The Organization of Economic Activity: A Review Article

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I. Introduction

The title and covers of Demsetz's (1988, 1989) two new volumes suggest an entirely new treatise, but the inside flaps already explain that they consist mainly of reprints of published articles, with some new chapters. Though the 'labeling' is deceptive, the contents are often stimulating. Demsetz has been an influential contributor to the foundations of property rights, transaction cost, law and economics, as well as mainstream industrial organization. His 1972 article with Alchian, in particular, stimulated much of the modern interest in the internal organization of the firm. Reading Demsetz's collected works together with his newer contributions provides an opportunity to reconsider some of the most important issues in economics, clearly if not always convincingly presented from a consistently *laissez-faire* point of view. Demsetz shows how rigorous verbal reasoning can illuminate the major questions in economics, questions which are often neglected in the more rigorous mathematical modeling of matters of detail which dominate many journals, and even his errors and omissions provide more food for thought than many a faultless formal deduction from questionable assumptions.

II. Ownership, control and the firm

In the introductory autobiographical sketch to his Vol. I, Demsetz lists Alchian, Coase, Knight and Stigler among his main intellectual influences, and he follows these writers fairly closely in style and (collective) scope. Demsetz defines "ownership" as his central theme, and summarizes his views in a "framework for the study of ownership" which provides a useful opening in Chapter 2. Politicians and especially Eastern reformers should note that "effective decentralization cannot be achieved without de facto movement towards private ownership because privatization means that controllers of resources (their "owners") bear more of the consequences of their actions than do controllers (the bureaucracy) when "the state" is owner" (p. 24).

Part II contains chapters on exchange of property rights, liability, transacting cost, minorities, and theory of property rights, mainly extending ideas of Coase but without adding any very major new insights.

Part III, in contrast, on "the firm and the problem of control" represents the core of Demsetz's work. His 1972 AER paper with Alchian on monitoring and team work as foundations of firm organization is surely their most cited piece, and together with Doeringer and Piore's (1971) book on internal labour markets provided a major impetus to modern economics of organization, more than 30 years after Coase's pioneering article on the subject. While monitoring and agency problems have of course become of central concern, it is ironic that a key element in Alchian and Demsetz's theory of the firm is now recognized as fundamentally mistaken. Their denial of any element of authority in the employment relationship is contradicted both by casual observation and most writers on the firm, including Knight, Coase, Williamson, and even in the later review by Alchian and Woodward (1988).

Alchian and Demsetz defined the firm in terms of joint production (team work), and monitoring of individual contributions by the residual clai-

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mant, *without* authority or any long-term contractual relationship. They completely missed what has come to be regarded as an essential feature of firm organization, namely *specific* investment and assets which impose costs of mobility, and generate the long-run employment relationships (implicit, if not explicitly contractual) which Doeringer and Piore (1971) had already shown to be of central importance in the firm. Informational problems generally require internal enforcement and monitoring by some team members of these relationships. As FitzRoy and Mueller (1984, p. 37) emphasized, "thus, in contrast to Alchian and Demsetz, it *is* 'the power to settle issues by fiat, by authority, or by disciplinary action' *vested in some participants in the teamwork activity*, and not the presence of teamwork per se, that is the distinguishing characteristic of the firm".

It follows that the least mobile participants, with the most specific investment, are most vulnerable to breach of contract or opportunism by other parties. The immobile will thus demand ultimate authority and residual claimant status, which is traditionally the role of suppliers of physical capital. However Alchian and Demsetz miss the immobility and consequent vulnerability of specific *human* capital, a point made already by Knight (1921, pp. 346, 356) and emphasized by FitzRoy and Mueller (1984).

Major current policy concerns, such as declining competitivity of much of American manufacturing, are not mentioned by Demsetz. The extensive literature on the flexible team work, participative management, profit sharing and other organizational innovations replacing traditional adversarial collective bargaining in many of the most successful enterprises everywhere is ignored, although these developments relate to Knight's neglected concern with specific human capital (Aoki, 1989; Dertouzos *et al.*, 1989).

