MANAGEMENT VS. THE MARKET: AN EXAGGERATED DISTINCTION

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Why do business firms exist? Do firms substitute for the market or complement the market? Why do firms buy some inputs but make others?

These are basic economic questions. Economists of different methodological stripes, as well as business historians, have attended to these questions, and their work has helped us better understand the functioning of the firm, but the leading answers to these questions fall short. It is the purpose of this article to show that Austrian economics provides some needed insight to the study of the firm.

COASE AND THE FIRM

The leading theory of the firm in economics largely remains the theory offered by Ronald Coase in his famous 1937 article, "The Nature of the Firm." Coase lays out the matter at hand.

> Outside the firm, price movements direct production, which is coordinated through a series of transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production. It is clear that these are alternative methods of coordinating production. Yet, having regard to the fact that if production is regulated by price movements, production could be carried on without any organization at all, well we might ask, why is there any organization? (Coase 1988, pp. 35–36)

To Coase, what makes a firm a firm is vertical integration. When every level of a production process is carried out by independent contractors, Coase classifies it as production coordinated by the market. But when several levels of production are undertaken by a single entrepreneur, that arrangement is classified as a firm, an alternative to the market. In Coase's words: "A firm consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur" (ibid., pp. 41–42).

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Why do firms come into existence? Coase explained that in organizing production, a businessman must decide between using the market and managing. That is, he must decide whether to buy certain inputs on the market or to produce the inputs himself. There are costs either way. If he uses the market, he must determine what inputs are available and what the characteristics of those inputs are; he must negotiate contracts to use the inputs, and then he must make sure the terms of the contract are observed. If he produces the inputs himself, he must manage that production and incur all the costs that managing entails. The businessman will choose the alternative which he believes costs less. When it costs less to purchase inputs on the market, he uses the market. When it costs less to manage, he becomes an entrepreneur, and his operation becomes a firm; he supersedes the market, and produces inputs himself. In other words, firms come into existence when the cost of managing is less than the cost of using the market.

Coase uses his notions of managing costs and the costs of using the market to explain not only the existence of firms but also the size of firms. Firms grow so long as the costs of using the market exceed the costs of managing. The optimal size of a firm is attained when, at the margin, the costs of managing equal the costs of using the market.

CHANDLER AND THE FIRM

Another perspective on the firm to consider is that of business historian Alfred Chandler in his 1977 book *The Visible Hand: The Managerial Revolution in American Business*. Few works have influenced a discipline as much as Chandler's *Visible Hand* has influenced business history.

The Visible Hand is a rich history. Its theme is that "modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating its resources" (Chandler 1977, p. 1). Before the rise of the modern business enterprise, Chandler argues, American business firms were small, single-unit operations which generally produced a single product for a small geographic area. The activities of these firms "were coordinated by market and price mechanisms" (ibid., p. 3). But the modern business enterprise is a large, multi-unit operation which often produces many different products for many locations. Their activities, according to Chandler, are not coordinated by the market, but by managers. Specifically, "modern business enterprise took over the functions of coordinating flows of goods through existing processes of production and distribution, and of allocating funds and personnel for future production and distribution" (ibid., p. 1). In other words, the advanced enterprise superseded the market, and it did so because "administrative coordination permitted greater productivity, lower costs and higher profits than coordination by market mechanisms" (ibid., p. 6).

Chandler and Coase would find some things to disagree about, to be sure, but considering how enormously different the business historian's approach to the firm is from the economist's, the similarities in the two scholars' views are striking. Each

sees vertical integration as the distinguishing feature of the firm. Each views management as a substitute for using the market. And each argues that firms supersede the market when managing costs less than using the market.

MANAGEMENT VS. THE MARKET?

Coase and Chandler can teach us much about the firm. However, the view that managing is fundamentally distinct from using the market is false.

