Reply to *Comment on "The Organization of Economic Activity"* by H. Demsetz

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As Demsetz acknowledges in his Comment, it is difficult for a reviewer to do justice to such a wide-ranging collection as Demsetz's (1988, 1989) collected works. While focussing on some of what Demsetz himself suggested were his central topics, I could not, regretably, discuss all of his chapters in the limited space of my (1990) review, in spite of their interesting themes.

Turning to substantive issues, Demsetz claims that I improperly criticized his 1972 paper with Alchian by referring to their neglect of more recent work. In fact, the references to more recent work *followed* my discussion of Alchian and Demsetz, in a paragraph that began: "Major current policy concerns . . . are not mentioned by Demsetz". Obviously I was referring to the *new* pieces by Demsetz which do make up about a quarter of the books and are explicitly claimed to bring them up to date. International differences in the organization of firms and economies are systematically ignored in *all* of Demsetz's work, which is arguably a serious lacuna in the writings of any institutionalist economist who claims to be laying down general principles of universal applicability. Thus I did not "ignore the time dimension", and Demsetz should not ignore major current, comparative-institutional debates if he claims to have updated his earlier articles.

Going back to his paper on the firm with Alchian, and his new chapter on the firm, Demsetz has misread or misinterpreted my critique as well as much of the literature on the theory of the firm and the employment relationship. Demsetz seems to consider my critique of his and Alchian's neglect of "authority" in the employment relation to be "ideological". He does not seem to realize that the terminology has been fairly standard since H. Simon's (1951) article. In fact, the *necessity* of authority in the firm is generally recognized to follow from the prevalence of incomplete contracts in employment due to Simon's bounded rationality. The standard 10 text by Tirole (1988) devotes several pages to authority — defined as "the power to fill unspecified contingencies" (p. 30).

The employment relationship is thus fundamentally different from the customer-grocer relationship which Demsetz still seems to consider equivalent. The differences are of course exacerbated by the fact that mobility-costs of "severing" the relationship are usually higher for an employee with specific assets than for the grocer's customer. Contra Demsetz, monitoring and shirking in the firm can hardly be understood *without* incorporating the role of "unexpected contingencies" and discretionary authority.

After all this, it is quite surprising to find Demsetz "call attention to the importance of managing within the firm by *directing* persons in their tasks", in his new Chapter 9, Vol. I, "The Theory of the Firm Revisited". Thus "directability" leads to an "increase in productivity" by aiding specialization but "carries none of the ideological baggage of FitzRoy's notion of authority". Since Simon (1951) had already shown that authority, directing, managing or whatever was generally a *prerequisite* for any productive organization, it is hard to see the point of reducing "directability" to a mere "increase in productivity" through specialization. Overriding issues in industrial relations such as the optimal *scope* of authority, limitations

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under codetermination, etc., are again ignored or implicitly consigned to ideology.

On the issues of ownership structure, I certainly did not assert that "owners perfectly control management", as Demsetz suggests. Quite to the contrary, I presented evidence that top managerial compensation is much more strongly related to size than to profitability, supporting the original Berle and Means separation-of-ownership-and-control thesis. Some of the growing body of evidence for *diseconomies* of scale and widespread inefficiency of large corporations was certainly available for consideration in the relevant new chapters of his (1988, 1989) volumes. My point was just that the available evidence which contradicts Demsetz's long-standing faith in the efficiency of the large American corportion should have been considered by him, and not simply ignored. A careful discussion of all sides of this and other debates in the new chapters (whatever the outcome) would have enhanced both Demsetz's reputation for impartial scholarship as well as the utility of his collected works for most readers.

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