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Specificity, Specialization, and Coalitions

Comment

by

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Professor Alchian's paper covers a broad range of subjects and ideas within the field of economic theory of organization. Right at the beginning he provides a list of 8 possible sources of economic misunderstanding to be found in debates on the role and the functioning of firms. European discussions of economic and institutional questions associated with firms would be enriched if they concentrated more on the kind of issues outlined at the very beginning of the paper. This catalogue could serve as a kind of checklist to find out whether a person participating in discussion within the field has done his homework.

The picture of the economic theory of organization that Professor Alchian unfolds is very stimulating and offers many valuable insights. My comments concentrate on four subjectively chosen points though clearly there are more that could or should be discussed.

1. The Concept of Resource Specificity and its Significance for the Definition of Coalition and Management

A considerable part of the paper is dedicated to development and discussion of the concept of resource specificity based on an earlier and wellknown article by KLEIN, CRAWFORD and ALCHIAN [1978]. This concept is the foundation stone upon which Professor Alchian outlines a general economic theory of contract. Resource specificity exists if a resource's value in the coalition is higher than elsewhere. The higher the specificity of a resource and the higher the expropriable quasi-rent that is inseperably linked with a specific resource, the more integrative and the more long-term-oriented contracting will take place in order to cope efficiently with the risks arising from that situation. Professor Alchian shows convincingly that this kind of reasoning is not restricted to the explanation of firms but is also helpful when applied to that of many other social institutions.

A first question concerns membership. A person is called a coalition member if their "wealth (or utility) is dependent on the actions of the coalition".

Thus it is very difficult to imagine that anyone transacting with another person will not form a coalition for the duration of the contract. The case of pure indifference between alternative courses of action is rare in economic life. Almost willy-nilly, transactions are engaged in because a comparative advantage is discovered which does not seem appropriable otherwise and would be lost if the coalition/transaction fails, with consequent effects upon the respective wealth positions. If this is a correct description of the concept, what would be the meaning of that implication of membership?

However, more important than this aspect is the management question which comes with it. Professor Alchian states that "owners of the coalition-specific resources want to be the managers more than do owners of the general resources". "Any person whose constrained, conditional distribution of effects on values of (specialized) resources in the coalition is wider is more of a manager – no matter what particular tasks he performs."

Two remarks come into my mind when I think about this unusual definition of management:

a. Does this mean that e.g. an operator in a power plant's central control room is more of a manager than the chief executive in charge because the operator's actions, based on the use of very specific know-how, can have more effect on the other's specific resources in the coalition? Similar examples refering to inside specialists or outside suppliers could be found. Are air traffic controllers among the managers of the economy?
b. It seems to me that Professor Alchian's position could serve as an interesting economic basis for institutionalization of participation or codetermination. If ownership of any specific resource brings about influence or even management, we would have available a litmus test for economically legitimate participatory aspirations.
   However, later in the paper, Professor Alchian contradicts that point by arguing that worker participation would be nothing more but a "wealth confiscation scheme". He implies that workers hold only generalized resources. I am not so sure that this is generally true. I can imagine many examples where at least certain groups of floor or office workers and of lower or middle managers do own resources that are highly specific to the coalition.

2. *Explanation of Limited Liability*

Though it is true that transferability of specialized resources is one argument for the formation of institutions with limited liability, especially for companies with public stock, I do not believe that it is the only one. Contrary to Professor Alchian, I believe that risk aversion still plays an important role in explaining limited liability. How otherwise could the fact be explained that there are many companies with limited liability in Germany whose shares are not easy to transfer at all, not to speak of an anonymous transfer. And on the other hand: why is it that many businesses still do have unlimited liability (e.g. lawyers, physicians) and that these businesses, at the same time, are quite easily transferable? Limited liability could not assist them to recover their loss of prestige and human capital in case of a failure.

3. Intra-firm Competition

There is no doubt that it is important to apply economic concepts such as competition within organized institutions. Divisionalized organizations, intra-firm transfer pricing, and intra-organizational labor markets are well-known examples. However, I would like to add two qualifications to Professor Alchian's remarks on that field:

a. Intra-firm competition can only function in an efficient manner, i.e. in a way which improves overall resource allocation, if the firm itself is under external competitive pressure. Otherwise internal competition takes place within a monopoly and degenerates into forms of utility maximizations that do not serve the outside world. Thus, I doubt whether the newspaper example in Professor Alchian's paper is really convincing.
b. One should not overestimate managers' capabilities to "act as surrogate markets". Though an experienced manager's judgement can in some cases substitute for outside market experimentation, this capability is fairly limited. Marketing literature is full of examples of surprises in both directions. Products highly scored by managers failed in the market place and products held in very low esteem by managers became very successful. For many types of products (not all) the information processing abilities and discovery capabilities of markets are much greater than those of most managers.

4. How Important is a Definition of "the Firm"?

Adding to endeavours of others in our profession, Professor Alchian proposes a tentative definition of the firm involving two dimensions: measurement problems of input performance *and* existence of expropriable quasi-rents. On this definition, the putting-out system could not be called a firm. It consists of interspecific resources but it allows for measurement of the marginal productivity of those working at home. Is a craftsman who leaves the accomplishment of single orders to one of his workers, the productivity of the latter being therefore measureable, not the head of a firm? Again, resource specificity is given but not the measurement problem. Thus measurement problems deriving from team production are one possible but not a necessary nor a sufficient reason for profit sharing or employment contracts.

Having such difficulties in mind I would rather and with much pleasure underwrite another statement of Professor Alchian: That the real question is "what kind of contractual relations are institutionalized in what circumstances." One should definitely agree: "It is hard to see what would be lost if the term firm were abandoned, except a source of confusion" and, I would add, a source of unjustified simplification. The at first sight so clear-cut distinction between "market" and "hierarchy" (or firm), to be found in most of our textbooks and even dividing our disciplines, obscures the diverse and much more complex nature of organizational modes suitable for overcoming the great variety of problems arising with the organization of division of labor.

The comparative efficiency of different coordination forms with respect to various contingencies of cooperation is at stake, not firms or markets. If somebody wants to call certain patterns of contractual relations a firm, one should not object. But I do not see the real scientific benefit of such an exercise. However, *there is greater need for a good definition of the entrepreneur, and his integration into an economic theory of organization.* The entrepreneurial function is the starting point and the driving force of a firm, specificity of resources is a consequence of entrepreneurial activity. In order to put promising ideas into effect, the entrepreneur engages in different forms of contracts. I think that a better understanding of the entrepreneurial function is very important for the advancement of an economic theory of business organization. This will probably demand a shift from static to dynamic analysis. New Austrian concepts such as those of Israel KIRZNER [1973], which view the entrepreneur as somebody who discovers and temporarily exploits opportunities for arbitrage or for economizing of transaction costs, could be a fruitful starting point for further work in the field instead of wasting time on definitions of "the firm". *What is called resource specificity in Professor Alchian's approach is from a dynamic standpoint an entrepreneurial investment in order to benefit from some arbitrage opportunity and information advantage discovered in the imperfect world of economic relations.*

References

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