

**Contribution to the International Encyclopedia of Social Sciences, 2<sup>nd</sup> Edition**

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## 1. Introduction: the economic theory of the firm as a fundamental unit in economic analysis.

Seventy years ago, Ronald Coase, Nobel Prize in 1991, wrote a seminal paper “The nature of the firm”. This paper is now traditionally considered as the origins of the development of an economic theory of the firm. Before this article, the firm was assimilated to a ‘black box’, incorporating inputs and generating outputs. Coase (1937) argued that the firm was more than this purely technical vision: the firm has a concrete existence in the business world, and its internal modes of organisation (especially the coordination of individuals by hierarchies) are different from simple market transactions (coordinated by prices). With this statement, he encouraged economists to elaborate realistic hypotheses on what is a firm, and what a firm does. Today, the research agenda opened up by Coase is far from being completed. Recent works on the economics of the firm converge to show how difficult it is to fully grasp and qualify this subject. The outcome is that the economics of the firm is a combination of different subjects, and no single model or theory captures all elements of the puzzle. This chapter is intended to give an overview of some of the key analytical and empirical issues that are debated today, and especially how the distinction between managerial and entrepreneurial evolves but still firms structures the current research agenda on the economics of the firm.

## 2. Managerial firms

The focus of economists on large, managerial firms reflects the impact that this type of firms played in the early stages of the capitalist economist system (1900-1970s): large, vertically integrated corporations appeared as a dominant, stable and performing form of organization. Schumpeter (1941) qualified them as the major engines of production, while Chandler (1977) describes the emergence of a ‘visible hand’ era driven by these firms. These firms represent an important field of investigation for the following reasons: they can operate a significant power on the market, they are able to affect the social and economic environment, and they

can also elaborate complex strategies based on an appropriate organizational structure. Further, these firms have two distinctive features: i) the separation between ownership and control where the professional manager has the function to define the objectives of the firm, a function that was formerly devoted to the owners of the firm, and ii) the transition from the United to the Multidivisional form of internal organisation (U- and M-forms). These characteristics became one of the privileged fields of exploration of agency theory (Jensen and Meckling, 1986) and transaction costs approach (Williamson, 1975, 1985), as soon as they were interpreted in terms of private information and opportunism. In the first case, the manager benefits from a private information (on production costs, state of demand, work or product quality) that the investor cannot access, and this leaves room for opportunistic behaviours. In the second case, the united organization of the firm favours the development of suboptimal levels of effort which only become observable when competition is introduced amongst the different divisions of the firm.

Note that the objectives of the firm may largely differ from one author to the other. On the one hand, Baumol (1959, 1962) supports the maximization of sales or growth rate of sales. On the other hand, Williamson (1964) advocates the maximization of the managers' discretionary power through opportunistic behaviours. Simon (1957) has criticized both alternatives, arguing that the firm which has only a 'limited rationality' because of the uncertainty related to the environment will only pursue objectives defined by the term 'satisficing'. In this perspective, the search for profit, known as one of the firm's main objective will not be on the basis of maximum profit. In fact, it is impossible to estimate the maximum profit in this case since knowledge is not perfect. The objective can only be to maintain a satisfying profit level in order to keep the firm afloat in an uncertain world.

### 3. Entrepreneurial firms.

The discovery that the capitalist system has underwent a second period of transition, sufficiently different from the one observed since the beginning of the 20<sup>th</sup> century to be termed as the ‘vanishing hand’ (Langlois, 2003), marks the beginning of specific focus of economists on a novel sort of firms. Since the late 1970s, small, vertically disintegrated firms seem to perform as well as large incumbent firms. Evidence on that is the remarkable persistence across industries, countries, and over time of the skewed firm size distribution in industrial dynamics (exhibiting a large number of small firms and a small number of large firms), and the extremely important contribution of small firms to the global economic development (Geroski, 1995). In the late 1990s, the critical resource theory (Rajan and Zingales, 1998; Zingales, 2000) developed on the notion of talent diversity and human capital accumulation (Blair, 1995; Becker, 1976) to explain the performance of knowledge intensive companies where the entrepreneur plays a central role in knowledge creation. The point of departure of the analysis is that the nature of the firm is effectively changing. In the modern firm, the entrepreneur has a critical resource due to his specific skills, talents and ideas, which are the most important source of potential value creation for the firm. The effective value created by the firm is ultimately dependent on how the entrepreneur develops complementarities between his own specific resource and the resources of each of his collaborators.

### 4. Decision-making, ownership and power

One of the important issues in the economics of the firm is related to who decides within the firm, in other terms who has the power. A preliminary remark is that the concept of ownership has traditionally been perceived by as the ownership of physical assets and, consequently, power and authority were all based on this vision of ownership. Today, however, firms are

also composed of a range of other resources as creative knowledge, ideas and unique skills, professional control, corporate reputation, that sometimes generate a higher value than physical assets. The concepts of ownership and control have thus to be redefined to include these changes concerning the firm.

A further remark is that the answer to the question “who has the power?” seems, at least at first glance, rather obvious. Within small firms, the founder entrepreneur generally is the decider; while in large firms, the manager and more often the board of managers decides. In the real world, however, things may appear differently. In small firms, the founder entrepreneur, who has a technical skill, is often replaced or at least assisted by a professional manager or a venture capitalist, whose task is to transform this technical knowledge into a commercial opportunity. In large firms, the board of managers can be composed of shareholders who may significantly influence the decision process. These observations have stimulated a large number of analytical and empirical investigations. First, the definition of the respective tasks and scopes of experience of the entrepreneur, the manager, and the venture capitalist within small firms developed as a specific field of research. The basic results of this trend of literature is that different arrangements between the entrepreneur, the manager and the venture capitalist can be envisaged: from a shared power between the three actors in highly uncertain fields of activity where each of them can contribute in a complementary manner to the development of the company (Audretsch, 1995), to an exclusive power of the fund provider in less risky businesses where the entrepreneur or the manager may turn to have lower incentives choosing the optimal decisions in terms of investment and effort (Grossman and Hart, 1986; Hart and Moore, 1988). Second, the question of how large corporations should be owned and managed has been a recurrent theme. The emergence of the shareholder value ideology recommends that corporate governance

should be oriented in the interests of investors, namely in the realignment of the managers' incentives to avoid any forms of managerial discretion, the most extreme one being empire building (Schleifer and Vishny, 1997). Uniformity in modes of governance, however, is now widely debated. The predominant thesis that there should be a superior model is contested, since the adoption of a unique and universal set of rules neglects the diversity of national experiences and the heterogeneity of firms (Becht, Jenkinson, and Mayer, 2005; Lazonick and O'Sullivan, 2002). Moreover, evidence and analytical results show that this unique model tends to generate major failures and turbulences. What emerges as a result is that different types of rules should be proposed to govern firms that differ in size (small, large), type (entrepreneurial, managerial), industry of origins (knowledge intensive, traditional), stages of development (early, late phases of the life cycle) (Fransman, 2004; Krafft and Ravix, 2005, 2006).

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