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SCALING THE CORPORATE WALL

READINGS IN BUSINESS AND SOCIETY

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Readings in Business and Society

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PREFACE

This anthology represents a continuity of effort first presented in *Business and Society: Dimensions of Conflict and Cooperation*, edited by S. Prakash Sethi and Cecilia M. Falbe (Lexington Books, 1987), and more recently in *Scaling the Corporate Wall: Readings in Social Issues of the Nineties*, edited by S. Prakash Sethi, Paul Steidlmeier and Cecilia M. Falbe (Prentice Hall, 1991). Our approach in this compendium, as in the previous instances, has been to present a systematic, albeit evolving, framework, encompassing advances in theory development, and various approaches to problem identification, analysis, and issue resolution, in the ever-changing and enlarging domain of the context of business-society interface. The issue-analysis arena draws from a number of fields including management, economics, political science, sociology, philosophy, ethics, and law. Therefore, in search of appropriate materials, we have drawn from professional and scholarly journals covering diverse fields of social enquiry. To these have been added a number of invited original essays by scholars representing distinct points of view and perspectives that provide a newer approach to examining both the existing and emerging issues involving business-society relationships.

The book has been organized in eight major subject areas and includes thirty-one articles. It is by no means a comprehensive collection touching all facets of our enquiry. From some perspectives, it may not even be considered a representative collection. For the selection of articles reflects the preferences and subjective, albeit professional, judgments of the editors in bringing about what is significant and elucidatory in a narrative form. Notwithstanding, we believe that the outcome of these combined judgments should provide the readers with a rich, diverse, and provocative treatment of the subject matter in hand while provoking them with intriguing, and hitherto, unanswered questions and opening up new fields of enquiry for further exploration.

In the opening segment of the book, we address the concept of competitive dynamics and the characteristics of market economies in affecting production and distribution of wealth, the role of the individual entrepreneur, and its organized counterpart, i.e., the firm. The first two papers in this section by Coase and Demsetz have for some time been the bellwether for those who would undertake a more critical analysis of the nature and function of the firm. This reflection is fundamental to the whole of business and society endeavor. It cannot be simply assumed that a firm is merely a "profit maximizer" or that managers are dedicated to "maximizing shareholder return on investment" or, more importantly, that they should somehow ideally attempt to do so. The firm manifests a far more subtle nexus of interrelationships than the canons of economic rationality might suggest.

Along similar lines, the work of Harris and Carman leads us to question our presuppositions concerning the actual nature of markets and regulation. The authors describe the conditions of "ideal markets" that provide the foundation of microeconomics and the economic theory of the firm. This is followed by a discussion of imperfections in the operations of perfect markets leading to "market failures" and creates grounds for market regulation. Even ideal markets, or markets approaching perfection, may not be completely socially acceptable because the market-created income distributions were perceived by large segments of society to be inequitable and unfair. The authors go on to provide an equally insightful discussion to suggest that market failures can have their counterpart in "regulatory failures" and that given a set of circumstances, imperfect markets may be preferable to regulated markets and vice versa.

The section on Business Ethics (Section II) provides a more direct contrast between the logic of economic rationality and the moral basis of human economic behavior. It critically examines both the opportunities and constraints that a market-based competitive economy imposes on individuals and firms in their effort to engage in business and economic activities. The first article by Sen takes the basic lifeblood of the economic system, that is money, and subjects it to an analysis of value. In so doing, he offers a stimulating critique of contemporary financial practices by subjecting the notions of economic use-value to a broader critique of human fulfillment. The next article by Sethi raises the issue of ethics in the marketplace. Sethi demonstrates that, even if the ideal conditions of economic theory were fulfilled, market dynamics do not always tend toward the realization of ethical behavior. These ideas force us back to the question raised earlier by Harris and Carman. To wit, assuming that markets function efficiently, one must ask under what conditions is it possible for the market milieu to create an ethical environment? The article in this section by Donaldson and Dunfee argues in favor of the notion of a "social contract" as the basis for a unified conception of business ethics. They assert that it is the notion of contract that lies at the core of both a market economy and a democratic polity. The social contract itself represents an ideal thought experiment designed to ensure justice and fairness. In its origin, social contract has secular roots recognizing as valid only that authority which is voluntarily conceded by those who would be subjected to it. The final article by Taka presents a Japanese view of business ethics and asks us to consider the cultural limitations (as well of the richness) of our conceptualizations of the business and society interface.

