

Part I

Foundations



# 1

## Markets and organizations

### 1.1 The economic problem

Imagine a world of abundance – perhaps a tropical island where you are basking in the sun, with lots of food and a tribe of friendly islanders as your companions. Would you have any economic problems on this island? Well, ‘No’, you may say, ‘I can’t imagine *any* problem on such an island, let alone an economic problem.’ You might be right, but you may be right for the wrong reason.

Many people associate economic problems with money. As money would be either absent or abundant on our imaginary island, they would think there would be no economic problems. An economist, however, would not be content with this reasoning. She<sup>1</sup> would enquire further, asking, for example, whether you felt you had enough time to enjoy all the pleasures of your island or your needs for housing, education, culture, friendship and so on had been met? The point is that an economist would identify an **economic problem** in any situation where needs would not be met as a result of scarcity of resources – ‘resources’ being quite broadly conceived as meaning all factors that may contribute towards the satisfaction of human needs. So, yes, you may not have an economic problem on your fantasy island, but only if you could truly say that all your needs would be met.

Economic problem

Time to return to the real world, where economic problems abound, whether we apply a narrow definition or the broader one presented above. We do not have enough land to meet all our needs for cultivation as well as ecological preservation. We do not manage to feed the world’s population properly. Many raw materials are in limited supply. Talent is always scarce and so is time. Most people, even in rich countries such as the USA, Germany and Japan, do not earn enough money to buy everything that they would like to buy. In short, scarcity is a fact of life in the real world. Given this predicament, the economic problem may be rephrased as the problem of how to make the best use of the available resources. Alternatively, in economic jargon, what is the **optimal allocation** of the scarce resources over the alternative uses that can be made of them? Resources that are optimally allocated exhibit **efficiency**.<sup>2</sup>

Optimal allocation

Efficiency

This book is concerned with economic approaches to organizations. Now, economics might not be the first discipline you think of when trying to understand organizational phenomena. Indeed, it will be argued later that

Economic aspect

economics had for a long time hardly any contribution to make to the study of organizations. The approaches that we present in this book have been developed relatively recently, although in some cases their origins are much older. So, you are quite justified in wondering what insights economics have to offer. Our answer is that economic approaches to organizations are fruitful whenever the problem to be studied has an **economic aspect** – that is to say, whenever part of the problem deals with the (optimal) allocation of scarce resources.

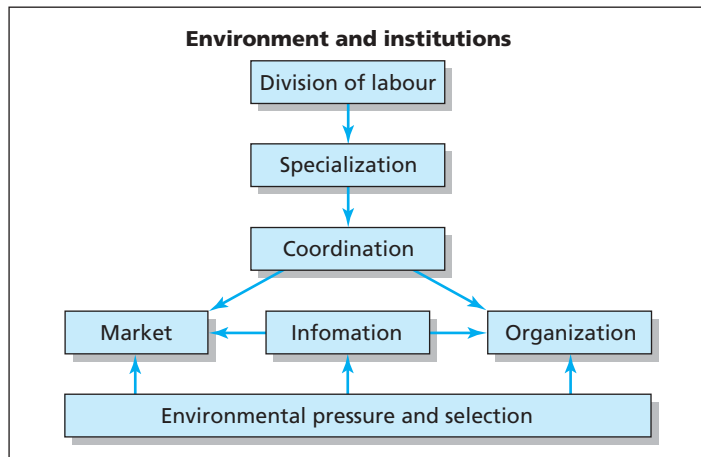
Note that we have carefully specified that economics deals with parts and aspects of problems. We believe that there are hardly any ‘purely economic’ problems. Similarly, there are hardly any purely legal, sociological or psychological problems. All these social sciences deal with aspects of real-world phenomena. All illuminate a part of social reality. Whoever believes that economics can explain entirely the ‘marriage market’ or, for that matter, organizational phenomena is guilty of ‘economism’ (which, we are informed, is a contraction of economics and colonialism). There is an equal danger of legalism, sociology or psychologism, too, whenever the explanatory power of one discipline is exaggerated. Having said that, we do believe economics has an important contribution to make to the understanding of organizations. From the perspective outlined above, two points follow:

- economic approaches to organizations focus specifically on the economic problem of optimal allocation of scarce resources (broadly conceived);
- the economic contribution to our understanding of an organizational problem increases when the economic problem forms a greater part of the organizational problem that we are trying to understand.

In this book, we present the major strands of the current economic approaches to organizations. In addition, we illustrate some of the applications of those approaches to organizational problems. In doing so, we shall avoid technical expositions and, instead, concentrate on the basic concepts involved. Our aim is to provide a conceptual introduction to these novel approaches. By focusing on the basic concepts, we hope also to present a more coherent picture of organizational economics than has been provided before. In this first chapter, we build, step by step, the basic conceptual framework that we use to explain the fundamental economic approach to organizations. This framework is shown in Figure 1.1. The framework will clarify the crucial role of information and the various ways in which information can be mediated. This central role of information will be elaborated further in Chapter 4, where we argue that this is the glue that binds the various economic approaches to organizations together.

## 1.2 The division of labour

Adam Smith is usually credited as the founding father of modern economics. In his book *An Inquiry into the Nature and Causes of The Wealth of Nations* (1776), he accords great importance to the division of labour: ‘The greatest



**Figure 1.1** The basic concepts

improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which it is anywhere directed, or applied, seem to have been the effects of the division of labour.'

His famous example is that of a pin factory. He showed that a tremendous increase in the productivity of the work of pinmakers could be achieved by splitting this work up into distinct tasks and having each worker perform one specific task rather than making entire pins (see Box 1.1).

### Box 1.1 The pin factory

To take an example, therefore, from a very trifling manufacture; but one in which the division of labour has been very often taken notice of, the trade of the pin-maker; a workman not educated to this business (which the division of a labour has rendered a distinct trade), nor acquainted with the use of the machinery employed in it (to the invention of which the same division of labour has probably given occasion), could scarce, perhaps, with his utmost industry, make one pin in a day, and certainly could not make twenty. But in the way in which this business is now carried on, not only the whole work is a peculiar trade, but it is divided into a number of branches, of which the greater part are likewise peculiar trades. One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which, in some manufactories, are all performed by distinct hands, though in others the same man will sometimes perform two or three of them. I have seen a small manufactory of this kind where ten men only were employed, and where some of them consequently performed two or three distinct operations. But though they were very poor, and therefore but indifferently accommodated with the necessary machinery, they could, when they exerted themselves, make among them about twelve pounds of pins in a day. There are in a pound upwards of four thousands pins of a middling size. Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day. Each person, therefore, making a tenth part of forty-eight thousand pins, might be considered as making four thousand eight hundred pins in a day. But if they had all wrought separately and independently, and without any of them having been educated to this particular business, they certainly could not each of them have made twenty, perhaps not one pin in a day; that is certainly, not

the two hundred and fortieth, perhaps not the four thousand eight hundredth part of what they are at present capable of performing, in consequence of a proper division and combination of their different operations.

