Este texto serviu de base para a minha intervenção no Simpósio ‘Theory of the firm within the field of Business Policy and Strategy’, na reunião anual da Academy of Management em Cincinnati, em Agosto de 1996. Neste Simpósio intervieram ainda Jay Barney, Kathleen Conner, Richard Rumelt, C.K. Prahalad. Estou grato a Jay Barney pelos seus comentários a uma versão anterior deste texto e a Kathleen Conner pelo incitamento a publicá-lo, mesmo assim, o que comete para o seu futuro desenvolvimento

ALL MANAGERS HAVE A THEORY OF THE FIRM

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All managers have a theory of the firm, and their theory of the firm has a strong impact in their decision-making and behavior.
My point is not that of showing that there is a ‘right’ theory of the firm, though I will not refrain from expressing my view. What I hope to leave as a message, is that the Theory of the Firm is relevant for management and should be more researched and taught to managers. Indeed, managers, even of the more ‘practical’ kind, do know a theory of the firm.
What I mean is that most managers have some implicit explanation of why firms exist, and some idea about their purpose, their appropriate size and scope. These ideas are not neutral. They play a direct and decisive role in matters such as strategy and business policy (e.g., why and what to outsource, how to grow, how to diversify, why and how to structure an alliance), organizing (e.g., how to coordinate and control, how to contract with a vendor or a customer), and the management of human resources (e.g., why and whom to hire or fire).
Most managers' theories of the firm consist of non-articulated knowledge, and are an integral part of a manager's mindset. They are rooted in three dimensions: (1) an empirical dimension consisting of insights and generalizations from a manager’s experience actively learned in a hands-on and visceral fashion, (2) a theoretical dimension developed through a managers formal education and professional training, and (3) a cultural dimension reflecting a managers basic assumptions, beliefs, and values directly and indirectly learned from the environment in a mostly passive fashion.
However, even though most managers have an implicit theory of the firm, if you were to ask many of them why firms exist, their answer would usually be: "What do you mean? Firms exist, that's it". As with much tacit knowledge, it is easy for those without it (e.g., in this case, academics) to misconstrue this tacit knowledge, to assume that it is ignorance.

Another manager may answer the same question differently: "Firms exist because of transaction costs. You see, people are limited in their rationality and they are opportunistic, too. That is why we have some activities within the firm, under our control. The rest we just buy out there in the market." In this case, a more articulated theory of the firm is apparent. The theoretical dimension is stronger, at least in an espoused sense. It was acquired, say, when the manager studied the subject of business economics.

The three dimensions of the manager's theory of the firm, the empirical, the theoretical, and the cultural, are not equally present from manager to manager. And they evolve with time, in each of us. The 'practical' manager, not having studied management or economics, will not have the theoretical component. The young 'MBA', out from a school with a strong IO group, will have it. In his case, the empirical dimension is yet small, though the cultural one may be largely shaped already. This is, I believe, an interesting and still open area for inquiry, demanding some grounded research and careful inference.

That most managers have an implicit theory of the firm does not imply that all those theories are the same. Nor does it imply that they are all equally valid. Many manages may have a "wrong" theory of the firm guiding many of their decisions and behavior. Take, for example, the "make versus buy" decision. Often, I have witnessed this decision made solely of the basis of a simple cost comparison: how much does it cost us to produce the good or service required (usually an estimate of the accounting cost of providing the good or service) compared to buying the 'same' good or service in the market. No considerations of transaction costs, opportunity costs, or the long term strategic implications of this decision are included in the decision making process. Because implicit managerial theories of the firm can vary in their validity, examining these theories through research, and sharing the results of this research with managers through teaching, is extremely important.

I have more than twenty years experience as a manager. I first begun to understand what the Theory of the Firm was all about by reading Coase, and his elegant argument of the cost of using price. This was some only some four years ago. Soon thereafter, I read Williamson's development of transaction cost economics. While impressed, I was not convinced. In particular, I felt that such transaction costs logic could not explain the existence of firms I had been associated with. In general, Williamson's transactions cost logic suggests that in a world without opportunism, firms would not exist. I felt that this could not be correct. And, moreover, I believed then, and continue to believe, that the role of management cannot be reduced to suspecting, contracting, and economizing. There is an underlying assumption about the nature of humankind in the conventional formulation of transaction cost economics - and it is not an enlightening one. Add the notion that organizations exist because markets fail, one that transmits a stigma of last recourse. Hierarchies end up being seen as harmful, albeit the least of harms in some unfortunate circumstance. If I was a young MBA, armed with my recently acquired TCE ability, I might end up looking for asset specificity, for opportunistic behavior and for ways to be 'cleverer', for ways of cutting down the cost of transacting in the firm, for contracts pinning down my suppliers, for controls and sanctions- the more the better. Convinced that the market should be present as much as possible, then surely a way to succeed in having a performing corporation is to introduce 'market controls', such as arms-length deals between divisions inside the corporation. Add similar mechanisms even within divisions. The point is that as TCE ends up being normative, it potentially

leads to reactive or negative management - and contradictory management, for that matter, as illustrated by the ‘market controls inside the firm’ exemplar.