Section III covers one of the thorniest areas of business-society interface by focusing on the legitimacy of the right of managers to control a corporation's resources and how that legitimacy affects the rights of various stakeholders on the one hand and that of social relevance and corporate performance on the other hand. In the lead article, Bratton gives us a tour de force of different theories and rationalizations that have been offered over time to define the scope and justify the authority of corporate management over a corporation's resources. He critically examines the legal dogma of stockholders owning the corporation and managers operating the corporation under the direction of a representative board of directors elected by the corporation's owners. Having demonstrated the fallacy of effective shareholder control and accepting the fact of corporate management as a self-perpetuating oligarchy, he examines various theoretical and practical arguments currently in vogue that justify managerial authority or seek to impose constraints upon its use. In doing so, he offers a succinct description and critical assessment of various theories of corporate governance ranging from managerialism to transaction-contract and from stockholder to stakeholder. Within the same general perspective, but from a management vantage point, Jensen depicts the changing nature of the public corporation in terms of its interactions with its various constituents as well as in terms of its governance structures.

The role of board of directors and how it might be made more effective is the subject of the remaining two articles in this segment. Weidenbaum chronicles the evolving character, nature and function of corporate boards. Cochran, Wartick and Skaggs, on the other hand, underscore the cozy, if not incestuous, relationships that can develop between a corporation's board of directors and its top managers, such that the latter opportunistically serve their own narrow career interests rather than the interests of shareholders, much less those of other stakeholders in society.

The area of Social Issues in Management is explored in Section IV. Whether business creates the issues that society then must cope with, or whether society's ills constrain the activity of the firm, the dynamic of the business-society relationship is certain to exert pressure on a firm's management to examine the values it applies to the firm's decisions, define its relevant constituencies, and account for its social performance. The first two articles appearing in this section present the theoretical underpinnings toward developing a framework for understanding corporate social performance. Sethi advances the concept of social responsibility to one of social accountability by considering those economic and institutional factors that establish the parameters of the corporation's ability to act ethically. He argues for a consideration of these factors both in evaluating corporate performance and in generating programs and creating incentives that will serve to promote positive social behavior. Swanson, in her article, argues in favor of a new normative and operational model for evaluating corporate social performance that synthesizes previously competing orientations to business and society research. In so doing, she reformulates the existing perspectives to arrive at an interactive approach to the business-society relationship, linking individual, institutional and societal ethics in a non-hierarchical configuration.

Moving from the broader theoretical realm to more concrete dilemmas, the next two articles deal with defining who are the stakeholders of the corporation and the extent of their relative stakes. While it is accepted that managers generally must deal with a wide variety of constituents, it is not always so clear why, in a moral sense, they may be obligated to do so nor what is owed each constituent who raises his or her voice. Beginning with a discussion of stakeholder theory, Donaldson and Preston argue that stakeholder claims must rest on a foundation of normative principles. Next, Williams speaks to the specific conflict between corporate and stakeholder interests as characterized by the actions and demands of citizen activist groups. Using illustrative real-world examples, he explains how pressure can be brought to bear on corporations to adopt policies that are in better harmony with societal expectations of good corporate behavior. In the final article, Shrivastava presents a model of ecocentric management in terms of risk and industrial ecosystems. He views industry in ecological terms and rejects more traditional perspectives that regard the environment as an independent externality.