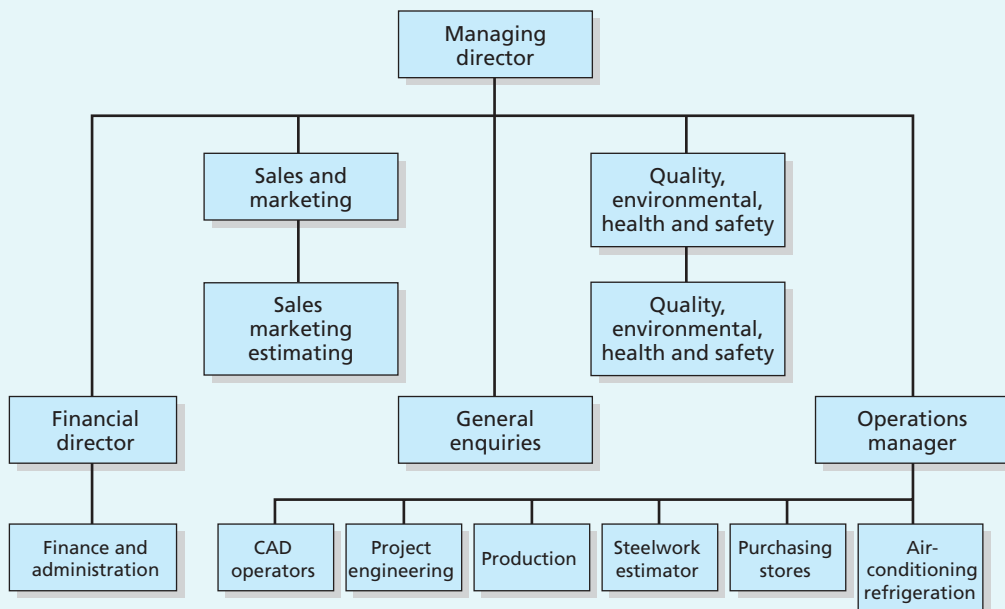
Source: Adam Smith, *The Wealth of Nations*, Book I, Chapter 1, 1776

#### Division of labour

**Division of labour**, therefore, refers to the splitting of composite tasks into their component parts and having these performed separately. It is a pervasive phenomenon in modern societies.

Our primeval ancestors were much more self-supporting. They built their own houses, grew or hunted their own food, made their own tools, defended themselves from various threats and so on. Since then, gradually these tasks have come to be divided into separate sectors in society (such as the private and the public sectors), and, within those sectors, further divided into separate entities (such as government agencies, industries and firms). An economic system has developed in which we normally buy these goods or services in exchange for money. Most of us work in organizations where we earn our money. Looking inside those organizations we can see that the division of labour occurs there as well. We usually perform but a small part of an entire organization's task. In order to accomplish its task the organization itself is split into different parts (such as divisions and departments), levels and functions. As a result, we need organization charts (see Box 1.2) as maps to guide us through the organizational territory. These charts are one reflection of the division of labour within organizations.

Box 1.2 Labtech organization chart, September 2007



It was Adam Smith's contention that the progressive division of labour led to productivity increases that constituted the main source of the increasing 'wealth of nations'. In the next section we shall see what the basis for this was. Here we want to conclude by emphasizing that we take the division of labour as a fact of life in our kind of society. No matter what position we occupy, every time we interact with others to obtain goods or services we need, we may be reminded of this fact. This is what forms the starting point for our conceptual framework, which is outlined in Figure 1.1.

## 1.3 Specialization

Why would an increasing division of labour lead to such great productivity increases and, thus, to a growth in 'the wealth of nations'? Smith gave the following explanation:

This great increase in the quantity of work, which, in consequence of the division of labour, the same number of people are capable of performing, is owing to three different circumstances; first, to the increase of dexterity in every particular workman; secondly, to the saving of the time which is commonly lost in passing from one species of work to another; and lastly, to the invention of a great number of machines which facilitate and abridge labour, and enable one man to do the work of many.

### Economies of specialization

In our present economic terminology we say that there are **economies of specialization** to be gained. In the specialized pin factory the same amount of output can be produced with less labour effort than in the unspecialized factory. Conversely, a greater amount of output can be achieved with the same level of labour input (ten men), as Smith showed. Specialized production is thus more *efficient* than unspecialized production.

Among the reasons for this being true are the ones mentioned in the quotation above. Essentially, when work is split into specific tasks, we may select one that particularly suits our own needs and capabilities. When we specialize in that task, we can devote all our attention to improving our performance of that task. We can learn from more experience and we can use that experience to devise methods and instruments to further improve our execution of the task. For all these reasons, a specialized economic system is usually more efficient than an unspecialized one.

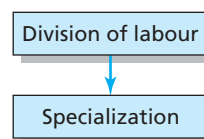
Division of labour thus leads to specialization, which allows for efficiency gains (Figure 1.2). This is a pervasive phenomenon in society. Let us consider some examples. In the family, household work is usually split into different tasks and the members of the family specialize in distinct tasks (while others may be shared). They become good at those tasks but not at others. Some know exactly where to shop for particular goods and get the best value for money. Some know how to operate the household appliances; perhaps others know how to fix them. Some have specialist skills in filling out the tax forms; others perhaps in monitoring the budget. Whatever the particular distribution

of tasks, some degree of specialization is present in all families and, in most families, the efficiency of running the household is seriously disturbed when members have to switch to unfamiliar tasks. In that sense, there is a cost to specialization.

Similarly, in sports, specialization leads to higher performance, but comes at a cost. An individual cannot compete, let alone excel, in all sports. Choices have to be made and long, specialized training has to be undertaken. Once specialized, high performance is necessarily restricted to a narrow range of options. Even an admirable sportsman such as Tiger Woods is restricted to playing professional golf. Specialization, building on a unique talent, has allowed him to reach the top in playing golf, but even Tiger Woods would not be able to compete at the highest level in two sports (for example, in tennis and golf). In team sports such as hockey or soccer, it is usually very unproductive to switch goalkeepers and field players. Good teams make the best use of their members' specializations. Specialized skills are scarce. Good teams allocate those with these skills in an optimal manner to the tasks to be executed and, thus, are organized efficiently.

In many fields, such as medicine or transportation, it would even be disastrous to switch specialists. However much we favour variety of work, we are not willing to enter hospitals or board aircraft where the specialists take turns doing each other's work.

For the individual, then, specialization has the advantage of allowing higher levels of performance to be reached, but the disadvantage of restricting choice. At the individual level, the limits of specialization are reached when the satisfaction gained from higher performance (and the consequent rewards) is outweighed by the dissatisfaction from too narrow an area of application of one's skills (with the resulting boredom and frustration). As many organizations have learned over time, the gains from further specialization are easily offset by the costs of dissatisfaction when those individual limits are exceeded. The conveyor belt, for instance, enabled great gains in productivity, but only to the extent that the workers accepted the range of activities required of them. If such a range becomes too narrow, the gains are offset and a restructuring of activities (for example, into semi-autonomous workgroups) is called for. Individual limits are thus one boundary to increasing specialization, but there is also another boundary, which is the subject of the next section.