More recently, I have become aware of the possibility of a knowledge-based theory of the firm - as in Conner & Prahalad current work. This theory is based on the assumption that different people have different portions of knowledge that are private to them. In this approach, hierarchy is one alternative that people can use to gain access to each other's knowledge. Individuals may well decide to become more productive by utilizing the required portions of knowledge that are private to other individuals. Firms exist because, as the former makes free choices about the organizational mode that is more convenient to them, they may elect to achieve such desideratum by working under the authority of the latter. And, concomitantly, the latter may also favor such form of relating. This arrangement will also be preferred in some instances of adaptation, say, to a changing environment.

For this knowledge-based theory of the firm, bounded rationality suffices. The critical notion is that we all have different knowledge profiles. Order is a choice of knowledge substitution or knowledge flexibility. To order is to substitute knowledge. Hierarchies will therefore exist in a world fully populated by good human beings, as long as we remain “intendedly rational, but only limitedly so”. To start with, the knowledge-based view brings in a more positive feeling. Integration will involve more coordination and less control.

Hierarchies fail. And, when that happens, markets come in (here I consider only the polar forms of organizing, and will not cover networks nor trust). We will have to understand organization failure better. However, let me just briefly state my belief on two major causes for hierarchy failure - both from a knowledge perspective. Firstly, a perceived or a real misfit of knowledge profiles. For example, a manager does not take into proper account the knowledge of the employee and his command eventually substitutes all the employee’s knowledge - with great loss. Secondly, the rigidity of interlocked knowledge profiles. The value of the knowledge stock inevitably depreciates, in time and space. That rigidity, possibly reinforced by the success of the firm, will induce failure by making new knowledge too costly or impossible.

I believe that a manager who uses a knowledge-based theory of the firm will gain an awareness of differences in the knowledge profiles of individuals associated with a firm, and an understanding of how the nature of knowledge may affect the outcome of an economic exchange. The more the articulated portion of knowledge prevails, the easier it is to learn, and the more likely that markets will be used to manage an exchange, and the narrower the scope of operations of a firm - e.g. as in the mold-making industry over the last twenty years or so.

On the other hand, the less articulable and more context dependent the knowledge is, the more difficult it is for others to learn, and the more likely that hierarchies will be used to manage an exchange. Here is a short example, showing how problematic an implicit model and the derived behaviors can be. There are businesses or strategies where personal (or direct) selling is used and which require some specific knowledge about each and many customers. That is difficult for the manager to have, and that points to a form of contract with the salesperson that is different from the typical employment contract, and much nearer to a market contract. A price (‘salary’) may be set that is fully variable. It is not an issue of motivating the salesperson. It is just a form of relating the manager

and the salesperson that clearly establishes boundaries for command and for autonomy. Because of different legal contexts, in the case I know well, there are countries where the more typical employment contract is enforced by law. If I compare the behavior of managers and salespersons in these countries with that of their counterparts in countries where a more market-like contract is used, there are differences. Under the employment contract, the salesperson that is hired tends to be of a lesser entrepreneurial nature, and I observe a remarkable tendency for managers to dictate more.

We should not limit the universe of manager's theories of the firm. I have been exposed to more theories of the firm, coming out from my experience and inquiry on such matters. I will briefly articulate two interesting ones.

The first one will show well the relevance of the culture dimension, repeatedly forgotten. In some national cultures, unlike the American one, there are strong collective beliefs and values that may well be together with a large acceptance of power differences. This is the case of many Asian countries and a couple of European countries (e.g., Portugal). It should not be a surprise to find that the existence of firms may be explained by a somewhat moral theory: society includes persons with different 'strength'; it is the role of the stronger ones to protect the weaker, and they should do so with kindness.

In the economic context, managers may share the deep belief that firms exist for that purpose - for stronger elements of society to protect the weaker. Big firms are not necessarily desirable, because humanity will be hard to preserve. The scope of firms is not an issue, but is dealt with indirectly through size. Once again, this theory of the firm has managerial implications, and these may be hard to understand from another cultural point of view. To start with, employment for life is pervasively implicit. I know of managers that refuse to fire people, or do so only as a last resort - sometimes too late. For each individual in the firm, after a certain period, the issue is no longer that of having the right person for the job. What a manager must find is the right job for the person.

Another example is what I could name an entrepreneur’s theory of the firm: firms exist for people to realize a dream. This happens when the entrepreneur’s dream can not be attained in the market. He has to build and lead a hierarchy for his dream to come true. There is here a notable link with a knowledge-based theory, in the sense that the dream can be interpreted as tacit knowledge that the entrepreneur owns exclusively - something he saw that others can't see. This is where the firm is an opportunity-exploiter, much more than a problem-solver. The scope of the firm has to do with its integrity, a key element in the eyes of both the consumers and the employees. As far as firm size is concerned, there seems to be only one direction: to grow, until the dream is fulfilled. Once more, there is an apparent managerial relevance for this theory of the firm - one, by the way, where the empirical dimension is dominant.

Clearly, as managers live, understand and interpret their own experiences, they develop an implicit theory of the firm. However, these implicit theories in use would gain considerably if they were developed, formalized, and tested. That is a role that can best be accomplished by academic researchers, working closely with managers. Though wisdom cannot be taught, the process of acquiring wisdom can be informed by the experience and knowledge of others.

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