The Objective, Nature and Essence of the Firm

An Alternative Integration

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The objective, nature and essence of the firm: An alternative integration

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Abstract

In a recent article in European Management Review, Pitelis and Teece (2009) argue that extant explanations of the nature and scope of firms, such as transaction costs, property rights, metering team production, and resource-based, can be integrated into a more general (capability-based) theory of the firm. Despite acknowledging their account offers new insights on the issue, I am critical of their claim that the (dynamic) capability-based perspective can integrate the existing theories, which they in fact have failed to substantiate for three reasons. Firstly, they downplay the role of opportunism and simply categorize it as a kind of market failure, which they suspect its explanatory power. Secondly, their account is entrepreneur-centric, ignoring the role of employees in the formation of the firm, a problem they see in the transaction cost theory but nevertheless fail to address themselves. Thirdly, their critique of the market-failure-based explanation is problematic. I briefly introduce my own relationship-based theory as an alternative integration of the existing theories.

Keywords: theory of the firm, integration, opportunism, optimism, relationship, harmony

Introduction

Theory of the firm is a source theory for organizational economics and strategic management. In a narrow sense, i.e., in accordance with Coase (1937), a theory of the firm should address three issues regarding the nature of the firm: the existence, the boundaries, and the internal organization of the firm, of which the existence is fundamental. On top of these three, Foss (1999) suggests that a *strategic* theory of the firm should also explain the competitive advantage of the firm.

Broadly speaking, there are three schools of thought within the existing literature on the theory of the firm: transaction cost economics (TCE), knowledge-based theory (KBT), and entrepreneurial theory. The TCE is based on Coase's (1937) transaction cost theory and currently dominated by Williamson's (1975, 1985) opportunism-based theory of asset specificity. The KBT is pioneered by Kogut and Zander (1992), Conner (1991), Conner and Prahalad (1996)[1], and Grant (1996). The entrepreneurial theory is proposed by Casson (1998, 2005), Foss and Klein (2005) and Langlois (2005). Each of the three schools offers different answers to the three Coasian themes.

Foss (1999) points out that in this research field there are two approaches toward theory advancement. Some people prefer developing the theory of the firm along each line of thinking while some others see an integrative theory combining different schools necessary and desirable. Pitelis and Teece (2009) take such an integrationist approach and argue that

[1] Although Conner (1991) initially aims to argue for resource-based theory as a new theory of the firm in comparison to the transaction cost theory, Conner and Prahalad (1996) argue that 'a knowledge-based view is the essence of the resource-based perspective'.

extant explanations of the nature and scope of firms, such as transaction costs, property rights, metering team production, and resource-based, can be integrated into a more general (capability-based) theory of the firm. They see it possible to categorize most existing theories of the firm, i.e., those of Coase, Williamson, Arrow, Grossman, Hart, Moore, Buckley, Casson, Knight, Kogut and Zander, etc., as the market-failure-based approaches (p. 9). They contend that 'the genesis of the firm' is 'not only because of market failure, but also…the very creation of a credible player (firm) with a chance to realize its objectives'. They claim that 'in many cases firms exist because of their (dynamic) capabilities which enables entrepreneurs and managers inside firms to co-create markets (as well as to responding to market failures)', i.e., 'market co-creation is a *raison d'être*'. Yet, in their mind, it is actually 'the *raison d'être*' (p. 10).

Despite acknowledging their account offers new insights on the issue, I am critical of their claim that the (dynamic) capability-based perspective can integrate the existing theories, which they in fact have failed to substantiate for three reasons. Firstly, they downplay the role of opportunism and simply categorize it as a kind of market failure, which they suspect its explanatory power. Secondly, their account is entrepreneur-centric, ignoring the role of employees in the formation of the firm, a problem they see in the transaction cost theory but nevertheless fail to address themselves. Thirdly, their critique of the market-failure-based explanation is problematic. In the following sections, I discuss in more detail with respects to these three drawbacks in Pitelis and Teece (2009) and offer my own integration by briefly explaining the relationship-based theory of the firm (R'BT).