**Figure 1.2** Division of labour leads to specialization

## 1.4 Coordination

In the previous paragraphs we have seen that division of labour and specialization are pervasive phenomena in society. As a result, hardly any people are economically self-reliant, in the sense that they produce all the goods and services they wish to consume. In order to obtain those goods and services, they have to acquire them from other specialized people.

### Exchange

In economic terminology we say that **exchange** has to take place. Goods and services are exchanged whenever the right to use them is transferred. Much exchange takes place through markets. In a market, the right to use particular goods and services is bought (and, of course, sold at the same time). When I buy a piece of soap in my local store, I acquire the right to use the soap, while the storeowner acquires the right to use the money I have paid for it.

Exchange of goods is usually beneficial to both parties to the exchange. For example, a painter should paint and a cook should cook. They can both specialize when they exchange their products. A nice example is given in Box 1.3.

### Box 1.3 Exchange of art for food

John Kay tells the story how the French hotel and restaurant Colombe d'Or acquired an extensive collection of modern art:

For two hundred years European artists have been attracted to the bright light and brilliant scenery of the south of France. The walled village of Saint-Paul de Vence still houses a community of artists. Paul Roux, who bought a small hotel and restaurant at the entrance of the village in 1919, offered food and lodging to artists in return for examples of their work. Today, the Colombe d'Or's collection of modern French art is the envy of many galleries.

Mr Roux was a talented cook and his visitors talented painters. It therefore made sense for Paul Roux to cook and for Georges Braque, one of the artists he encouraged, to paint. The exchange of food for paintings benefited both parties. It is common to think of exchange as a process in which one party wins at the expense of another, or one party makes a mistake. But the exchange between Braque and Roux, like most economic exchanges, was characterized by mutual gains from trade.

The division of labour between Braque and Roux made these gains possible. By getting together each obtained a mixture of food and art. The two individuals had different capabilities. But these capabilities were, in themselves, insufficient for their needs. Braque needed to eat, and Roux did not wish to live by bread alone. Whenever there are differences in talent and a mutual desire for variety, there is the possibility of a division of labour and mutually beneficial exchange.

Source: Kay (2003)

Exchange, though, is broader than just market exchange. First, the goods involved need not be only goods that are marketable. Economists speak of goods whenever scarce resources are involved. We can indeed also exchange favours as they are very scarce and can be used to get things done. Similarly, we exchange information as soon as the right to use the information has been transferred. Second, the transfer of rights need not be mutual. When I offer you some of my time, I am offering you the right to use a scarce resource. An

economist would regard your use of my time as an example of exchange, whether or not you reciprocate in any way.

#### Transaction

Whenever exchange takes place, we speak of an (economic) **transaction**. Owing to the division of labour and to specialization, innumerable transactions have to occur in society. As on the one hand, we are all specialized ourselves and, on the other hand, need the specialized goods and services of others, a vast network of exchanges is necessary to allocate the available goods and services. How is that accomplished? How do the parties who are willing to engage in a transaction find each other? Phrased in economic terminology, how is the **coordination** achieved within an economic system?

#### Co-ordination

Specialization leads to a need for coordination (Figure 1.3). Essentially, we shall submit, there are two types of co-ordination: transactions may take place either across markets or within organizations. The next section will discuss this distinction further.

## 1.5 Markets and organizations

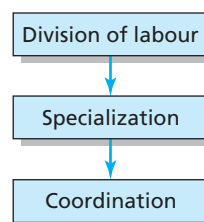
Consider the stock market. Each day on the major stock markets of the world, millions of shares and bonds are exchanged. On the New York Stock Exchange alone, as many as 1 million transactions may be carried out on an average trading day, involving more than 100 million shares with a total value of more than \$5 billion (Box 1.4 shows an extract from a London Stock Exchange listing). Buyers and sellers are not only British, but include private and institutional investors from all over the world.

How do all those parties find each other to sort out the opportunities for transactions? How, for instance, does a Japanese buyer find out who (from the USA, Germany or Hong Kong) wants to sell the stocks in which he is interested? The answer is, he does not.

He does not because the stock market comes close to that ideal type of market in which it is not necessary for buyers and sellers to have any kind of personal contact. The reason is that the **price system** is the coordinating device that takes care of allocation.

#### Price system

Suppose you are a potential buyer or seller of IBM stock. All you have to do is inform yourself of the current price of IBM shares, make up your mind whether or not you want to transact at that price level and, if so, instruct your bank or broker to carry out the transaction. You will never know the party with



**Figure 1.3** Specialization entails co-ordination

**Box 1.4 Stock exchange prices****Explanatory notes**

**Prices** are as quoted on the individual exchanges and mostly last traded prices.

**Chng** is change on the day.

**P/e** is price to earnings ratio, where earnings are unadjusted year end earnings, except UK where the UKSIP Headline Earnings formula is used.

**Yld** is the dividend yield, where dividends are latest rolling 12 month figures.

**k behind the values** is value \* 1000 (4.5k = 4500).

**Highs & Lows** shown relate to a period of less than 52 weeks.

Source: *The Financial Times*, 10 September 2007

— A/W to come —

## Sufficient statistic

whom you exchanged the stock. It is not necessary to know the other party. The price contains all the information you need to base your transaction on: it is a **sufficient statistic** (Hayek, 1945).

No wonder economists marvel at the functioning of these types of markets. Through the interlinked system of stock exchanges in the world, all potential buyers and sellers of, in our example, IBM stock are connected with each other. What is more, if, globally, there are more potential buyers than sellers, the price goes up. This has the effect that some buyers are discouraged at that price level and some new sellers are interested in entering the market. This goes on until demand and supply of stock is in equilibrium. At that point, we can say that an optimal allocation of that stock has been achieved as the buyers who are most interested in that stock have been satisfied, while the sellers who were least interested have sold. This optimal allocation obtains without any personal contact being made between the transacting parties.

There are a number of such markets. Markets for raw materials often approximate ideal markets. Let us borrow an example from Hayek (1945) to emphasize how efficiently such markets operate:

Assume that somewhere in the world a new opportunity for the use of some raw material, say tin, has arisen, or that one of the sources of the supply of tin has been eliminated. It does not matter for our purpose – and it is very significant that it does not matter – which of these two causes has made tin more scarce. All that the users of tin need to know is that some of the tin they used to consume is now more profitably employed elsewhere, and that in consequence they must economize tin. There is no need for the great majority of them even to know where the more urgent need has arisen, or in favor of what other needs they ought to husband the supply. If only some of them know directly of the new demand, and switch resources over to it, and if the people aware of the new gap thus created in turn fill it from still other sources, the effect will rapidly spread throughout the whole economic system and influence not only all the uses of tin, but also those of its substitutes and the substitutes of these substitutes, the supply of all the things made of tin, and their substitutes, and so on; and all this without the great majority of those instrumental in bringing about these substitutions knowing anything at all about the original cause of these changes.

Again, the adjustment of the price levels of tin and its substitutes is sufficient for a worldwide communication of all the necessary information to all relevant parties. As if led by the famous ‘invisible hand’ of Adam Smith, the individual decisions made by these parties will lead to new aggregate equilibrium levels of the supply and demand of tin.

