Why Do Firms Exist?

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Ronald Coase, the author of “The Nature of the Firm” (1937), turns 100 on December 29th

For philosophers the great existential question is: “Why is there something rather than nothing?” For management theorists the more mundane equivalent is: “Why do firms exist? Why isn’t everything done by the market?”

Today most people live in a market economy, and central planning is remembered as the greatest economic disaster of the 20th century. Yet most people also spend their working lives in centrally planned bureaucracies called firms. They stick with the same employer for years, rather than regularly returning to the jobs market. They labour to fulfil the “strategic plans” of their corporate commissars. John Jacob Astor’s American Fur Company made him the richest man in America in the 1840s. But it never consisted of more than a handful of people. Today Astor’s company would not register as a blip on the corporate horizon. Firms routinely employ thousands of workers and move billions of dollars-worth of goods and services within their borders.

Why have these “islands of conscious power” survived in the surrounding “ocean of unconscious co-operation”, to borrow a phrase from D.H. Robertson, an economist? Classical economics had little to say about this question. Adam Smith opened “The Wealth of Nations” with a wonderful description of the division of labour in a pin factory, but he said nothing about the bosses who hired the pin-makers or the managers who organised them. Smith’s successors said even less, either ignoring the pin factory entirely or treating it as a tedious black box. They preferred to focus on the sea rather than the islands.

Who knows the secret of the black box?

The man who restored the pin factory to its rightful place at the heart of economic theory celebrates his 100th birthday on December 29th. The economics profession was slow to recognise Ronald Coase’s genius. He first expounded his thinking about the firm in a lecture in Dundee in 1932, when he was just 21 years old. Nobody much listened. He published “The Nature of the Firm” five years later. It went largely unread.

But Mr Coase laboured on regardless: a second seminal article on “The Problem of Social Cost” laid the intellectual foundations of the deregulation revolution of the 1980s. Eventually, Mr Coase acquired an army of followers, such as Oliver Williamson, who fleshed out his ideas. In 1991, aged 80, he was awarded a Nobel prize. Far from resting on his laurels, Mr Coase will publish a new book in 2011, with Ning Wang of Arizona State University, on “How China Became Capitalist”.

His central insight was that firms exist because going to the market all the time can impose heavy transaction costs. You need to hire workers, negotiate prices and enforce contracts, to name but three time-consuming activities. A firm is essentially a device for creating long-term contracts when short-term contracts are too bothersome. But if markets are so inefficient, why don’t firms go on getting bigger for ever? Mr Coase also pointed out that these little planned societies impose transaction costs of their own, which tend to rise as they grow bigger. The proper balance between hierarchies and markets is constantly recalibrated by the forces of competition: entrepreneurs may choose to lower transaction costs by forming firms but giant firms eventually become sluggish and uncompetitive.

How much light does “The Nature of the Firm” throw on today’s corporate landscape? The young Mr Coase
first grew interested in the workings of firms when he travelled around America’s industrial heartland on a scholarship in 1931–32. He abandoned his textbooks and asked businessmen why they did what they did. He has long chided his fellow economists for scrawling hieroglyphics on blackboards rather than looking at what it actually takes to run a business. So it seems reasonable to test his ideas by the same empirical standards.

Mr Coase’s theory continues to explain some of the most puzzling problems in modern business. Take the rise of vast and highly diversified business groups in the emerging world, such as India’s Tata group and Turkey’s Koc Holding. Many Western observers dismiss these as relics of a primitive form of capitalism. But they make perfect sense when you consider the transaction costs of going to the market. Where trust in established institutions is scarce, it makes sense for companies to stretch their brands over many industries. And where capital and labour markets are inefficient, it makes equal sense for companies to allocate their own capital and train their own loyalists.

But Mr Coase’s narrow focus on transaction costs nevertheless provides only a partial explanation of the power of firms. The rise of the neo-Coasian school of economists has led to a fierce backlash among management theorists who champion the “resource-based theory” of the firm. They argue that activities are conducted within firms not only because markets fail, but also because firms succeed: they can marshal a wide range of resources—particularly nebulous ones such as “corporate culture” and “collective knowledge”—that markets cannot access. Companies can organise production and create knowledge in unique ways. They can also make long-term bets on innovations that will re-define markets rather than merely satisfy demand. Mr Coase’s theory of “market failure” needs to be complemented by a theory of “organisational advantages”.

All this undoubtedly complicates “The Nature of the Firm”. But it also vindicates the twin decisions that Mr Coase made all those years ago as a young student at the London School of Economics: to look inside the black box rather than simply ignoring it, and to examine businesses, not just fiddle with theories. Is it too much to hope that other practitioners of the dismal science will follow his example and study the real world?

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