Surprisingly also, the role of technology in firm-organization has been largely neglected by Alchian and Demsetz as well as by subsequent writers such as Williamson (1985) and Alchian and Woodward (1988), although Leijonhufvud (1985) argued persuasively that technological developments rather than monitoring considerations provided the main impetus for the historical development of the factory system. Recent changes in production technology and shifts of demand towards more specialized products which favour smaller firms and more flexible team work with reduced division of labour likewise receive no mention, in spite of their policy relevance (FitzRoy and Acs, 1989).

An even more serious weakness running through much work by Demsetz and other *laissez-faire* American institutionalist writers such as Alchian and Williamson is their lack of attention to international differences in the organization of economic activity, notably Japanese success with flexible team work or codetermination in Europe (Aoki, 1989). While emphasizing team work, Alchian and Demsetz neglect aspects of collusive behaviour in the workforce usually subsumed under "industrial relations", although differences in industrial relations seem necessary to account for major international productivity differences between plants with similar capital equipment and standards of training (Prais, 1981).

A new chapter, "the theory of the firm revisited" was presented at a 1987 conference in honour of R. H. Coase, and follows him in distinguishing between transacting costs of market exchange, and *management* costs of "organizing resources within firms". Demsetz aptly criticizes Williamson's indiscriminating use of transaction cost terminology in these very different contexts, and also his neglect of "the importance of technological conditions to economic organization" (p. 163). He acknowledges Knight's (1921) prior recognition of the shirking problem, which Knight called "moral hazard" but failed to develop further, and admits that Alchian and Demsetz's account of the firm was incomplete. However he does not concede their fundamental inconsistency noted above, nor indeed even mention most of the critical literature on Alchian and Demsetz. In spite of some suggestive remarks on the role of differential knowledge in the firm, this chapter remains disappointing.

Demsetz's next Chapter 10 on vertical integration provides an interesting empirical test of Williamson's and other theories of vertical integration. Essentially no support for these standard theories is found, though data problems, particularly in the measurement of asset specificity, are severe.

The following Chapters 11 and 12 on the

theory and empirical facts of ownership and control are the high points of the volume in this reviewer's opinion. Demsetz first argues that concerns about the separation of ownership and control voiced by Berle and Means and others are meaningless because an owner-manager with *complete* control of his firm should maximize utility, not profit. He can trade-off pecuniary rewards for on-the-job consumption such as excessive growth or autocratic management style. Demsetz mentions cases where stock price has risen dramatically upon the death of a dominating owner-manager, such as Henry Ford.

On the other hand, 'outside' owners who are not managers are likely to prefer policies which maximize the market value of the firm. Empirically, Demsetz argues that ownership of American corporations is much less dispersed than is commonly believed, so effective control of management should be feasible by small groups of outside owners, backed up by the threat of takeover. Finally, management shareholdings are supposed to link management and owner interests in profit maximizing.

In Chapter 12 (with K. Lehn), regressions are presented to explain ownership concentration. Accounting profit rates are also estimated, and various measures of ownership concentration are found to be insignificant as explanatory variables. In concluding that corporate ownership and control "vary systematically in ways that are consistent with value maximization" (p. 229), Demsetz has once again neglected the strongest evidence that contradicts his faith in existing American institutions. Indeed, his references seldom go beyond a small circle of like-minded associates and colleagues, so that critical evidence can be systematically ignored.

In the present context, much recent research on mangerial compensation and corporate performance has been summarized by Baker, Jensen and Murphy (1988). The relationship between total CEO-compensation (including stock-related pay) and stockholders' returns is generally weak, while the relationship between firm-size and CEO-compensation is highly significant, with a sales-elasticity of about 0.3. Baker, Jensen and Murphy (p. 609) conclude that "the size/pay relation is causal and therefore reflects more than a matching of CEOs to firms on the basis of their abilities. It also suggests that CEOs can increase their pay by increasing firm size, even when the increase in size reduces the firm's market value. This could explain some of the vast amount of inefficient expenditures of corporate resources on diversification programmes that have created large conglomerate organizations in the last 20 years."