Assuming you are now convinced of the efficiency properties of ideal markets, we may proceed to ask, why is not all exchange executed across markets? In fact, this is a rather old question. It was raised most effectively by Coase in 1937, who put it this way:

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 . . . The example given above is typical of a large sphere in our modern economic system

... 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?

Coase went on to provide an answer along the following lines. Contrary to the standard assumptions for ideal markets, Coase maintained that usually there is a *cost* associated with using the price system. First of all, there is usually a cost (if only time) involved in finding out what the relevant prices are. Next, when important, a *contract* is usually drawn up to provide the basis for a market transaction. For instance, with the labour market, employment contracts are necessary to specify the conditions under which most exchanges take place. It is costly to draw up those contracts. Finally, there may be conditions under which it is hardly possible (or extremely costly) to reach a contractual agreement that may serve as a basis for market exchange.<sup>4</sup> In those cases, too, *organization* may provide an alternative.

Therefore, Coase posited markets and organizations as alternatives for the execution of transactions. For markets, the price system is the coordinating device. Within organizations, the price system is replaced by authority as a coordinating mechanism.<sup>5</sup> The question remains as to the circumstances under which the market will be employed for exchange transactions and the conditions under which organizations will be preferred.

Coase's answer was that it is determined by the relative cost of transacting under these two alternatives. Transactions will typically be executed at the lowest cost. As a consequence, transactions will shift between markets and organizations as a function of the *transaction costs* under those two alternatives.

This last answer was taken up much later by Williamson (1975) to establish 'transaction cost economics', as we shall see in Chapter 8. Here we conclude by noting that Coase's analysis (1937) allowed standard economic reasoning to be employed in analysing both the nature and the size of the firm:

When we are considering how large a firm will be, the principle of marginalism works smoothly. The question always is, will it pay to bring an extra exchange transaction under the organizing authority? At the margin the cost of organizing within the firm will be equal either to the cost of organizing in another firm or to the costs involved in leaving the transaction to be 'organized' by the price mechanism.

We adopt Coase's original distinction between markets and organizations as two ideal types of coordination for exchange transactions. In the next section we argue that markets and organizations differ most essentially in the way that information is communicated between the transacting parties. The argument developed above entails that an **ideal market** is characterized by the fact that prices act as 'sufficient statistics' for individual decisionmaking. If we adopt this characterization, **ideal organizations** can be characterized as all those forms of coordination of transactions that do *not* use prices to communicate information between the transacting parties. In fact, we argue in Chapter 3 that most transactions in the real world are governed by hybrid forms of coordination. Most markets are to some extent 'organized'. Most organizations do use prices (such as transfer prices) to communicate information within the

Ideal market

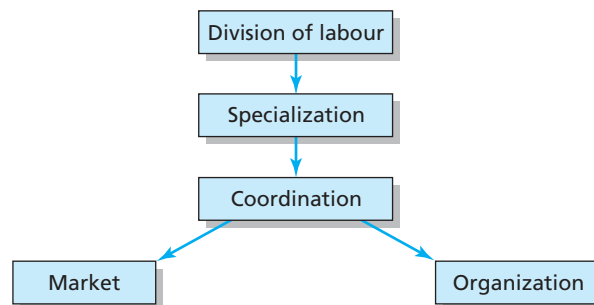
Ideal organizations

organization. As a summary of the argument so far, we may present the conceptual framework in its present stage of development, in Figure 1.4.

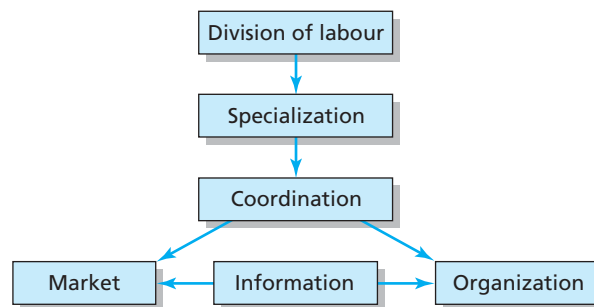
## 1.6 Information

We now arrive at a decisive step in the development of our conceptual framework. We have seen that the division of labour, leading to economies of specialization, necessitates the coordination of transactions. We have seen that there are two ideal types of coordination: market and organization. We shall now argue that the actual mix of coordination mechanism(s) that we will observe in any situation will depend mainly on the information requirements that are inherent in that situation. Thus we present *information* as the crucial concept in our framework, explaining how coordination will take place (Figure 1.5). We introduce this concept below and elaborate on its significance in Chapter 4.

Recall that ideal markets are characterized by the operation of prices as sufficient statistics – that is to say, the price contains all the information needed for the coordination of transactions. The price mechanism is therefore a perfect channel of information to all parties potentially interested in transacting. In situations where the price mechanism is applicable as a coordination



**Figure 1.4** There are two types of ideal co-ordination: market and organization



**Figure 1.5** The market/organization mix depends on the particular information requirements of the situation

device, it is, therefore, hard to beat its efficiency properties. However, we have also argued that in many situations the price mechanism is complemented or substituted by organizational coordination mechanisms. There are many situations in which the price cannot absorb all the information necessary to enable the execution of transactions. When Volkswagen buys ignition systems for the Audi A6, it will probably use a long-term contract containing many details with respect to quality and quantities with one or a few suppliers. In such a situation – where Volkswagen buys ignition systems rather than making ignition systems itself – we still have market transactions, but we cannot say that price is a sufficient statistic. Rather, we have a situation in which the price mechanism (which is still important: Volkswagen will try to buy from the cheapest source) is supplemented by a form of planning not unlike the planning used within organizations.

There are also many situations in which the price mechanism is totally incapable of performing its coordination function. In Chapter 4, we delve into the reasons for this. We show there are fundamental information problems that cannot be resolved by the price system. A number of these problems can, however, be dealt with by means of organizational coordination. Thus, from the perspective developed in this book, *organizations arise as solutions to information problems*.<sup>6</sup> Organizations are more suited to dealing with certain information problems than are markets.

As Figure 1.5 indicates, the market/organization mix depends on the particular information requirements of the situation. Information and communication costs determine, to a large extent, the relative efficiency of the two broad coordination mechanisms (markets and organizations). This is also illustrated in Box 1.5

### Box 1.5 Organizations and the Internet

We argue in this book that organizations arise as solutions to information problems. A similar line of reasoning was followed recently by *The Economist* when analysing the effects that the rise of the Internet and other new communication technologies may have on the shape of firms:

A prime reason why economic activity is organized within firms rather than in open markets is the cost of communication. The costlier it is to process and transmit information, the more it makes sense to do things in firms; the cheaper communication becomes, the more efficient (relatively) markets will be. Because the Internet and other inventions have cut the cost of communication so much, firms ought to be able to do less in-house and to outsource more. In 1999, General Motors, a byword for vertical integration, spun off Delphi Automotive Systems, one of its supply divisions, for instance.

In Chapter 9 we shall discuss vertical integration and show that more factors are involved in General Motors' decision than just the cost of communication. However, the basic reasoning in *The Economist* is sound and well in line with the approach taken in this book:

- markets and organizations represent alternative ways to coordinate transactions;
- information will determine their relative efficiency.

