RELATIONS AS FACTORS OF EVOLUTIONARY CHANGES WITHIN THE THEORY OF THE FIRM

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Abstract

The paper looks into the understanding of relations within the theory of the firm. Three-level definition of relations from a firm perspective is in line with author's belief that the success of an organization depends on the ability to manage relations within organizations, among them and with their broader environment. By employing the concept of relations, the author argues that relation can be understood as the least common denominator and consequently as a factor of evolutionary changes within the theory of the firm. The evolution of theory of the firm indicates that evolutionarily recent theories show higher competence to understand relations. The best measure of theoretical development for theories of the firm is its contribution in the understanding of relations. The concession required for this improvement is a lower degree of theoretical generalization, more intense heterogeneity of the economic theory itself and sociologization of theory of the firm. This has driven the theory of the firm away from the orthodox neoclassical starting points; thus has enabled it increasing returns with regard to understanding relations.

Key words: theory of the firm, relations.

JEL: Z13, L00, A14.

1 INTRODUCTION

Every research requires a certain organizational form, which makes the choice of organization quite sensible, since it involves several activities regarding the relations. At the break of the millennium, the latter are becoming an important source of competitive advantage and its efficient management is of key importance for development of every company. In the paper, I wish to: 1. Show, how deep the understanding of relations within the economic theory of organization is; 2. Define relations as the lowest common denominator in the economic theory of organization; 3. Argue that the more contemporary and modern the theory, the more advanced is its understanding of relations.

2 DEFINITION OF RELATIONS ON THE ORGANIZATION LEVEL

The importance of relations in the organization has been stressed lately through the concept of social capital. The emphasis on the word "capital" namely means the relations comprise a value component that can become a source of competitive advantage (Putnam 1995; Collier 1998; Portes 2000; Adler and Kwon, 2002). Social capital is unlike other types of capital; it is not embodied in respective individuals (like human capital), but rather in relations between them. Since social capital is embedded in relations between individuals it cannot therefore be transmitted by only one person (Adler and Kwon, 2002). Consequently it does not benefit solely those who generate it, but also brings utility to those that do not take part in the process of its creation; thus, the "free-rider" problem arises, with certain individuals avoiding responsibility for relation's reproduction (Coleman 2000). Social capital is a public good and is thus subject to externalities.

However, the social capital lacks a general agreement upon a unified definition. The differences between multiple definitions and measurement methods stem from various sources, levels and approaches. With regard to the sources of social capital, the scientific literature most commonly refers to networks (Coleman 2000; Burt 1992; Putnam 1995; Granoveteer 1973), norms (Portes 2000; Putnam 1995), social beliefs (Nahapiet and Ghoshal 2000) and rules (Adler and Kwon 2000). The authors differ not only in the significance that they ascribe to respective sources, but also in the level at which the analysis is conducted, and may either be the level of an individual (e.g. Coleman 2000), an enterprise (e.g. Baker 1990), a geographic region (e.g. Putnam 1995), a nation (e.g. Fukuyama 1995) or a network (e.g. Burt 1992). Due to differences in the level of analysis, sources, and approaches, scientists often arrive at contradictory conclusions.

As for the intent of defining relations at the organizational (firm) level, I shall follow a three level approach. I shall focus on relations within organizations (organizational level), among them (inter-organizational level) and on relations between organizations and their environment (institutional level). Accordingly, these three levels will serve as guidelines when defining relations from an organizational (firm) perspective:

a) Organizational level refers to relations within an organization. Economists take interest in relations predominantly for the incentives they may have for the rational economic agents, while sociologists stress that not all relations are based on efficiency, as there are other important factors in complex relationships (e.g. power, trust, knowledge transfer). According to Williamson (1981), the organization is therefore far more complex than economists tend to believe. Drucker (1988), Quinn (1992), Nonaka and Takeuchi (1995) and Jones (1999) stress that organizational structure is becoming more open and non-hierarchical.

b) Inter-organizational level refers to relations among organizations. The economic approach emphasizes efficiency, because economists believe that efficiency coordinates inter-organizational relations (Collier 1998; Oliver and Ebers, 1998). Vertical integration is a common form of inter-organizational connection in the conditions of high knowledge specificity, uncertainty, repetitive relationships, small number of partakers, long-term agreements and opportunism (Oberschall and Leifer 1986; Jones 1999). Sociologist tend to believe that inter-organizational relations cannot be understood exclusively based on administrative relations driven by market rationale; as such, they are no longer merely a subject of choice between the firm and the market (Richardson 1972; Fligstein and Dauber 1989; Klein et al. 1996). High technological product complexity, information technology and more efficient transfer of knowledge continuously increase the level of co-dependence between organizations (Blois 1972; Grant 1997). Therefore, today's organizations are characterized by complex, flexible and informal inter-organizational relations that are not based entirely on economic efficiency (Richardson 1972; Fligstein and Dauber 1989; Baker 1990). In their research, Sobrero and Schrader (1998) find that none of the 32 studies in the field of inter-organizational relations considers both viewpoints. I strongly believe that only a complementary approach enables an undistorted understating of inter-organizational relations.

