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Revisiting the Little Planned Society

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Why do business firms exist? The question is not as foolish as it looks. Some type of organization is necessary as the scale of business activity expands from the family farm to the massive size of Wal-Mart or GE. Nevertheless, it is still fair to ask why CEOs choose to make so many organizing and allocating decisions inside the firm instead of through buying and selling in the marketplace. After all, most of us subscribe to the notion that free markets organize production and allocate resources more efficiently than other systems, and especially in contrast to planned economies.

I raised this question in this space once before, in my introduction to our issue of Winter 1993, quoting a phrase suggested by Ronald Coase: "If prices can do the whole job," I wrote, "why do we have the institution of the firm, 'that little planned society'?... The so-called free-enterprise economies around the world are dominated by huge corporations, in some of which the internal transactions actually match or even exceed the volume of their external sales and purchases."

This assertion is even more relevant today than it was back in 1993.

Coase won the Nobel Prize in 1991 for his 1937 essay on this matter, where he justified the existence of business firms by the costs the pricing mechanism imposes on business operations—matters like price discovery, product search, contract negotiations, inspections, and settlement of disputes. Sixty-five years later, the issue of which activities belong inside the corporation and what belongs outside it is as vital and determining today as it has been at any time in the past. As I concluded in 1993, "In the end, the whole process [is] a battle over who would manage those little planned societies."

I return to this matter now, not because I would disagree with the earlier discussion, but because I failed to recognize another factor of immense importance: uncertainty. John Kenneth Galbraith, in his classic work, *The New Industrial State*, gives uncertainty the pivotal role in how great corporations seek to control their fates by managing internally instead of depending on market forces. Galbraith's book is over 30 years old, but his thesis seems strikingly appropriate in 2002. Today's irresistible urge to merge can hardly be due to concerns about the costs of outsourcing the firm's needs.

To the contrary, outsourcing is a popular buzzword these days, because overhead and greater flexibility are essential for profitability in the fast-moving environment in which we live. Why, then, does outsourcing grow right along with the great wave of M&A, where increasing numbers of activities are wrapped into one firm instead of spread among many? Clearly, Coase failed to recognize all the elements shaping the size and structure of the firm.

Today, time seems to be rushing toward us at terrifying speeds as technological innovation and the dissemination of information push forward with extraordinary velocity. Change always goes on, and the new always smashes into the old, but today's pace and power are without precedent. Controlling outcomes is becoming increasingly elusive. Mergers mean size, and size means both scale and control. Mergers build up a network of controls that create strategic ramparts against external attacks as yet unknown—indeed, unknowable.

At this stage of the game, Galbraithian uncertainty dominates the theory of the firm, while Coase-ian transaction costs take second place. The little society is growing larger.

REFERENCES

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Galbraith, J.K. *The New Industrial State*. London: Hamish Hamilton, 1967. See also a fascinating interview with Galbraith by Stephen Dunn, "The Origins of the Galbraithian System," *Journal of Post Keynesian Economics*, Spring 2002, pp. 347-365.