The collection of four articles in Section V examine the impact of the news media on business activities. In the first article, Riley examines the uncritical way in which major business magazines and newspapers portray corporate leaders arising from their eagerness to please advertisers and upper-level managers who are their audience. In their ambition to pump up circulation and ad revenues, the press has created a cult of the business personality, making journalists into hagiographers and lionizing certain CEOs even in the face of serious problems with their performance or that of their companies. Riley focuses on the way the business press covers AIDS as an example of how the truth is modified to suit the corporate point of view.

The media's capacity for making or breaking reputations and framing public perception is well-depicted in the next article. Abolafia traces the rise and fall of Michael Milken as an illustration of how valiant heroes can be transformed by the press into demonic villains by virtue of their non-conformance to social expectations and lack of restraint. The author exposes the 1980s as a decade of greed and misdeeds during which corporate elites, finding themselves threatened by the unorthodox tactics of Wall Street-backed raiders, sought methods of redress to restore the social balance that had previously favored them. While Americans were held transfixed by the media events swirling around the personages central to this drama, the social fabric of our financial institutions unravelled to reveal motivations and behaviors that belied the public's self-image.

In this section's last article, Sharpe demonstrates how the role of the media can be pivotal in creating public awareness around issues that might otherwise be obscured by corporate public relations efforts. In "Losing Ground," the plight of Blacks in their attempt to climb the corporate ladder is unfolded, disclosing the numbers that argue against company claims of minority empowerment. Here, the media is wielded as a tool for prying open the doors of prejudice that seal off opportunities for Blacks in American society, and unlock the myth of minority advancement at the expense of the majority.

The role of organizational culture in explaining corporate social performance (Section VI) adds another important dimension to this anthology. A great variety of corporate accomplishments—as well as corporate sins of omission and commission—are attributed to corporate culture. Notwithstanding the importance of the association between culture and corporate social performance, the phenomenon is poorly understood and has suffered from a lack of systematic research. In part, this neglect can be attributed to the fact that culture-related research has been carried out in a number of disciplines whose connection to the study of business and management was at best tenuous, and at worst, nonexistent. As a result, there was little useful material available on how organizational culture affects business activity and corporate social performance, and how (or even whether) organizational culture can be managed. In the absence of sound knowledge of how an institution's culture is developed and maintained, and the roles culture can play in an organization, it is difficult to understand the relationship between corporate culture and performance. Fortunately, a number of important integrative theoretical and empirical pieces have appeared recently that have meaningful implications for managers that offer useful insights.

The paper by Trice and Beyer provides us with an overview of the most important issues in culture research. It sorts out some of the major disagreements regarding the characteristics of culture including whether there are single or multiple cultures in an organization, the extent to which we can generalize about cultural elements across organizations, and the extent to which cultures are malleable or rigid. In the next article, Fiol writes from the resource-based perspective of the firm. The author is critical of the two traditional approaches to culture —deep level assumptions and surface level behavioral manifestations—noting that neither contributes much to the study of competitive analysis. She reframes the concept of culture and introduces the notion of contextual identities to link behaviors and their social meaning in organizations. Managing the cognitive aspect of distinctive competency is to manage the linkages between identities and abstract cultural values and identities and behavioral expressions of these values. Applying Fiol's framework to corporate social performance shows promise for explaining the persistence of types of corporate behavior.

The article by Jackson and Alvarez discusses managing diversity in light of the recent increase in service businesses, global competition and the resulting restructuring of organizations. It includes an overview of the types of diversity that reflect changes in the labor force including cultural, gender and age diversity as well as diversity in corporate cultures as a result of mergers and alliances. The authors note that in a recent major survey of business managers, the most frequently cited problem in managing customer and client alliances was differences in corporate cultures.

As recent news events relate, the image of the corporation as good citizen has been sorely challenged if not shattered by the line of corporate executives in the docket. Part of the business-society landscape depicts corporate illegal behavior, and this is the subject of Section VII. The focus of this section is to define the scope of corporate behavior that is deemed illegal and socially unacceptable; various mechanisms developed by society to detect corporate illegal behavior and measures that might be used to seek restitution for the victim, and punish the culprit; and, even more important, deter future illegal behavior on the part of the corporations and individuals within corporations.