Source: 'Electronic glue', *The Economist*, 2 June 2001

## 1.7 The environment and institutions

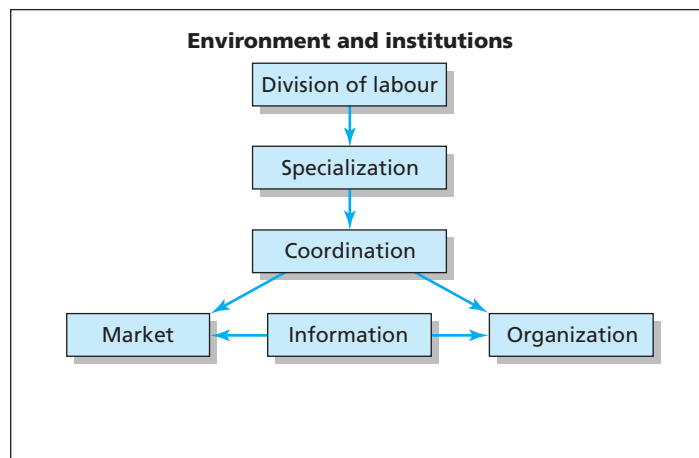
Finally, we want to add the *context* in which the trade-offs between market and organizational coordination are made. Broadly speaking, we will call this context the *environment*. The broad concept of the environment includes many dimensions. They are not only economic in nature, but may also be social, political, cultural or institutional (see Figure 1.6).

In Chapter 10 we will discuss evolutionary approaches to organizations. In those evolutionary approaches, attention is paid to the fact that organizations not only adapt to their environment, but are also shaped by pressures from the environment and may also be selected by their environment. We can best see such environmental pressures operating when we take a somewhat longer time horizon.

Consider, for instance, how environmental pressures have shaped organizations with respect to their labour practices (such as the abolition of child labour), waste management (such as reductions in carbon emissions) or internationalization (as a result of the international trade agreements negotiated by the World Trade Organization, for example).

Consider also how rapidly changing environmental conditions allowed first the creation of many new companies during the ‘dot-com bubble’ (see Box 1.6) of the late nineties and then the rapid selection of the few companies that survived and have become successful (such as Amazon and eBay), while others have perished. Who remembers today such companies as Boo.com, Kozmo.com or Webvan? These examples illustrate that organizations do not operate in a vacuum, but live in an *environment* that:

- provides the conditions for particular organizations to be created;
- shapes all organizations by exerting economic, social, political and other pressures;



**Figure 1.6** Environment as context for the market/organization mix

- is also the ultimate *selection mechanism* for determining which organizations can survive and be successful (other organizations are ‘selected out’ and perish).

### Box 1.6 The dot-com bubble

The ‘dot-com bubble’ was a speculative bubble covering roughly 1995–2001 during which stock markets in Western nations saw their value increase rapidly from growth in the new Internet sector and related fields. The period was marked by the founding (and in many cases, spectacular failure) of a group of new Internet-based companies commonly referred to as *dot-coms*. A combination of rapidly increasing stock prices, individual speculation in stocks, and widely available venture capital created an exuberant environment in which many of these businesses dismissed standard business models, focusing on increasing market share at the expense of the bottom line. The bursting of the dot-com bubble marked the beginning of a relatively mild yet rather lengthy recession in Western nations.

Source: [http://en.wikipedia.org/wiki/Dot-com\\_bubble](http://en.wikipedia.org/wiki/Dot-com_bubble), January 2007

Not only organizations but also markets are shaped and selected by environments. In ‘centrally planned economies’, such as the Soviet Union used to have, many markets were non-existent because the government attempted to coordinate economic activity by administrative rule. In ‘market economies’ too, governments have a fundamental influence on which markets are allowed to exist and how they function. Consider, for example, the government monopoly on military force, the prohibition of commercial markets for human organs for transplantation or the strict regulations on gambling. In all these cases, the government (as an important actor in the environment) determines which markets can come into being and shapes the rules by which such markets must function.

The functioning of markets will also be affected by other actors in the environment, such as trade unions, which have an impact on labour markets in many countries, or environmental pressure groups, which attempt to set standards of acceptable eco-behaviour in many markets. Moreover, markets are susceptible to more subtle environmental pressures, of social and cultural origin, for instance. In the United States of America, the market for chief executive officers of large corporations allows for them to receive much higher levels of compensation than in similar markets in Europe, where the American salary levels for CEOs are generally regarded as ‘excessive’.<sup>7</sup>

Finally, new markets come into being as a result of environmental developments, such as advancing technology (the market for mobile phones) or ecological needs (the markets for renewable energy and resources). At the same time, ‘old markets’ shrink or disappear for such reasons – the market for fixed telephones or Freon (the traditional cooling agent for refrigerators, that was banned for ecological reasons). As such examples show, markets do not function in a vacuum either. Markets operate in an environment that:

- provides the conditions for particular markets to be created;
- shapes all markets by exerting economic, social, political and other pressures;

- is also the ultimate *selection mechanism* for determining which markets can survive and be successful (other markets are ‘selected out’ and perish).

Economists have paid particular attention to the environmental dimension that we call *institutional*. **Institutions** have been defined by Douglass North (1990), one of the most prominent ‘institutional economists’, as follows:

Institutions are the rules of the game in a society, or more formally, are the humanly devised constraints that shape human interaction.

This definition includes both formal and informal rules of the game and the way those are enforced in a society. Formal rules are written laws, constitutions, regulations and the like. Informal rules are norms of behaviour, conventions and internally imposed rules of conduct – those in a company culture, for example. Enforcement of the rules can also be formal (such as through the legal courts) or informal (through peer pressure and social sanctions).

In most countries, the role of formal rules and enforcement has increased over time. As explained by Douglass North (2005b, p. 27) himself:

Throughout most of history, exchange has been based on personal knowledge of the other party. Reputation and repeat dealings have been the basis for confidence that the exchange would be lived up to in terms of both the quantity and the quality of the good or service exchanged and that the agreement would be executed in accordance with the understanding of both parties. Transaction costs in such cases were small. But, also, markets were necessarily small.

As long-distance trade expanded in the Middle Ages, the difficulties of exchange between parties that did not know each other posed fundamental transaction problems. At the champagne fairs in France in the twelfth century, one merchant was designated to collect information on the reliability of the merchants attending the fair; when contemplating an exchange that was not instantaneous, a merchant would seek advice from the designated merchant on the reliability of the other party. But extending personal knowledge by such devices has limits with respect to the size of markets. And Adam Smith, the patron saint of economists, was unequivocal in his assertion that specialization, division of labour, and the size of the markets are the source of the wealth of nations. Everything economists have learned since then reinforces this assertion.

Impersonal exchange – exchange between parties with no knowledge of each other and occurring over time and space – not only runs counter to innate genetic features that evolved over the several million years that humans were hunters/gatherers; it is also simply an open invitation to fraud, cheating and corrupt practices. In fact, in the absence of the essential institutional safeguards, impersonal exchange does not exist, except in cases where strong ethnic or religious ties make reputation a viable underpinning.<sup>8</sup>

What is required is a political institutional structure that will put in place the rule of law and the necessary enforcement structure. Such a framework must substitute effectively for the ‘trust’ that comes with personal exchange. The failure to create the essential institutional base is the central problem of economic development.