What does using the market really mean? Coase is correct, of course, that there are costs to using the market. There are costs to any action. But when a firm searches the market to determine what inputs are available and how they might be employed, when it negotiates contracts to use the inputs, and when it measures and monitors the performance of the inputs, what is it doing? Isn't it managing?

We could say that what using the market really means is managed buying, and then press on with the Coase and Chandler argument by saying that the firm will produce its own inputs when the costs of managed buying exceed the costs of managed production, but to do so still leaves plenty of confusion. When a firm chooses to produce some of its own inputs and hires managers to coordinate that production, is it really superseding the market? Coase and Chandler say yes, but how does the firm come upon its managers? It buys their services in the market. Isn't that using the market?

The point is that the firm's decision to produce an input or buy it on the market —its make-or-buy decision—cannot be explained by creating a distinction between managing and using the market. No matter which decision the firm makes, the firm must manage and it must use input markets. Buying an input involves a whole series of decisions which amounts to managing; making an input requires the firm to use the market for managers. In other words, the firm's make-or-buy decision is not a decision about whether to manage or use input markets; it is a managerial decision about which input markets to use.

Above all, it is a profound error to assert that by employing managers to coordinate production a firm supersedes the market. Recall Chandler's thesis in *The Visible Hand*: "Modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating its resources." Not but ten pages later Chandler qualifies his theme. He states:

> The new bureaucratic enterprises did not, it must be emphasized, replace the market as the primary force in generating goods and services. The current decisions as to flows and the long-term ones as to allocating resources were based on estimates of current and long-term market demand. What the new enterprises did do was take over from the market the coordination and integration of the flow of goods and services from the production of raw materials through the several processes of production to the sale to the ultimate consumer. (Chandler 1977, p. 11)

But how can it be that the modern business enterprise supersedes the market "in coordinating the activities of the economy and allocating its resources" when the market is "the primary force in generating goods and services?"

Chandler disciple William Lazonick makes the same error. Lazonick writes: "History shows that the driving force of successful capitalist development is not the perfection of the market mechanism, but the building of organizational capabilities" (Lazonick 1991, p. 8), and further, "Through managerial coordination, industrial corporations were able to develop the combined productive capabilities of human and physical resources in ways that market coordination, with its unplanned interaction of specialized producers, was unable to do" (ibid., p. 29). What must a business organization do to be successful? According to Lazonick, "it *must* develop its productive resources in order to produce a superior product at competitive cost, a saleable product at lower cost, or both" (ibid., p. 199). Yet, what is it that compels business organizations to attempt such things but market competition?

The notion that the firm supersedes the market is a variation of the socialist calculation error. Coase explicitly makes the socialist calculation error in "The Nature of the Firm." Of managing within the firm, Coase writes:

> Those who object to economic planning on the grounds that the [coordination] problem is solved by price movements can be answered by pointing out that there is planning within our economic system which is quite different from the [use of the price mechanism] and which is akin to what is normally called economic planning. (Coase 1988, p. 35)

But managing and planning the firm are not at all akin to "what is normally called economic planning." The market is not the impersonal buying and selling of goods and resources by independent contractors. The market is a system of private ownership rights which guides and constrains the actions people take to improve their situations. The market mechanism is the actions people take under a system of private ownership rights. The firm is a market institution. Firms are created and organized in certain ways by people seeking to improve their situations under a system of private ownership rights. Creating and organizing firms are part of the market mechanism. Hiring managers in an attempt to seize opportunities and create value is part of the market mechanism. Take away the market and the whole process in which people make economic decisions changes. Take away the market and there is no firm of the type we wish to better understand.

In other words, *managing* cannot be disassociated from *using* the market. There is a difference between making an input and buying it, of course, but the choice exists because of the market, and the choice is part of the market mechanism. The firm and all its actions cannot be disassociated from the market and the market mechanism.