In the first article, authors Holcomb and Sethi examine the effectiveness of existing systems of punishment for corporate crime in actually deterring recidivism, controlling excesses, and in appropriately addressing the scope of the problem. They argue for a more comprehensive understanding of the conditions that enable criminal activity, both internal and external to the organization, in order to arrive at legal remediation that serves the twin objectives of deterrence and economic survival of the firm. Too often, the current legal standards neglect the complexities of organizational life contributing to corporate misdeeds, such as political power, decision-making patterns, and competitive pressures. Lack of identifiable individual accountability for corporate misdeeds renders the process of criminal punishment less than equitable from the viewpoint of all concerned parties. The authors recommend the development of a new model of corporate liability whereby deterrents to crime that simultaneously permit the firm to meet its objectives be constructed with an eye to benefiting social welfare.

An interesting comparison between the effectiveness of the American and the Japanese legal systems in curtailing corporate crime in their respective societies is brought forth by Laufer and Cohen. The authors point to cultural determinants of the relative ability of each society to control deviance and suggest that reliance on social control in Japan over more formal, legal mechanisms for deterrence, has been relatively effective. However, as the borders between Japan and the West become more indistinct, the call for more rigorous regulation of Japanese corporate activity intensifies. In the final analysis, both societies are cautioned against an overreliance on either borrowed principles from a distant culture, or on tradition-bound rituals that serve expediency at the expense of uprightness.

The final section (Section VIII) of the anthology addresses a number of issues pertaining to the international dimension of business-society interface. It is well-nigh impossible to treat this subject with any degree of completeness in this book given the enormity of the subject matter and its complexity. Therefore, we have confined ourselves to addressing the issues along those dimensions that we feel are of particular importance to corporate executives and students concerned with business-society issues within an international context.

The first article by Sethi, Kurtzman, and Bhalla challenges the notion of "global village" which has become the defining rhetoric in the supposedly ever-increasing interdependence of nations in international trade and investments; its implications in terms of globalization of our concerns in business behavior; and, the role of national governments and regional bodies in creating both generalized and country-specific conditions for acceptable corporate behavior. This article suggests that while there may indeed be a "global village," it is confined to a small part of the globe and a small minority of the world's population living in the First World. The vast majority of the world's people live under conditions best described as the Third and the Fourth Worlds. These people have no concept of the First World, do not share in its economic largesse and are not privileged to live under enlightened social organizations and democratic political systems. And yet, this other "global village" cannot be ignored without imperiling the progress made in the First World.

The next two articles by Preston, and Sethi and Bhalla, address the issue of new policy regimes that define and create order for conducting international economic relations on the one hand and business-government relations on the other hand. Preston's paper provides a theoretical framework describing various types of international policy regimes and how they operate to facilitate international economic relations at the international, regional and national levels. In particular, he describes the new international (supranational) organizations, created by the United Nations and other regional political systems to address emerging issues in international economic relations. Sethi and Bhalla report on the working of one such regime where an international body, that is, the World Health

Organization, created an international code to regulate and guide the marketing and promotional activities of multinational corporations in the sale of infant formula products. Unfortunately, the prognosis of the two authors as to the working of the new policy regimes, at least in this case, was not very encouraging. Notwithstanding the fact that the code was enacted with an almost unanimous consent by the voting member nations and was urged upon by the Third World countries, these countries have been singularly remiss in creating the implementing mechanisms to put the code into practice in their home countries.

Another approach to policy regimes is suggested by Curwen wherein he discusses the new European Community Charter of the Fundamental Social Rights of Workers, usually known as the European Charter. The Charter was enacted in May 1990. Although, as yet it does not have a legal force, it contains a mandate allowing the European Commission to set out detailed proposals on workers' rights in twelve areas, including employment and remuneration; improvement of living and working conditions; rights to social protection, freedom of association and collective bargaining, vocational training, equal treatment of men and women, information, consultation, workers' participation, health protection, workplace safety, and, protection of children and adolescents, elderly, and the disabled.