Indeed, the creation of appropriate institutions has not only been the central problem of economic development in historical times but also remains so today. Box 1.7 illustrates this for the recent development of Russia. In Chapter 4, Corporate Governance, we will provide modern-day examples of the importance of institutions.

### Box 1.7 The importance of institutions

Consider the problems facing Russia (or the other countries) in 1989. There were institutions in Russia that had names similar to those in the West, but they did not perform the same functions. There were banks in Russia, and the banks did garner savings; but they did not make decisions about who got loans, nor did they have the responsibility for monitoring and making sure that the loans were repaid. Rather, they simply provided the 'funds,' as dictated by the government's central planning agency.

There were firms, enterprises producing goods in Russia, but the enterprises did not make decisions: they produced what they were told to produce, with inputs (raw material, labour, machines) that were allocated to them. The major scope for entrepreneurship lay in getting around problems posed by the government: the government would give enterprises quotas on output, without necessarily providing the inputs needed, but in some cases providing more than necessary. Entrepreneurial managers engaged in trades to enable themselves to fulfill their quotas, in the meanwhile getting a few more perks for themselves than they could have enjoyed on their official salaries. Those activities – which had always been necessary to make the Soviet system merely function – led to the corruption that would only increase as Russia moved to a market economy. Circumventing what laws were in force, if not breaking them outright, became part of the way of life, a precursor to the breakdown of the 'rule of law' which was to mark the transition.

As in a market economy, under the Soviet system there were prices, but the prices were set by government fiat, not by the market. Some prices, such as those for basic necessities, were kept artificially low – enabling even those at the bottom of the income distribution to avoid poverty. Prices for energy and natural resources also were kept artificially low – which Russia could only afford because of its huge reservoirs of these resources.

Old-fashioned economics textbooks often talk about market economics as if it had three essential ingredients: prices, private property, and profits. Together with competition, these provide incentives, coordinate economic decisionmaking, ensuring that firms produce what individuals want at the lowest possible cost. But there has also long been a recognition of the importance of institutions. Most important are legal and regulatory frameworks, to ensure that contracts are enforced, that there is an orderly way of resolving commercial disputes, that when borrowers cannot repay what is owed, there are orderly bankruptcy procedures, that competition is maintained, and that banks that take depositors are in a position to give the money back to depositors when they ask. That framework of laws and agencies helps ensure securities markets operate in a fair manner, managers do not take advantage of shareholders nor majority shareholders of minority shareholders. In the nations with mature market economies, the legal and regulatory frameworks had been built up over a century and a half, in response to problems encountered in unfettered market capitalism. Bank regulation came into place after massive bank failures; securities regulation after major episodes in which unwary shareholders were cheated. Countries seeking to create a market economy did not have to relive these disasters: they could learn from the experiences of others. While the market reformers may have mentioned this institutional infrastructure, they gave it short shrift. They tried to take a shortcut to capitalism, creating a market economy without the underlying institutions, and institutions without the underlying institutional infrastructure. Before you set up a stock market, you

have to make sure there are real regulations in place. New firms need to be able to raise new capital, and this requires banks that are real banks, not the kinds of banks that characterized the old regime, or banks that simply lend money to government. A real and effective banking system requires strong banking regulations. New firms need to be able to acquire land and that requires a land market and land registration.

Source: Stiglitz (2002)

If we regard institutions as the rules of the game, imposed by the environment, then we can see how the economic ‘game’ played is fundamentally shaped by the institutional framework of a particular country. The government is, of course, a particularly important actor in the environment of markets and organizations. Market processes may, by themselves, leave many people with too few resources to survive. In countries that have been most successful, government has stepped in and compensated for such ‘market failures’, providing a safety net for the poor. Governments provided a high-quality education to all and furnished much of the institutional infrastructure, such as the legal system, which is required for markets to work effectively. They regulated the financial sector, ensuring that capital markets worked more in the way that they were supposed to. They fought against fraud and corruption. They promoted technology, for example, by setting up technological institutes and public research programs. Sometimes they intervene directly in the operation of markets, as Box 1.8 illustrates for the market of mobile phone calls in Europe.

### Box 1.8 Market intervention by the European Union

Europeans will save up to 70 per cent on the cost of using their mobile phones while abroad under a landmark deal agreed yesterday. The fees for making and receiving calls while in another European Union country will be slashed from mid-August following the vote by the European Parliament in Strasbourg. The decision to impose price caps on what the European Commission describes as ‘exorbitant roaming charges’ is a significant intervention by the EU in the market and comes despite fierce opposition from operators such as Vodafone.

Source: ‘EU to cap price of mobile calls’, *The Economist*, 24 May 2007

There is much debate about the appropriate roles of government and the desirable extent of a government’s reach in the economy. Among economists, however, there is ‘broad agreement that government has a role in making any society, any economy, function efficiently – and humanely’ (Stiglitz, 2002, p. 218).

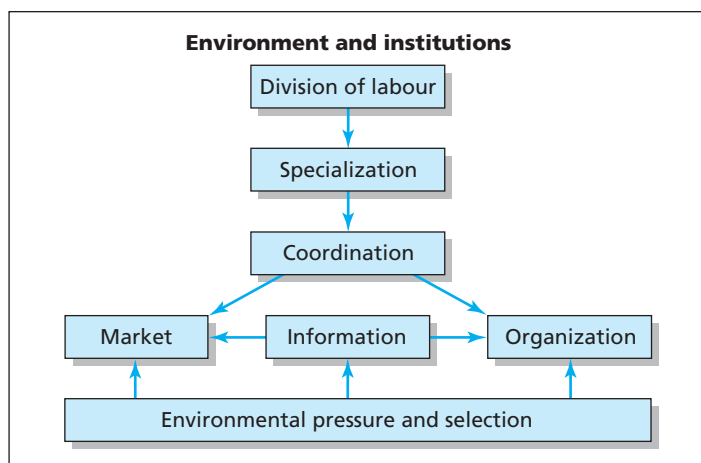
Next to the government, many other actors and factors play a role in shaping economic activities in markets and firms. Think of the legal system, trade unions, consumer groups, non-governmental organizations (NGOs), often acting as pressure groups for specific causes and so on. Add to this the many informal institutional rules that countries develop over time – traditions, norms of (non-)acceptable behaviour – and specific codes of conduct.

Together, all such actors and factors constitute the specific environmental context and institutional framework in which economic activity is carried out in organizations and markets. Given the many different choices that can be made in those dimensions in different countries, the context will also vary from country to country.<sup>9</sup> We will highlight some of such differences in forthcoming chapters – for instance, in Section 13.4, Business groups and Chapter 14, Corporate Governance.

All in all, it should be clear by now that we have to complete our basic conceptual framework by showing how markets and organizations are embedded in an environmental context and, particularly, an institutional framework. Environmental and institutional factors codetermine which markets and organizations are allowed to exist and also exert pressure on how they function. Those factors are not static, but evolve over time as governments change, laws are amended, social norms develop, new issues and challenges have to be addressed by societies.

