or the long-term value of their shares. But we ignore here the issues arising from these arrangements and focus on the owner-manager.

Of course, it would be possible to examine the historical evolution of the legal entity of the limited-liability company, for example, but our purpose here is to provide a perspective on possible logical explanations of the firm, and to try to answer the questions posed above.

What have economic theorists had to say about the firm? Ten years before Keynes wrote the words quoted above, Frank Knight had argued that the existence of risk was a possible explanation for the firm.

Knight's firm is one where, because commitments in capital and production processes and inputs must be made before the final demand and price are known, there is risk. He distinguished risk, where the probabilities of certain events can be calculated, from uncertainty, where the likelihoods of events can only be guessed at: risk allows actuarial tools to be used. He argued that the firm allows an efficient allocation of risk between the poorer, perhaps more risk-averse workers and the richer, perhaps less risk-averse owners, who may also have better information with which to direct the firm. The lower risk for the workers is reflected in agreed fixed wages, but the cost of this to the workers is lower returns than if they bore more of the firm's risk. This internal division of labour is both efficient at sharing risk and provides the incentive for the owners to monitor for loafing on the job.

Knight is better known for his rationale for profits, which, he argued, are the reward for forgoing consumption now in order to invest in the firm. Profits also provide the incentive for owners to invest wisely. The owners are the residual risk bearers, who may lose everything but who stand to earn any profits that the firm generates (above the normal competitive return to capital).

The alternative to the coordinating management of the firm is the price-directed mechanism of the market. This raises the question of why the owners of the various inputs (including the knowledge of how to combine them into outputs) could not just come together in the market and reach agreement on the terms of combining their inputs and selling the output, whether good or service. That is, they would write a short-term contract, which committed each input owner to a particular level of performance, and specified the division of the revenues generated. This is the standard pattern in the theatre, as discussed above.

Writing a few years after Keynes, Ronald Coase argued that writing the contracts necessary for coming together in the market are not costless, and that as this cost rises, there comes a point at which a less costly alternative is to bring the relationship inside the firm, to substitute managed coordination for price coordination, which obviates the need for a completely specified contract. He called the cost of writing the contract the "transaction cost", and noted that unforeseen eventualities (breakdowns, shortages, etc.) would require costly renegotiation of the contracts in the market, or even more costly attempts to anticipate all possible contingencies and specify them in the initial contract. The costs of renegotiation and the "price discovery process" could be economised by agreement beforehand to a hierarchical authority to sort things out.

More recently, Oliver Williamson has focussed not on the cost of Coase's price discovery and negotiation, but on the venture specificity of assets — if a supply relationship is via the market, and the firm's assets rely on input from another firm, then this supplying firm can "hold up" the buyer: "Pay us more, or your firm-specific assets will become worthless!" Common ownership of both firms' complementary assets, through vertical integration, will remove this risk and is often seen. An example is General Motors merging with Fisher Body, the independent firm that manufactured its automobile bodies, lest it be "held up". An alternative is long-term market relationships, such as seen in the Japanese car industry.

As Armen Alchian and Harold Demsetz argued, there is another cost that may be minimised within the firm: the cost of monitoring work effort. With economies of scale or scope, with joint production and no clear output from the individual worker, and with asymmetric information (workers know more of their abilities and effort than does management), there exist incentives to loaf or free-ride on others' labours. The owner-manager could appoint monitors to deter such behaviour; but this just raises the issue of monitoring the appointed monitors: *Quis custodiet ipsos custodies?* The best-motivated monitor is the person who is the residual claimant — the owner — who has the incentive to monitor most cost effectively in the firm's environment of coordinated management. If there is loafing on the job, then the owner will bear the eventual cost, in terms of lower returns, so the firm provides a means of centralising the monitoring.

Recent cases of the partner in a law firm misappropriating clients' money, and thus imposing a financial burden on the remaining partners, has highlighted the mismatch between risk bearing and monitoring of one's partners' behaviour in such firms. One solution is incorporation, a legal process which minimises the potential losses faced by the new owners — the erstwhile partners — but which does little to reduce the costs of

monitoring, absent a clearer hierarchy. The firm, however, includes a hierarchical organisational structure, which thus reduces cost of monitoring and the risk of cheating that the partnership exhibits.

Oliver Hart describes what he calles the property-rights approach, which is best understood by asking what changes hands when one firm acquires another: the answer is the physical or non-human assets of the acquired firm. This ownership, he argues, is a source of power when contracts are incomplete, as they will inevitably be. As well as bearing the residual risk (and reaping any above-mormal returns), the owner of an asset has the residual control rights over that asset. A separate supplying firm's management can threaten to make both its own assets and its labour unavailable for any uncontracted-for increase in production. If the increased production is important to the downstream firm, then this may be a costly threat. If the upstream firm were a division of the downstream firm, then the assets would not be under ultimate control of the upstream management. There is thus an incentive for ownership of the supply by the downstream firm, as mentioned in the case of Fisher Body above. This is an extension of Williamson's arguments.

There are sociologists who argue against the self-centred assumptions of the economics models and explanations, but they have not developed a theory of the firm based on altruistic motivations yet. When they do, perhaps Henri Szeps can dramatise it. For all the diversity of explanations of the firm, the assumption of self-centred owners, workers, suppliers, and managers is agreed on.

Can we explain why Henri Szeps is not employed in a repertory company, and why in the theatre such arrangements as we have been motivating with the above discussion are very unusual? First, the possibilities for economies of scale are small: for centuries theatres' seating capacities have not grown significantly, although machinery has appeared back stage for lighting and sound, as well as for scene changing. So the size of production has not grown, and the number of players has remainded much the same over time. (Given rising standards of living and labour-saving technical progress in other sectors, this poses a challenge for future theatrical productions, which may be priced out of reach of many playgoers; hence Henri's one-man show, and hence the importance of television, where the potential audiences can justify higher wages and costs of actors and others. Television programs, however, are produced by firms.) Second, actors are usually not in a financial position to act as producers, with up-front expenditures and with the possibility of sizeable losses if the production is not popular. Third, with the number of people — actors and backstage — a manageable size, monitoring, especially of the actors, of course, has been relatively inexpensive. (This is even more true of orchestras.) Fourth, there is little possibility of "hold-up" occurring, although some prima donas might like to think they are indispensible to a production. Plays, theatrical venues, actors, designers, musicians — all are to a greater or lesser extent substitutable, especially in a world where there are additional psychic rewards beyond the merely monetary.

For most enterprises, however, the four explanations discussed above are plausible, and help us see how economic theory can illuminate the existence of the black box known as the firm and its management.

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