The last two articles by Morfopoulos and Falbe, and Steidlmeier examine the influence of U.S.-based social activists on the behavior of U.S. multinational corporations (MNCs) in their overseas operations. Morfopoulos and Falbe examine the phenomenon of labor practices in plants in Third World countries whose product is sold primarily, if not, exclusively to the First World multinational corporations. The contentious issue in this case is the often abysmal work conditions and low wages of the workers and the extent to which MNCs should be held responsible for the actions of these subcontractors who are independent businesses and are invariably acting within the framework of local laws and customs. They analyze two instances where U.S. companies, namely, Nike and Levi Strauss, have been subjected to criticism and pressure by U.S. activist groups for their actions, or lack thereof, with regard to working conditions in the plants of their subcontractors in developing countries. At a more macro level, Steidlmeier examines the attempt by U.S.-based social activists in bringing pressure on the U.S. companies with investments in China in order to improve that country's human rights record and workers' rights. His analysis shows that such actions are, at best, of limited value where the country involved offers highly attractive investment opportunities; enterprises from other industrially advanced nations are not compelled to follow similar policies; and political and national security considerations severely limit the ability and desire of the governments of industrially advanced nations of the West to force the issue.

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THE NATURE OF THE FIRM (1937)

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Economic theory has suffered in the past from a failure to state clearly its assumptions. Economists in building up a theory have often omitted to examine the foundations on which it was erected. This examination is, however, essential not only to prevent the misunderstanding and needless controversy which arise from a lack of knowledge of the assumptions on which a theory is based, but also because of the extreme importance for economics of good judgment in choosing between rival sets of assumptions. For instance, it is suggested that the use of the word "firm" in economics may be different from the use of the term by the "plain man."[1] Since there is apparently a trend in economic theory towards starting analysis with the individual firm and not with the industry,[2] it is all the more necessary not only that a clear definition of the word "firm" should be given but that its difference from a firm in the "real world," if it exists, should be made clear. Mrs. Robinson has said that "the two questions to be asked of a set of assumptions in economics are: Are they tractable? and: Do they correspond with the real world?"[3] Though, as Mrs. Robinson points out, "More often one set will be manageable and the other realistic," yet there may well be branches of theory where assumptions may be both manageable and realistic. It is hoped to show in the following paper that a definition of a firm may be obtained which is not only realistic in that it corresponds to what is meant by a firm in the real world, but is tractable by two of the most powerful instruments of economic analysis developed by Marshall, the idea of the margin and that of substitution, together giving the idea of substitution at the margin.[4] Our definition must, of course, "relate to formal relations which are capable of being *conceived* exactly."[5]

