Comment on "The Organization of Economic Activity"

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The task of reviewing *The Organization of Economic Activity* (Demsetz, 1988 and 1989) is difficult to execute well because the material presented is a collection of papers covering diverse topics. About one-fourth of the material is new. The remainder is a selection of papers already published. The new material makes these volumes a somewhat different publishing venture than recently published collections that consist entirely of already published articles. A reviewer of volumes treating diverse topics inevitably brings an emphasis to his review that is not a balanced reflection of content. He focuses on those papers that cater to his own interest and expertise. Professor FitzRoy (1990) clearly reveals that his interest is in the economics of the firm.

FitzRoy obviously took up these volumes expecting them to contain only new work, and in his review he sometimes treats papers published long ago as if they were written only yesterday. It seems improper to critique older papers by referring to more recent work without at least noting that this work has appeared a decade after mine. Thus, in discussing the Alchian and Demsetz paper on the theory of the firm, which appeared in 1972, FitzRoy complains that work by Aoki (1989) and Dertouzos *et al.* (1989) is ignored.

Again ignoring the time dimension, FitzRoy cites as a more serious weakness running through much of the work of "*laissez-faire*" American institutionalists our "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 I disagree about the importance of issues such as these and about their neglect in *recent* writing of American institutionalists, I simply wish to call the reader's attention to the fact that the volumes being reviewed never pretend to address these policy issues and that much of what is in them was written well before these debates surfaced. The same may be said about FitzRoy's complaint, in his discussion of Volume, II, about lack of attention to such matters as the greenhouse effect, ozone depletions, etc.

FitzRoy obviously is most concerned with issues relating to the theory of the firm, and he devotes considerable space to the Alchian and Demsetz paper "Production, Information Costs, and Economic Organization." His chief complaint is that a "key element" in our theory of the firm is now recognized as fundamentally mistaken. This he describes as our "denial of any element of authority in the employment relationship." This may appear to be a key element to him and to those concerned with ideology, but it is not central to our theory. The important elements in our theory are shirking and the cost of monitoring. These explain some of the internal organization of firms whether or not authority is present.

However, what, after all, is authority? What we said in our paper is that arrangements within the firm involve no different authority from arrangements made across a market. A worker quits, thus severing his relationship to the firm. Has he exercised any more authority than a customer who stops shopping at the local grocery store because he does not like the way business is done there? An employer lays off a worker, but how does this differ from a firm that stops servicing a customer across a market? Sense can be made of the word "authority" by discussing the cost imposed on

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someone by the severing of a relationship, and not by focusing on whether the relationship existed within a firm or across a market. The cost can be high in the context of a firm, and it can be high in the context of market exchange. All we said when writing that paper is that we did not recognize a qualitative difference in these contexts. The validity of this belief has no special relevance to shirking and monitoring. Whatever makes monitoring costs high or low influences the organization of the firm.

I do, however, give a great deal of attention to the relevance of the cost of exercising alternatives in my essay "The Meaning of Freedom" (the last chapter of Volume I). FitzRoy fails to recognize the importance of this discussion to what he wishes to call authority, and he dismisses it in cavalier fashion saying only that there is "no great depth" to the essay. He may be correct. I hope not, for there surely is more depth in this essay than in most discussions of "authority" that exist in the literature of the firm.

In the "The Theory of the Firm Revisited" (Chapter 9, volume I), I call attention to what I think *is* an important shortcoming of the Alchian and Demsetz article, its neglect of the source of productivity in team (firm) organization. The A & D article essentially assumes this productivity exists in certain unspecified circumstances and then goes on to explore the consequences of shirking for team organization. I attempt to redress this problem, calling attention to the importance of specialized knowledge in rationalizing the productivity of team efforts. I also call attention to the importance of managing within the firm by *directing* persons in their tasks. The directability of some (workers) by others (managers) is shown to owe its origin to the increase in productivity it brings about. In general, team members will voluntary agree to a significant degree of directability because persons have command over different, specialized inventories of knowledge. The direction of some by others allows this specialization to be taken advantage of without making all who work together know the same things. Call this authority if you like, but it carries none of the ideological baggage of FitzRoy's notion of authority. Strange that FitzRoy makes so much of the authority issue but completely ignores my discussions of the relevance of directability to the theory of the firm and of the cost of exercising alternatives to a meaningful notion of freedom.

FitzRoy also gives attention to my papers (one with Lehn) on the ownership structure of the firm (Voume II). In the main, his discussion of these is appropriate. However, he does misapprehend a point of which he makes much. Demsetz and Lehn demonstrate empirically that the concentration of ownership in the modern corporation seems to be guided by rational economic considerations. This is not to assert that owners perfectly control managements, as FitzRoy seems to assert, only that the degree to which they are made able to exert control, by virtue of concentrated ownership, seems sensibly responsive to their interests.

Indeed, I am absolutely convinced that owners of what would be a truly efficient large firm necessarily must relinquish a degree of control and accept the positive probability that control will sometimes be exercised against their interests. It is efficient for them to do this because specialized management delivers more benefit than cost, on average, to owners, particularly by allowing them to diversify their holdings and by bringing specialized competence to bear on the firm's operation. None of this denies that some situations get out of control, nor that takeovers or buyouts may be necessary to reconstitute concentrated ownership when this happens. It might be mentioned again that these papers were written before much of the data relating to managerial compensation appeared. Were I to rewrite the papers I would refer to these data in order to guard against misinterpretations much like FitzRoy's.

The main deficiency in FitzRoy's review of Volume II, however, is in his neglect of the new work I offer on "The Indivisibility Rent Theory of Measured Oligopoly Profit" (Chapter 8). This paper merits either applause or jeers, but not, I think, neglect, for it offers a new theory and new supporting evidence to explain observed patterns in profit rates.

The second part of the first volume, *Ownership, Control, and the Firm*, consists of 5 chapters dealing with private rights and externalities. FitzRoy's sole comment on this part is that it "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." Clearly, either his interest or his expertise on these topics is deficient. In particular, my papers on "The Cost of Transacting" and "Toward a Theory of Property Rights" were not mere extensions of Coase's work. The first is the first attempt to measure the determinants of the cost of transacting (as measured by the bid-ask spread on organized stock exchanges), and it stimulated a major line of inquiry by financial economists. The second took an entirely different approach from Coase's in discussing the property rights problem. Coase assumes property rights exist and are known to market participants. My paper seeks to improve our understanding of what it is that brings property rights into existence. This paper also stimulated an important line of inquiry.

I have felt it necessary to correct the record as it appears in FitzRoy's review. There is much in the review that needs no correction. I do appreciate FitzRoy's willingness to undertake a difficult reviewing task.

References

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