The drawbacks of Pitelis and Teece's pespective

Foss (1996a: 470) treats the broad resource-based literature, including the dynamic capabilities perspective, as 'knowledge-based approaches to the theory of the firm'[2] as 'they are all agreed on the need for a knowledge-perspective on the firm, that is for conceptualizing firms as heterogeneous, knowledge-bearing entities'. Foss (1996a, 1996b) then dismisses the knowledge-based perspective being able to *independently* explain the key question of firm existence. Foss (1996a) made a 'very powerful' critique of KBT (Barney, 1996: 469) by arguing that 'it is erroneous to think that higher order organizing principles [i.e., Kogut and Zander's (1992) theory] are a qualitative differential of the firm relative to the market, although they are probably in reality a quantitative one. That is, the qualitative presence of higher order organizing principles does not necessarily distinguish the market relative to the firm; rather, there may be "more of it" in the firm than in the market, as Arrow (1974) forcefully argued'. Foss believes that the argument that firms better cultivate higher order organizing principles demands precisely an argument from opportunism. This is to say, Pitelis and Teece's (2009) dynamic capabilities view, as a dynamic resource-based view (Helfat and Peteraf, 2003), cannot *independently* explain why firms came to exist too, as Foss (1996b: 519) holds firmly the 'conventional' view that 'we cannot do without concepts such as opportunism if we wish to explain the existence of the firm', which I largely agree.

The other major drawback of Pitelis and Teece's (2009) account is its entrepreneur-centrism, or in Zajac and Olsen's (1993) term, 'a single-party' emphasis that 'neglects the interdependence between exchange partners'. Supprisingly, this problem is shared by all existing theories of the firm. For instance, the transaction cost theory is entrepreneur/buyer-centric because it says the buyer decided to form a firm to avoid the costs of transacting with

[2] Foss (1996a: 470) is aware of the existing differences among different branches of the broad resource-based view.

the sellers. It ignores the role of the sellers: why should the sellers obediently accept to become the buyer's employees just because the buyer wanted to avoid transacting costs? The entrepreneurial theory is entrepreneur-centric because it says the entrepreneur decided to form a firm in order to have some people to make derived judgments for him (Foss, Foss, and Klein, 2007). But, why should those people working freely on market obediently accept to become the entrepreneur's employees to take on the responsibilities of making judgmental decision? Similarly, why should those people give up their freedom to become someone's employees just because someone else wanted to take advantage of their own knowledge? All of them (TCE, KBT, and entrepreneurial theory) are silent on such a question or might have never considered it an issue. In contrast, Pitelis and Teece (2009: 10) are clearly aware of such issue when they make the critique that 'efficiency gains from transaction costs…may not be an adequate explanation for employees voluntary accepting to work for employers'. Ironically, their account is still entrepreneur-centric as they argue 'firm exist because of the intentions of their principals-to-be' (p. 11), i.e., 'for their principals-to-be to capture value (profit from) their appropriable value creating advantage' (p. 10). They clearly refer firm principals-to-be as the entrepreneurs (p. 10) or owner-shareholders (p. 8), ignoring the role of employees.

In addition, Pitelis and Teece (2009) argue that the market-failure-based approach cannot fully explain why firms exist from a situation of no firms at all (p. 9). This implies that a good theory of the firm should explain how the first ever firm came to exist. Their answer to this question is as follows. In a situation of no firms at all, there emerged an entrepreneur who had an entrepreneurial idea aimed to be put in practice. It was hard to *sell* the idea in the open market because it might be too tacit to transmit or it was possible that this idea be expropriated due to its public good characteristics. This presents a two-pronged type of market failure which is not directly linked to transaction costs. They argue transaction cost theory makes sense here only if one suggests that by designing contractual means the above two-pronged-type market failure problem can be solved, which 'presupposes the counterfactual of a potential existing market, even when it does not exist' (p. 10). Therefore, they suspect the explanatory power of the transaction cost in particular and market-failure-based theories in general. Pitelis and Teece (2009) claim that the entrepreneur needed a firm to control on the entrepreneurial idea in the cohesive shell of the firm. To support their argument of protecting the entrepreneurial idea, they even assert that 'it may well be as dangerous to explain to employees-to-be what your idea is all about, as it is to tell if to anyone else' (p. 10).

The problem with their critique of market-failure-based explanation above is that their entire analysis is based on an assumption that the entrepreneur intended to *sell* his/her entrepreneurial idea in the open market, but since doing so was dangerous to lose control over the idea, the entrepreneur had the *only* choice to start a firm. Unfortunately, this assumption is unrealistic. Why should the entrepreneur want to sell the idea in the open market in the first place? In modern time, entrepreneurs may need to 'sell' their ideas to venture capitalists in order to get initial finance; even so, it is not really to sell venture capitalists the ideas for cash. Imagine, in a remote past when the first ever firm was to emerge, there was highly unlikely a market for entrepreneurial ideas, viz. it was highly unlikely the first ever entrepreneur wanted to sell his/her idea to someone else in the open market. He or she could simply go to the market and try to find some other people to do whatever he or she wanted by paying them money or something they wanted. This is to say, there was a market for labor services even when there was no a market for entrepreneurial ideas. Then the transaction costs and opportunism can enter into the story.