I

It is convenient if, in searching for a definition of a firm, we first consider the economic system as it is normally treated by the economist. Let us consider the description of the economic system given by Sir Arthur Salter.[6] "The normal economic system works itself. For its current operation it is under no central control, it needs no central survey. Over the whole range of human activity and human need, supply is adjusted to demand, and production to consumption, by a process that is automatic, elastic and responsive." An economist thinks of the economic system as being co-ordinated by the price mechanism and society becomes not an organization but an organism.[7] The economic system "works itself." This does not mean that there is no planning by individuals. These exercise foresight and choose between alternatives. This is necessarily so if there is to be order in the system. But this theory assumes that the direction of resources is dependent directly on the price mechanism. Indeed, it is often considered to be an objection to economic planning that it merely tries to do what is already done by the price mechanism.[8] Sir Arthur Salter's description, however, gives a very incomplete picture of our economic system. Within a firm, the description does not fit at all. For instance, in economic theory we find that the allocation of factors of production between different uses is determined by the price mechanism. The price of factor *A* becomes higher in *X* than in *Y*. As a result, *A* moves from *Y* to *X* until the difference between the prices of *X* and *Y*, except in so far as it compensates for other differential advantages, disappears. Yet in the real world, we find that there are many areas where this does not apply. If a workman moves from department *Y* to department *X*, he does not go because of a change in relative prices, but because he is ordered to do so. Those who object to economic planning on the grounds that the 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 individual planning mentioned above and which is akin to what is normally called economic planning. The example given above is typical of a large sphere in our modern economic system. Of course, this fact has not been ignored by economists. Marshall introduces organization as a fourth factor of production; J.B. Clark gives the co-ordinating function to the entrepreneur; Professor Knight introduces managers who co-ordinate. As D.H. Robertson points out, we find "islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk."[9] But in view of the fact that it is usually argued that co-ordination will be done by the price mechanism, why is such organization necessary? Why are there these "islands of conscious power"? Outside the firm, price movements direct production, which is co-ordinated through a series of exchange 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 co-ordinator, who directs production.[10] It is clear that these are alternative methods of co-ordinating 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 might we ask, why is there any organization?

Of course, the degree to which the price mechanism is superseded varies greatly. In a department store, the allocation of the different sections to the various locations in the building may be done by the controlling authority or it may be the result of competitive price bidding for space. In the Lancashire cotton industry, a weaver can rent power and shop-room and can obtain looms and yarn on credit.[11] This co-ordination of the various factors of production is, however, normally carried out without the intervention of the price mechanism. As is evident, the amount of "vertical" integration, involving as it does the supersession of the price mechanism, varies greatly from industry to industry and from firm to firm.

It can, I think, be assumed that the distinguishing mark of the firm is the supersession of the price mechanism. It is, of course, as Professor Robbins points out, "related to an outside network of relative prices and costs,"[12] but it is important to discover the exact nature of this relationship. This distinction between the allocation of resources in a firm and the allocation in the economic system has been very vividly described by Mr. Maurice Dobb when discussing Adam Smith's conception of the capitalist: "It began to be seen that there was something more important than the relations inside each factory or unit captained by an undertaker; there were the relations of the undertaker with the rest of the economic world outside his immediate sphere . . . the undertaker busies himself with the division of labour inside each firm and he plans and organises consciously," but "he is related to the much larger economic specialisation, of which he himself is merely one specialised unit. Here, he plays his part as a single cell in a larger organism, mainly unconscious of the wider role he fills."[13]

In view of the fact that while economists treat the price mechanism as a co-ordinating instrument, they also admit the co-ordinating function of the "entrepreneur," it is surely important to enquire why co-ordination is the work of the price mechanism in one case and of the entrepreneur in another. The purpose of this paper is to bridge what appears to be a gap in economic theory between the assumption (made for some purposes) that resources are allocated by means of the price mechanism and the assumption (made for other purposes) that this allocation is dependent on the entrepreneur-co-ordinator. We have to explain the basis on which, in practice, this choice between alternatives is effected.[14]

II

Our task is to attempt to discover why a firm emerges at all in a specialized exchange economy. The price mechanism (considered purely from the side of the direction of resources) might be superseded if the relationship which replaced it was desired for its own sake. This would be the case, for example, if some people preferred to work under the direction of some other person. Such individuals would accept less in order to work under someone, and firms would arise naturally from this. But it would appear that this cannot be a very important reason, for it would rather seem that the opposite tendency is operating if one judges from the stress normally laid on the advantage of "being one's own master."[15] Of course, if the desire was not to be controlled but to control, to exercise power over others, then people might be willing to give up something in order to direct others; that is, they would be willing to pay others more than they could get under the price mechanism in order to be able to direct them. But this implies that those who direct pay in order to be able to do this and are not paid to direct, which is clearly not true in the majority of cases.[16] Firms might also exist if purchasers preferred commodities which are produced by firms to those not so produced; but even in spheres where one would expect such preferences (if they exist) to be of negligible importance, firms are to be found in the real world.[17] Therefore there must be other elements involved.