THE FIRM AND THE MAKE-OR-BUY DECISION: AN AUSTRIAN PERSPECTIVE

It would be remiss to leave the matter of the firm and its make-or-buy decision hanging. So if we are to understand the firm and its make-or-buy decision, our focus should not be on the costs of making an input versus the costs of buying an

input, but on the people who make the decision—entrepreneurs—and the environment in which they make the decision—the market. Comparing costs will likely lead us to a dead end for a number of reasons.

1. Costs are subjective. Costs are foregone alternatives, and the only relevant alternatives are those which an entrepreneur perceives. An entrepreneur asks: "How can we make our product? What alternatives do we have? Can we buy the inputs? Can we make the inputs?" The costs the entrepreneur confronts depend on how he answers those questions. And because the perceptions of entrepreneurs differ, the costs of buying an input versus the costs of making an input will differ from firm to firm.

2. Costs are uncertain. An entrepreneur does not know what it costs to produce a good until he produces it. He will anticipate expenditures and can compare anticipated expenditures to current and past expenditures and to the expenditures of other firms, but he cannot know his costs until he acts. And even then, he can never know what those costs *ought* to be. Neither can we.

3. Costs depend on the abilities of entrepreneurs. Entrepreneurs are not all alike; some are more daring, more ambitious, more perceptive, and more adept at economic calculation than are others. What that means is the productivity of an input depends not only on what the input is employed to do, but also on which entrepreneur employs it. This is another reason why the costs of buying an input versus the costs of making an input will differ from firm to firm.

It is certainly worthwhile for economists to think about the general kinds of costs firms incur when they make or buy inputs, but I do not believe that a general understanding of, say, agency costs or search costs will help us understand why a firm makes some inputs and buys others. As mentioned, the costs of making an input versus the costs of buying an input will differ from firm to firm.

What we can say about costs is that the firms with the lowest costs are the firms with the greatest entrepreneurial ability. As Kirzner and other Austrian scholars have pointed out, entrepreneurship can be found—and in the most successful firms *is* found—at many levels of a firm. Creating a firm is entrepreneurship, supplying capital to a firm is entrepreneurship, innovative managing is entrepreneurship. The most successful firms are organized in ways that persistently stimulate entrepreneurship at many levels. Such types of organization are quite complex and are extremely difficult for other firms to replicate. So it is likely that firms with great entrepreneurial ability will be able to produce a range of products—including some inputs—at less cost than other firms.

Firms with great entrepreneurial ability will perceive opportunities where other firms do not, and will be able to exploit those opportunities where other firms cannot. It may well be the case, as Coase and Chandler argue, that firms vertically integrate to reduce costs. But it might also be the case—and I believe it is more likely the case— that firms vertically integrate *because* they have lower costs as a result of their superior entrepreneurial ability. Even if Coase and Chandler are correct, entrepreneurship is the force behind vertical integration because entrepreneurship is what it takes to discover that vertical integration reduces costs.

Thus, the size of firms and the number and types of products they produce will vary with the entrepreneurial ability of firms. That proposition is not novel, except here it is grounded in Austrian theory.

Austrian scholars have noted many times over that entrepreneurship is inherently speculative. The make-or-buy decision is a case in point. For entrepreneurs, the make-or-buy decision is anything but a well-defined problem; it's a gamble. At the time they make the decision, entrepreneurs do not know if their decision is correct or incorrect. Time and the market will inform them of that.

A story Chandler tells about the American Tobacco Company illustrates a number of the points addressed in this article. In the early 1900s, James Duke's American Tobacco Company attempted to dominate the cigar market in the same way that the firm had come to dominate the cigarette market. The attempt failed. Why? In Chandler's own words:

> Like wines the many different brands of cigars had distinctive tastes and flavors. Each appealed to a different type of customer. Cigars were not a product that could be mass produced and mass distributed, nor could the raw materials be produced in bulk. Since these processes did not lend themselves to high-volume throughput, administrative coordination did not reduce costs and so raise barriers to entry. Neither massive advertising nor effective organization could bring the dominance of a single firm to the cigar business. (Chandler 1977, p. 390)

There is no such thing as a firm superseding the market.

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