For the economic problems in society, markets and organizations are appropriate responses. The choices between these two coordination mechanisms will be driven primarily by the information requirements of the situation, but will also, to some extent, depend on the environmental and institutional context in which the choice is made.

That concludes the basic conceptual framework we use to explain the economic approaches to organizations. We take the division of labour in society as our starting point, leading to specialization, which allows efficiency gains. However, with increasing specialization, there is a corresponding need for coordination. Coordination can be achieved via markets or organizations. Information is a crucial element in the trade-off between market and organizational coordination. In this section, we have shown that the trade-offs between markets and organizations are not made in a vacuum, but are embedded in an environment that shapes and selects the market/organization mix in various ways, particularly through the institutional context (see Figure 1.7).



**Figure 1.7** Environmental pressure and selection codetermines market/organization mix

## 1.8 Historical perspective

One may wonder why the economic approaches to organizations have been only fairly recently developed. Why did it take so long, for instance, to pick up on the fundamental question raised by Coase in 1937 – why do we observe so many organizations if markets are so efficient? The main reasons, as we see them, are summarized by the following two statements:

- until recently, most (but not all) economists focused their attention on how the market achieves co-ordination *between* organizations (and individuals);
- most (but not all) organization theorists studied coordination *within* organizations.

We shall briefly illustrate these statements below.

While the older economic writers, such as Adam Smith and Alfred Marshall, still had a lot to say about the functioning of organizations, over time, economists' fascination with the functioning of markets led them to study market coordination almost exclusively. The mainstream economists of the twentieth century elaborated a theory of markets. That theory is now highly developed. Meanwhile, however, there were some exceptional economists, such as Ronald Coase, who recognized that an important and growing share of the economic transactions within society were executed not across markets but within organizations. It was only fairly recently that more economists became interested in these economic processes and the resulting allocation within organizations, such as business firms. One of the reasons was that new theoretical approaches were developed that were more satisfactory than the older ones. It is the purpose of this book to introduce these approaches.

Organization theory, on the other hand, was interested primarily in what goes on within organizations. The first writers on organization focused on 'scientific management' – that is, discovering principles of work organization that would enhance productivity. Many of these early writers had a technical or engineering background and management experience to draw on. Later on, social and psychological considerations were introduced by writers in the 'human relations' school. Many of the early contributions to the field of organization studies attempted to formulate the 'one best way to organize'. Only since the 1950s and 1960s has it been recognized that the best way to organize is dependent on the particular situation the organization is in. The 'contingency theories' of organization were developed. These theories emphasized the technological and environmental factors that were important in shaping the organization. Still later, since the 1970s, organization studies have become even more multidisciplinary. Some would maintain that the subject has become increasingly fragmented. Diverse perspectives and approaches coexist. Contributions are made from the disciplines of sociology, psychology, political science, management, anthropology and so on. Perhaps it is inevitable that such a multifaceted phenomenon as organizations is studied from many different angles and backgrounds (see, for example, Morgan, 1997, or Clegg et al., 1996).

To these various contributions an economic perspective has been added since the 1970s. Initially, this occurred because economists became interested in organizations and exported their newly developed theories into the field of organization studies. As such, the economic perspective simply came to coexist alongside the other disciplinary perspectives on organizations. Organization theorists, however, became interested in those theories, too.

One reason for their interest was that some of the economic approaches incorporated concepts that had been borrowed by economists from earlier work within organization theory. Transaction cost economics, for example, makes extensive use of the concept of *bounded rationality*, developed in organization theory. Through such common use of concepts the integration of economic theories within organization studies is facilitated.<sup>10</sup> Another reason for the growing interest in economic perspectives on organizations is that they allow the analysis of organizational problems that are different from those studied in the other disciplines. As mentioned in Section 1.1, these problems always deal with the economic aspect of organizations – how to allocate the scarce organizational resources efficiently.

We conclude this section with a final introductory observation: there is currently a *family* of economic approaches to organizations. The family is bound together by their focus on the economic aspect of organizations. This identifies them as *economic* theories of organization. Within this common family resemblance, however, the various theories to be introduced differ in many respects. They differ, for instance, in the problems identified and in their basic modes of analysis, as will become clear when they are introduced. In the following chapters, therefore, the differences within the family may stand out more clearly than the similarities. In Chapter 11, we return to this observation and discuss the question of how tightly knit the family currently is and what the prospects are for its members' future development.

## 1.9 Summary: the conceptual framework of this book

This chapter has introduced the basic conceptual framework we use to explain the fundamental economic approach to organizations (Figure 1.1). The framework takes the division of labour in society as its starting point. The division of labour leads to specialization, which allows efficiency gains to be made. With increasing specialization, however, there is a corresponding need for coordination. Coordination is necessary in order to arrange the vast network of exchanges between specialized economic actors. This is illustrated in a modern, international context in Box 1.9.

### Box 1.9 Globalization, specialization and coordination: the case of Li & Fung

In this chapter we have used Adam Smith's original example of a pin factory as an illustration of the concepts of division of labour, specialization and coordination. These forces play not only at the local level of a factory, however, but also at the global level. This is shown by the case of Li & Fung, a Chinese firm that was called 'a surprising world leader in supply-chain management' by *The Economist*:

Li & Fung used to introduce Western retailers of clothes, toys and the like to the sweatshops of China. As such, it was no different from countless Chinese firms . . . But when Victor and William Fung, the brothers who today run the family business, sat down to think about globalization and what it means for Asia, they came up with a winning new strategy for their company.

To them, globalization meant above all *specialization*, and specialization brings complexity. If supply chains of companies once consisted of five links, they might soon have dozens, or even hundreds, they surmised. 'Somebody's got to pick up the pieces and bring them back together' says William Fung, the younger brother – which is what Li & Fung is now doing, to all appearances better than its rivals in the West.

It works like this. Say, a European clothes retailer wants to order a few thousand garments. The optimal *division of labour* might be for South Korea to make the yarn, Taiwan to weave and dye it, and a Japanese-owned factory in Guangdong Province to make the zippers. Since China's textiles quota has already been used up under some country's import rules, Thailand may be the best place to do the sewing. However, no single factory can handle such bulk, so five different suppliers must share the order. The shipping and letters of credit must be seamless, and the quality assured. *Coordinating* all this is the challenge of globalization . . . And this requires knowledge. Village women with sewing machines in Bangladesh are not on the Internet. Finding the best suppliers at any given time, therefore, takes enormous research – so much, indeed, that companies are increasingly deciding that it no longer pays to do it inhouse. Instead, they outsource the knowledge gathering to Li & Fung, which has an army of 3600 staff roaming 37 countries ('a machete in one hand, a laptop in the other', as Victor Fung likes to caricature them) for the purpose. In this sense, Li & Fung is itself a product of *specialization*. A company that focuses entirely on optimizing supply chains for other companies is a recent phenomenon.

Source: *The Economist*, 2 June 2001

We have argued that there are two ideal types of coordination of exchange transactions: markets and organizations. Markets use the price system as the coordinating device, while organizations use non-price systems, such as authority. In practice, both ideal types of coordination are usually mixed. We have argued that the actual mix found in any situation will depend mainly on the information requirements of that situation. Markets and organizations are different solutions to information problems that are inherent in (economic) transactions. From an economic perspective, they have different efficiency properties. They are efficient coordination mechanisms for different sets of transactions, depending on the information requirements involved.