The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of "organizing" production through the price mechanism is that of discovering what the relevant prices are.[18] This cost may be reduced but it will not be eliminated by the emergence of specialists who will sell this information. The costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account.[19] Again, in certain markets, e.g., produce exchanges, a technique is devised for minimizing these contract costs; but they are not eliminated. It is true that contracts are not eliminated when there is a firm but they are greatly reduced. A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is co-operating within the firm, as would be necessary, of course, if this co-operation were as a direct result of the working of the price mechanism. For this series of contracts is substituted one. At this stage, it is important to note the character of the contract into which a factor enters that is employed with a firm. The contract is one whereby the factor, for a certain remuneration (which may be fixed or fluctuating), agrees to obey the directions of an entrepreneur *within certain limits*.[20] The essence of the contract is that it should only state the limits to the powers of the entrepreneur. Within these limits, he can therefore direct the other factors of production.

There are, however, other disadvantages—or costs—of using the price mechanism. It may be desired to make a long-term contract for the supply of some article or service. This may be due to the fact that if one contract is made for a longer period, instead of several shorter ones, then certain costs of making each contract will be avoided. or, owing to the risk attitude of the people concerned, they may prefer to make a long rather than a short-term contract. Now, owing to the difficulty of forecasting, the longer the period of the contract is for the supply of the commodity or service, the less possible, and indeed, the less desirable it is for the person purchasing to specify what the other contracting party is expected to do. It may well be a matter of indifference to the person supplying the service or commodity which of several courses of action is taken, but not to the purchaser of that service or commodity. But the purchaser will not know which of these several courses he will want the supplier to take. Therefore, the service which is being provided is expressed in general terms, the exact details being left until a later date. All that is stated in the contract is the limits to what the persons supplying the commodity or service is expected to do. The details of what the supplier is expected to do is not stated in the contract but is decided later by the purchaser. When the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, that relationship which I term a "firm" may be obtained.[21] A firm is likely therefore to emerge in those cases where a very short-term contract would be unsatisfactory. It is obviously of more importance in the case of services—labor—than it is in the case of the buying of commodities. In the case of commodities, the main items can be stated in advance and the details which will be decided later will be of minor significance.

We may sum up this section of the argument by saying that the operation of a market costs something and by forming an organization and allowing some authority (an "entrepreneur") to direct the resources, certain marketing costs are saved. The entrepreneur has to carry out his function at less cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supersedes, because it is always possible to revert to the open market if he fails to do this.

The question of uncertainty is one which is often considered to be very relevant to the study of the equilibrium of the firm. It seems improbable that a firm would emerge without the existence of uncertainty. But those, for instance, Professor Knight, who make the *mode of payment* (the distinguishing mark of the firm—fixed incomes being guaranteed to some of those engaged in production by a person who takes the residual, and fluctuating, income—would appear to be introducing a point which is irrelevant to the problem we are considering. One entrepreneur may sell his services to another for a certain sum of money, while the payment to his employees may be mainly or wholly a share in profits.[22] The significant question would appear to be why the allocation of resources is not done directly by the price mechanism.

Another factor that should be noted is that exchange transactions on a market and the same transactions organized within a firm are often treated differently by Governments or other bodies with regulatory powers. If we consider the operation of a sales tax, it is clear that it is a tax on market transactions and not on the same transactions organized within the firm. Now since these are alternative methods of "organization"—by the price mechanism or by the entrepreneur—such a regulation would bring into existence firms which otherwise would have no *raison d'etre*. It would furnish a reason for the emergence of a firm in a specialized exchange economy. Of course, to the extent that firms already exist, such a measure as a sales tax would merely tend to make them larger than they would otherwise be. Similarly, quota schemes, and methods of price control which imply that there is rationing, and which do not apply to firms producing such products for themselves, by allowing advantages to those who organize