Based on above analysis, I argue Pitelis and Teece (2009) have failed to deliver their promise of integrating the existing theories into a general theory of the firm. Instead, they simply argue that the existing theories are market-failure-based approaches, which are incomplete at best and unimportant at worst as they believe 'market co-creation (or its absence) is as much an explanation of why firms exist as is market failure – indeed in our view more so' (p. 11). Simply put, they downplay the existing theories rather than integrate them. Somewhere else (Li, 2007a, 2007b, 2008, 2009, 2010a, 2010b), I have developed an alternative theory which aims to integrate the existing theories, which now I briefly introduce in the following section[3].

A relationship-based theory of the firm

The existence of the first ever firm

Imagine long time ago there was no firms at all. One day, a person E (i.e., entrepreneur) got an entrepreneurial idea he wanted to put it into practice. E realized that he alone could not make it happen so he needed other people to help him. So, E went to the market (or neighborhood) and found two people L_1 and L_2 (i.e., labors). He asked them if they could do something for him with a \$0.8 pay for each. They each asked for \$1.2. After negotiation, they agreed at \$1 for the service E wanted. So, L_1 and L_2 carried out the tasks E gave. At the end of this exchange, E wanted to extend this deal and L_1 and L_2 agreed. So the transactions continued. In modern term, this is market-based transactions and the relationship between E and L is market-based relationship.

After a while with the process of the above transactions, the L_1 or/and L_2 started to shirk. The service the shirking labor(s) provided to E became less than what was paid for. Say, the service he provided now was \$0.9 in value. This was then detected by E. E was unhappy and refused to pay the same price as before so E reduced the pay to \$0.9. Of course, the shirking labor then would not be willing to provide more service worth than \$0.9. Due to the mutual dissatisfaction, there might be a vicious circle happening to the relationship between them. So their gains from their exchange relationship may be further reduced to \$0.8, then \$0.7, and so on, before their relationship broke up and the exchange stopped. In modern term, we call the shirking behavior as opportunism.

In such a situation where opportunism is likely to appear or has appeared, the entrepreneur might want to avoid it by altering their buying-selling relationship into an employment relationship (Simon, 1951) in which the entrepreneur-employer has certain degree of authority over the labor-employees. This is Williamson's (1975, 1985) explanation of firm existence: firms exist to contain or avoid opportunism potential inherent in market-based transactions. However, this is only one possible, though likely, reason why the first ever entrepreneur wanted to form a firm. There is another possibility which is in the absence of opportunism, i.e., before the shirking behavior occurred or was detected, the entrepreneur might be unsatisfied with the \$2 gains from the market-based exchange, i.e., total services provided by L_1 and L_2. Then entrepreneur might be optimistic and confident that if he employed L_1 and L_2, he could effectively manage them to create more than the sum value of their separate services, i.e., \$1 + \$1 > \$2, say \$3. So, in this situation, it is his optimism rather

[3] As my latest paper detailing the relationship-based theory of the firm is currently under review by another journal, here, I only briefly introduce the core arguments and place a focus on the key question why the firm came to exist.

than others' opportunism that stimulated the idea of forming a firm and becoming a boss with certain authority to manage the labor-employees under his directions. Therefore, both opportunism and optimism are possible reasons for explaining the emergence of the firm, and we cannot exclude either a prior. We can understand the optimism was out of the entrepreneur's self-confidence in his own knowledge and capabilities to effectively manage a team/firm. In this way, we have integrated the entrepreneurship, opportunism and knowledge/capability perspectives in explaining the question why the firm exists (see Figure 1). But, with respect to knowledge or capabilities-based view, we should note that in the case of the first ever entrepreneur, it is *more* likely that what he was so confident about was applying his *own* knowledge and capabilities than utilizing the employees' knowledge and capabilities, though the latter is possible.