The relationship between top-managerial pay and the performance of West German corporations has been studied by FitzRoy and Schwalbach (1989), who find generally insignificant effects of profitability on pay, but a very strong size-pay relation. Furthermore, diversification was positively related to pay, but negatively and significantly to profit measures. Profits ultimately *declined* with sales in a quadratic specification. Ownership concentration was negatively related to managerial pay, but did not have consistent effects on profit measures.

All this evidence suggests that managers who are not dominating owners pursue excessive growth to maximize their personal wealth (as well as for non-pecuniary reasons), at the cost of outside shareholders. Even an institution like the West German two-tier board system seems unable to provide effective control of management, in line with informal and journalistic accounts. Influential bank representatives have encouraged major conglomerate mergers recently, in spite of accumulating evidence from the U.S. that this form of corporate growth is not efficiency-enhancing, evidence which is also ignored by Demsetz in his optimistic evaluation of U.S. corporate performance.

The rest of this volume will be of less interest to most readers. A short Chapter 14 extols private wealth inequality for facilitating control of the firm; Knight's views on risk, uncertainty and profit are quite effectively criticized in Chapter 15; and normative issues of social responsibility, ethics, efficiency, and freedom are touched upon, at no great depth, in Part IV.

Stimulating and influential as some of Demsetz's writings undoubtedly are, it must be emphasized that his scholarship is seriously flawed by his refusal to face up to theoretical argument and empirical evidence, which run counter to his faith in the optimality of the American economic system. This weakness of other institutionalists such as Alchian and Williamson was discussed by

FitzRoy and Acs (1989), and it isolates such policy-oriented economists from some of the most pressing issues of the day. The superior performance of Japanese firm organization, even in their Western subsidiaries, is explained by Aoki (1988) and others in economic terms, but ignored or ascribed to cultural factors by Demsetz and other believers in American superiority irrespective of the empirical evidence.

III. Competition, efficiency and policy

In his second volume, Demsetz "focuses on competition in both the market place and the political arena" (p. vii). He opens with a severe critique of a much-quoted pioneering article on information by K. J. Arrow, who argued that public-good properties of information will lead to underinvestment in basic research in a "free enterprise economy", so that government support is called for. While this seems obvious and unexceptionable, Demsetz retorts that Arrow is comparing a theoretical model of perfect competition with an unanalysed but supposedly superior government. Instead, imperfect competition with various kinds of realistic government intervention needs to be studied from a comparative institutional viewpoint. This represents an important critique of much modern economic modeling, particularly of perfect competition and Pareto optimality. However, Demsetz is really too hard on Arrow here. Theoretical models can yield insights by highlighting selected important features of complex reality. Public support of basic research is widely accepted, despite the well known imperfections of government, and Arrow's work on public-good and appropriability problems of information production provides a useful framework for starting any more detailed comparative institutional study.

In Chapter 2, Demsetz provides a deep analysis of barriers to entry, noting that "the problem of defining ownership is precisely that of creating properly scaled legal barriers to entry" (p. 32). Monopoly rights such as patents, which impede the free *transmission* of information, supply incentives for the *production* of (new) information in a dynamic context. Protection or at least tolerance of current monopoly may be necessary to stimulate long run competition in the innovative process. The comparative statics of theory and texts may be worse than useless for policy analysis in a dynamic world.

After a brief discussion of social variables and economic efficiency, Demsetz then criticizes monopolistic competition at some length, rejecting excess capacity and zero-profit equilibrium. However his diagrammatic approach is inadequate and more formal modeling of these technical problems would probably clarify the issues.

Chapter 6 on "why regulate utilities" is more interesting because it essentially predated the "contestable markets" literature by some 15 years (p. 86). Demsetz prefers "competition for the field" to regulation, but here he does not face up to the problems of dynamics and recontracting with sunk costs, and ignores recent critiques of contestability as well as the virtual non-existence of a supposedly more efficient institution.