Finally, we have argued that markets and organizations are embedded in an environmental context and an institutional framework. Therefore, environmental and institutional factors will codetermine the trade-off between market and organizational coordination. This basic perspective is further elaborated and illustrated in this book.

## 1.10 Outline of the book

This first chapter has introduced some basic concepts in a preliminary way. They will be elaborated in Chapters 2 to 10. Equipped with this further knowledge, we return to the common perspective in Chapter 11. There we discuss it more thoroughly and contrast various ways of highlighting the similarities and the differences in the economic approaches to organizations. Finally, we apply the economic concepts to the topics of mergers and acquisitions, hybrid forms and corporate governance in Chapters 12 to 14. These chapters illustrate the broad range of the applicability of the approaches introduced in this book.

In Chapters 2 to 4, the general ideas introduced so far are explored in more depth. Chapter 2 focuses on markets. Standard microeconomic theory is used to explain how coordination is achieved in an (ideal) market. This theory illustrates the role of the price mechanism in equating demand and supply for goods and services. The chapter serves two purposes: first, to introduce some basic economic concepts and modes of analysis and, second, to serve as a benchmark against which other economic approaches can be measured. If you are already familiar with standard microeconomics, you can either glance quickly through Chapter 2 or skip it entirely.

To conclude this introductory chapter, we borrow from the economist A. C. Pigou (1920, p. 3) the following quotation: ‘When a man sets out upon any course of inquiry, the object of his search may be either light or fruit – either knowledge for its own sake or knowledge for the sake of good things to which it leads.’ On your course of enquiry through this book, we wish you occasional light and fruit, as well as some fun along the way. To this end, Box 1.10 introduces you to some typical fun that economists enjoy – lightbulb jokes.

### Box 1.10 A Russian lightbulb

There are many lightbulb jokes in economics, including these:

Q: How many economists does it take to change a lightbulb?

A: Two: one to assume the existence of a ladder and one to change the bulb!

An alternative answer to this question is:

A: Eight: one to change the bulb and seven to hold everything else constant!

John McMillan tells the following version from Russia.

In Russia in 1992, amid the ruins of communism, the State abruptly ceased controlling the economy. A few years later, when the country’s progress toward a market economy had bogged down and the country was in a sorry state, a joke circulated on the streets of Moscow:

Q: ‘How many people does it take to change a lightbulb under communism?’

A: ‘Five: one to hold the lightbulb, four to rotate the table he is standing on.’

Q: ‘Under capitalism, how many does it take?’

A: ‘None, the market will take care of it.’

The Russian sarcasm underlines a key point. While markets can do a lot, they do not work automatically. Unaided, the market will not take care of things.

Source: McMillan (2002, p. 14) (For more jokes on economics and economists see: <http://netec.mcc.ac.uk/JokEc.html>)

## Questions

- 1 Suppose you are a Saudi prince and studying economics at Oxford University in the UK. Your family sends you a very large monthly allowance to cover tuition and other expenses. In fact, this allowance is more than ten times the average allowance of the other students. Do you think that you would still have an economic problem? Why?
- 2 Suppose you are an American student and you are about to obtain your MBA and start looking for a job. An economist would say that you are about to enter the job market. Compare this market with the tin market that is described in the text. Is the job market for MBAs also an example of an ideal market? Is price a sufficient statistic for this market? Discuss the latter question from the point of view of both employers and those seeking employment.
- 3 What might be the economic aspect of (partner matching in) the 'marriage market'?
- 4 Box 1.9 describes the success of a company named Li & Fung. What exactly is Li & Fung's business? Who are Li & Fung's customers? After having read Chapter 1, including Box 1.9, what do you think is the main point that the case brings forward?
- 5 In Box 1.5, it is argued that the rise of the Internet has cut the cost of communication so much that firms will be inclined to outsource more than before. Do you think this is true? Do you see an implicit assumption, made by the journalists of *The Economist*, that is highly relevant but which is not mentioned in Box 1.5? Discuss.

## Suggested further reading

- Barney, J. B. and Ouchi, W. G. (eds) (1986), *Organizational Economics*, San Francisco, CA: Jossey-Bass.
- FitzRoy, F. R., Acs, Z. J. and Gerlowski, D. A. (1998), *Management and Economics of Organization*, Prentice Hall.
- Kay, J. (2003), *The Truth about Markets: Their genius, their limits, their follies*, Penguin.
- McMillan, J. (2002), *Reinventing the Bazaar: A natural history of markets*, New York: W. W. Norton.
- Milgrom, P. and Roberts, J. (1992), *Economics, Organization and Management*, Englewood Cliffs, NJ: Prentice Hall.
- Putterman, L. (ed.) (1986), *The Economic Nature of the Firm: A reader*, Cambridge University Press.
- Roberts, D. J. (2004), *The Modern Firm*, Oxford University Press.
- Seabright, P. (2004), *The Company of Strangers: A natural history of economic life*, Princeton, NJ: Princeton University Press.

## Notes

- 1 We use he and she intermittently in this book.
- 2 Strictly speaking, we introduce here the concept of *static efficiency* or *allocative efficiency*. Another question is how resources should be (re)distributed over time to adapt an economy or an organization to changing circumstances and keep it efficient. This is a question of *dynamic efficiency*. See further Section 11.3.2.
- 3 These two types of coordination should be regarded as ideal types in the Weberian sense. That is to say, they are theoretical notions that are hardly observable in the real world in any 'pure' form. This is discussed further in Section 1.5.
- 4 This is further elaborated in Chapter 8.
- 5 As we argue in Chapter 3, authority (or direct supervision) is only one of several coordinating mechanisms employed within organizations.
- 6 We consider it fruitless to discuss the question whether 'in the beginning there were markets' (as Williamson has posited as an analytical device) or organizations 'came first' (as an historical analysis would probably reveal). We are concerned here with the explanation of present-day phenomena.
- 7 See, for instance, John Kay, 'A Star Executive does not make a Company', *The Financial Times*, 15 February 2005, or John Plender, 'It pays to simplify boardroom compensation', *The Financial Times*, 5 January 2007. We return to the topic of executive compensation in Chapter 7.
- 8 One modern institutional arrangement to foster impersonal exchange between strangers can be observed on the Internet: the concept of 'feedback', as used by eBay. After each transaction, buyers and sellers get to rate each other – positive, negative or neutral. In that way, every eBay member builds a reputation. We return to this topic in Chapter 8.
- 9 On the other hand, such differences have likely become smaller in recent decades as globalization and economic integration of the world has progressed (see Stiglitz, 2002).
- 10 In this book we use the terms 'economic theories of organization' and 'economic approaches to organizations'. Examples of economic theories of organization are the behavioural theory of the firm, agency theory and transaction cost economics (Chapters 6, 7 and 8 respectively). 'Economic approaches to organizations' is a broader term, encompassing also the economic contributions to strategic management that are described in Chapter 9.