The objective and essence of the firm

To form the firm, the entrepreneur needed an indispensable condition: the agreement of the employees-to-be to work for him under an employment relationship. But, why should those people working freely on market voluntarily accept to become the entrepreneur's employees and accept for his authority? According to Simon (1952: 327), individuals are willing to accept to join an organization (say, a firm) 'when their activity in the organization contributes, directly or indirectly, to their own personal goals', material or non-material. This is to say, the employees-to-be join the firm only if they believe the firm can contribute to the realization of their own personal goals, better than the market does.

In the story above, since the entrepreneur was optimistic and self-confident about his knowledge and capabilities to effectively manage the two employees-to-be to gain synergy, i.e., \$1 + \$1 = \$3, so, with the extra gain \$1 (=\$3 - \$1 - \$1) in mind, he was willing to offer the two labors an extra \$0.2 each as an inducement for them to become his employees. Since this offer could better contribute to their personal goals than any other options available, the two labors L_1 and L_2 accepted the offer. So they *jointly* formed the firm though the entrepreneur owned it. For the entrepreneur, after paying L_1 and L_2 each extra \$0.2, he still could have an extra gain of \$0.6 (= \$3 - \$1.2 - \$1.2). So, the firm at its very birth served as a mechanism to bring all participants (E, L_1, and L_2) more benefits than the market could. In this sense, the objective of the firm is for *all* voluntary participants to better realize their personal goals, as opposed to what Pitelis and Teece (2009) biasedly describe as 'for their principals-to-be to capture value (profit from) their appropriable value creating advantage' (p. 10).

In a way, we can say the formation of the firm as the result of a negotiation and compromise among all its initial participants (i.e., E, L_1, and L_2). What was negotiated could include issues like the contracts, the pay structure, the authority, and the property rights, etc. According to Simon (1952: 330), the organization objective itself is subject to change 'in response to the influence of those for whom the accomplishment of that objective secures personal values'. Simply put, organization objectives are constantly adapted in a process of compromise of the interests of several groups of potential participants of the organization, rather than just representing the interests of the controlling group (Simon, 1952).

A question remains: why the firm is better than market in realizing the participants' personal goals? To answer this question, I introduce the concept of relationship harmony. Here, we see two types of relationship: market-based transaction relationship and firm-based employment relationship. Relationship harmony is a concept to describe the quality of the relationship, i.e., is a relationship harmonious or not? I dimensionalize relationship harmony with three variables: shared interests, mutual trust, and obligation fulfillment. If the two parties of a relationship have shared interests and mutual trust and can fulfill their respective obligations, their relationship is harmonious. Conversely, if any of the three variables scores lower than a minimal level, the relationship is not harmonious, viz. there is relationship disharmony. I argue market-based transaction relationships are normally not harmonious due to the lack of shared interests (or, presence of conflict of interests) and mutual trust between the buyers and the sellers and opportunistic potential on the part of the sellers. Due to such relationship disharmony, neither side of a market-based relationship can gain maximized self-interest out of such a relationship. The firm came to exist to remedy the problem of relationship disharmony (via a shared interest at least) and to provide a vehicle for both parties to gain more self-interests than what available on market.

Although the firm has the potential to be a better vehicle than the market to bring more benefits to all participants, the realization of such a potential depends on how well the firm, more precisely the firm-stakeholder relationships, are managed and utilized. O'Reilly and Pfeffer (2000) forcefully demonstrate that some great companies have achieved extraordinary results with ordinary people by building corporate cultures and management systems in which the energy and talent of employees can be unleashed. Therefore, the essence of the firm – what Coase (1991) refers to as 'running the business' – can be said as a total relationship management (TRM): harmonizing the firm-stakeholder relationships and utilizing the harmonious relationships to stimulate the firm's participating stakeholders (entrepreneurs, directors, advisors, managers, and employees) to unleash their creativities to come up with competitive ideas, products and services to outcompete their rivals and ultimately to help every participant to realize his or her personal goals.

Conclusion

In this comment, I critique Pitelis and Teece's (2009) argument that the dynamic capabilities perspective can serve as a general theory of the firm to integrate the existing theories such as transaction costs, property rights, and knowledge-based perspectives. Due to their downplaying of opportunism, entrepreneur-centrism and problematic critique of market failure explanation, I conclude that they have failed to deliver the promise of integration. Nevertheless, I appreciate the insights of the dynamic capabilities perspective in explaining the competitive advantage of the firm, though I did not make an analysis in this paper as it has been well-accepted. In the end, I briefly introduce my own relationship-based theory of the firm as an alternative integration with a focus on the question of existence of the firm.

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Figure 1 The emergence of the first ever firm