


ASSIGNMENT I

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1 ANALYSIS

1.1 Purpose of the Texts

Both authors, Friedrich August von Hayek with “The Use of Knowledge in Society” and Ronald Harry Coase with “The Nature of the Firm”, write about definitions and properties of centralized and decentralized economic organizations. But their texts have different purposes: Hayek tries to persuade the reader of the best economic order on a basis of knowledge. He says that competition with the price mechanism is right while a planned economic system is not. Coase informs the reader with his text, what he thinks is the definition of the firm as an organization that flees the price system and taxation. Representing a set of long term contracts, a firm is basically the opposite of a market. The papers have to be seen in their historical background and although they follow different purposes, their content describes the same phenomenon.

1.2 Economic Assumptions

Both authors complain about the inappropriate use of economic models. Hayek states that problems of models are mainly the assumptions and the careless transfer of models into practice (Hayek, 1945, p. 519). Coase on the contrary realizes the dilemma: economic assumptions cannot be perfect but they exist as a tradeoff always on a knife-edge between manageable and realistic (Coase, 1937, p. 386). According to Coase an economist should at least clearly communicate the assumptions of his model – his definition of a firm is one in terms of economics and not in terms of a “plain man” (Coase, 1937, p. 386). Hayek says that unless all information from the real world is given, as-

assumptions and implications have to be made in order to analyze an economic problem – he gives an answer to the question “how to secure the best use of resources” (Hayek, 1945, p. 519 / 520).

1.3 Economic Organization: Levels of Organization

Hayek treats the entire economic system: should it be centrally planned or rather decentralized operated by the “man on the spot” (Hayek, 1945, p. 524)? Coase in return examines a more downstream question: if the society already decided in favor of a decentralized structure, how should economic rational individuals organize (Coase, 1937, p. 387)? In the decentralized market, in the sense of Hayek, operated by supply and demand, entrepreneurs should form firms (Coase, 1937, p. 387). These firms can be described as substitutes of the market (North, 1981, p. 41). So both authors treat the same problem but with a different zoom.

1.4 Economic Coordination: Information

Hayek states that there can be either the centralized solution with one unified plan, a decentralized solution with competition or the hybrid organization of a monopoly (Hayek, 1945, p. 521). Central planning is based on knowledge available by the planner, but a plan is a long term institution (Hayek, 1945, p. 524). Because economic problems always arise in consequence of change, continuous decisions have to be made after each little change in order to establish a continuous and optimal flow (Hayek, 1945, p. 524). These continuous decisions can only be taken appropriately by decentralized decision makers who live in this local environment (Hayek, 1945, p. 524). These men on

the spot have decentralized knowledge but also need centralized knowledge (Hayek, 1945, p, 525). The prioritization between those is a matter of relative importance (Hayek, 1945, p. 525).

In Coase's analysis the entrepreneur would be such a man on the spot. He does half of the coordination of work while the other half is done by the price mechanism (Coase, 1937, p. 389). Both, price system and entrepreneur are forces of integration (Coase, 1937, p. 398). The market is relatively abstract: it's a system build for exchange transactions (Coase, 1937, p. 391) and a firm can always revert to the open market (Coase, 1937, p. 392): A firm replaces a certain amount of coordination of the price system by contracts (Coase, 1937, p. 401). A firm employs workers under contract in order not to have to make short term contracts all the time on the market (Coase, 1937, p. 392). So each employee needs only one general contract that ties him to the firm (Coase, 1937, p. 391). This diminishes the transaction costs, that is the costs of using the market (Coase, 1937, p. 391). And it is also the wish to reduce the uncertainty of the market that builds the basis of a planning economy (Hayek, 1945, p. 523). Coase's firm doesn't fight the uncertainty of the market but builds a separate island entity consisting of a set of long term contracts to diminish this incertitude (Coase, 1937, p. 388 / 392) on the market.

Again, Hayek and Coase use different zooms: Hayek's analysis of a planned economy would treat the economy as a giant Coase firm but without an outside market. Both authors' analyses are related through the problem of uncertainty and the discussion of centralized versus decentralized management. Hayek's man on the spot and Coase's

firm can reduce uncertainty with their use of decentralized information and information compressed in a form of prices.

1.5 Economic Coordination: Prices

In general, both authors praise the prices as medium of coordination that reflects scarcity and allows us to use division of labor (Hayek, 1945, p. 526 and Coase, p. 389 / 400). However, for Coase, “there is a cost of using the price mechanism”: cost of contracts, cost of operating a market, and taxes (Coase, 1937, p. 390 ff.). Firms arise in order to flee these costs (Coase, 1937, p. 390). Furthermore, Coase analyses the difference between the master and servant relationship and those of employer and employee (Coase, 1937, p. 403 ff.): the first one consists of control and service which would be planned (Coase, 1937, p. 404) in terms of Hayek. The second one consists of the difference between paying a worker as employee, that is supervise the process and product, or pay the worker as contractor, that is only supervise the product and let the worker the freedom of the process (Coase, 1937, p. 404). The long term contracts of a firm concerning employees and other resources avoid costs of more numerous short term contracts on the market (Coase. 1937, p. 391). Coase doesn't use the term of transaction costs in this particular paper yet but his main argument can generally be expressed with words of North: organizations exist because of lower transaction costs (North, 1981, p. 168). A firm is planned so it doesn't have to pay a lot for operating a market but for example for marketing as interface to the market (Coase, 1937, p. 394).

1.6 Centralization and Decentralization: A Tradeoff

Hayek prefers the competitive market but the Hayek market also has centralized elements: there is knowledge that is best used by central authorities and there is knowledge that is best used by decentralized authorities (Hayek, 1945, p. 521). So it is knowledge according to Hayek that separates the economy in centralized and decentralized. A man on the spot has his decentralized knowledge but also needs centralized knowledge (Hayek, 1945, p. 525). At least for operating an efficient price system, the Hayek market economy would require at least some centralized elements.

A Coase firm is decentralized from the view of the entire market but the firm itself is centrally organized and planned with an entrepreneur at the top. The border between the firm and the market, that is between centralized and decentralized organized, is expressed by the size of the firm: it depends on the intensity of internal economies (Coase, 1937, p. 393), on increasing and decreasing returns (Coase, 1937, p. 394) as well as on diminishing returns to management (Coase, 1937, p. 395). The Coase firm will tend to be larger when the measures and the first derivatives of the measures are low: costs of organization, relative factor price and mistakes by the entrepreneur (Coase, 1937, p. 396 / 397). According to Coase, there is an optimal size of a firm, that is “an ,optimum’ amount of planning!” (Coase, 1937, p. 389). Hayek on the contrary doesn’t treat the sizes of centralized or decentralized organizations in particular.

1.7 Summary

Hayek and Coase treat different levels of economic organization. There is no direct conflict between their statements. However, their theses are related through the tradeoff between centralized and decentralized institutions, uncertainty and the price system of the market. Hayek remains relatively general and avoids specifying sizes of centralized and decentralized organizations and he avoids discussing firms or advantages of the planned economy. Although Hayek denies the centrally planned market, he does not exclude that some of his men on the spot are entrepreneurs that operate decentralized firms within the market. Furthermore, a Hayek market with only isolated economic people wouldn't make any sense so that his analysis must also assume firms on the market. And if these firms were organized exactly as the surrounding market they would not exist. So Hayek indirectly even assumes planned firms on his market. Coase, on the other hand, explains clearly the tradeoff that determines the size of a firm. The Coase firm can be described as a planned island on a competitive market ocean in order to reduce transaction costs. A Coase firm would typically exist on a Hayek market.

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