Demsetz's pioneering attack on concentration as a source of monopoly profits in chapter 7 was first published 16 years ago. His arguments that efficiency and scale economies can lead to both concentration and higher profits, and that *persistent* monopoly usually depends on government support or regulations are cogently made, and have found considerable support from later writers. The arguments are developed further in a new Chapter 8. A major omission in this work is the neglect of the capture of monopoly rents in concentrated industries by labour unions, as established by Karier (1988) and Belman (1988). Widespread rent-sharing in the form of wage differentials which are very difficult to explain by unobserved individual characteristics or unionization (Dickens and Katz, 1986) raises further problems for accounting profits that are also ignored in most industrial organization studies.

The role of advertising in barriers to entry is rejected in Chapter 9, and it is argued that monopolization without government support is unlikely to yield returns as high as static price theory suggests. Following chapters provide a devastating critique of J. K. Galbraith's technostructure and other hypotheses, and find no empirical support.

It is ironic that Demsetz again derides theories of wasteful growth by corporate management put forward by Baumol and others and espoused by Galbraith. Yet currently, one of the few authors usually quoted with approval by Demsetz has rediscovered manager-shareholder conflict over free cash flow, and argues that value-creation by leveraged buyouts is clear evidence for waste by managers who benefit from growth (Jensen, 1989).

Further irony in the history of ideas is provided by the fact that Jensen himself until recently also dismissed concern about corporate inefficiency as unfounded. Thus Fama and Jensen (1983) and many others were in agreement with Demsetz that an efficient market for corporate control solved the problem of any separation of ownership and control. What is most astonishing, however, is that none of these authors, including Jensen (1989), make any mention of much earlier, *direct* empirical evidence for wasteful investment of retained earnings by Baumol, Hein, Malkiel and Quant (1970), Hiller (1978) and others. Jensen's (1989, p. 66) observation that "A central weakness and source of waste in the public corporation is the conflict between shareholders and managers over the payout of free cash flow" goes back to Berle and Means (1933) and was further developed by FitzRoy and Mueller (1984, 1977) among others. Jensen's (1989) neglect of prior scholarship is remarkable, as is Demsetz's failure to acknowledge *any* of the recent literature on the problems of the public corporation.

Following chapters on antitrust and regulation of the stockmarket reaffirm Demsetz's faith in competition and efficiency as a cause of concentration. The concluding Part 4 discusses various aspects of *political* competition, interest groups and the growth of government, including parts of the authors F. de Vries lectures.

Demsetz points to various familiar weaknesses of political competition as compared to market competition. In parts the 'analysis' is superficial to the point of triviality, as when externalities are dismissed with the claim that "intellectuals who dwell on problems of externalities when criticizing the ability of markets to protect future generations often fail to examine the political alternative" (pp. 289—90). No mention is made of the greenhouse effect, ozone depletion, and other pressing global problems for which there is no alternative to coordinated government action. While externalities may usually be traced back to lack of appropriate property rights, it is surely incumbent upon government to create the appropriate rights, or adopt other measures when market transaction costs appear excessive.

While neglect of ecology is common place in economics (and also *vice versa*), Demsetz's approach to more traditional areas of economic policy within his own fields of expertise remains surprisingly parochial. Policy differences between capitalist, market economies are barely mentioned, and in spite of stern injunctions to analyze government in his critique of Arrow, Demsetz himself ignores the rich variety of international experience with widely differing government roles and institutions in his reliance on market competition to solve most problems. His almost complete neglect of morality in economic (and political) activity falls far behind Arrow's (1974) important and comprehensive treatment of organization. In spite of his commendable attempts to grapple with some central questions of economic organization, Demsetz ultimately offers only an *apolitical* economy which is inadequate for the task he sets himself. As noted above, failure to respond to critics and discuss alternative viewpoints is a major weakness. Nevertheless, Demsetz's contributions are often original and can still be read with profit by economists of widely differing persuasions.

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