c) The institutional level links the understanding of between the firm and environment. North (1988) examines the relation through the idea that a higher level of mutual trust will decrease transaction costs. The institutional framework can be defined as a set of formal and informal rules in a society where, unlike the formal rules (e.g. laws and regulations), the informal ones (e.g. values, norms) are much more stable and more difficult to change. (In)formal rules are not only important for being a source of relations, but also for representing the environment where relations are both located and appraised (Adler and Kwon 2000). Kogut and Zander (1992) and Sorge (2001) maintain that success of an organization largely depends on its institutional environment.

These three levels are considerably interwoven. For instance, institutional environment affects how relations are generated both within and among organizations, since this generation process necessarily requires observance of mutual obligations, responsibilities and reciprocity (Adam et al. 2001). On the other hand, relations on the level of an organization determines the features of inter-organizational relations (Paxton 1999; Krishna and Shrader 1999; Uphof and Wijayaratna 2000).

3 UNDERSTANDING OF RELATIONS WITHIN THE THEORY OF THE FIRM

3.1 Understanding of relations within the neoclassical theory of the firm

The mainstream economic theory in most of contemporary business and economics schools is based on the neoclassical synthesis. With regard to its substance, neoclassical theory of the firm can be equated with Marshall's abstract theory of the firm[1]. The economic logos and the neoclassical organization theory became rooted in methodological individualism which equates rational behavior of an individual with the behavior of a firm, in perfect information and rationality, and in profit maximization; from these starting points, it is then possible to reach the equilibrium state by deductive reasoning. Theory is based on diminishing returns and rising marginal costs, which implies that the equilibrium is reached by equating marginal cost and marginal revenue. Numerous authors point to the deficiency in understanding relations within the theory, on all three levels:

a) Organizational level: It is believed by many authors, that focusing on market price mechanism and production factor allocation precludes theory from understanding the inner structure of the firm (black box). According to Arrow (1974) neoclassical theory of the firm in its purest is a theory of relative prices with an emphasis on market allocation of production factors. Failure to

[1] Chronologically, the term "neoclassical synthesis" was coined after Marshall's death and denotes merging the Marshallian microeconomics with the Keynesian macroeconomics.

understand relations in organization is mostly a consequence of fascination with geometrical-algebraic models. Perfect decentralization makes the market price mechanism increasingly important, the firm becomes the market's mirror image and the allocation efficiency a synonym for information efficiency; all this indicates an attitude of stark underestimation towards organization's inner structure.

b) Inter-organizational level: The need for efficiency in conducting business spurred the neoclassical economics to develop certain forms of accounting for the unconscious cooperation within firms and among them (Papandreou 1952). The notion that paying some attention to the relations with others is in a rational interest of any individual subject indicates that relations on inter-organizational level are understood primarily from the viewpoint of economic efficiency (Winter 1993).

c) Institutional level: Margolis (1958), Sen (1977), Hannan and Freeman (1977) and Etzioni (1990) underline that organization is a part of the broad environment which neoclassical theory does not look into. An individual cannot act or function without the environment, as humans are necessarily entangled in numerous relations, rather than being isolated and selfish entities, subordinated to the laws of economics. Neoclassical theory accounts for the broad institutional environment mostly by means of the demand curve (Williamson 1975; Penrose 1980). In this case, organization is represented in the market by a supply curve (Machlup, 1967). According to Kaldor (1934), it is possible to understand the demand's reaction to price, but it cannot be understood how the supply reacts, since that would take a mechanism that transcends psychological boundaries and translates them into a quantity/price relation. Cyert and Hedrick (1972) maintain that the neoclassical firm draws some information from its environment, which enables making more rational decisions; this could point to some sort of understanding of the broader environment.

Methodological individualism, rational behavior and concept of equilibrium drove the theory into the embrace of scientific deductivism which has prevented understanding of the inner organizational structure (black box). The sociological aspect of organizational and inter-organizational relations is completely overlooked. Scientific positivism caused a loss of several potent Marshall's ideas, as duality in the organization theory was replaced by cost curves and equilibriums that prevent the understanding of relations within neoclassical theory of the firm any deeper than to the level of economic efficiency. In spite of that, it should not be claimed that neoclassical theory does not pay any attention to relations (e.g. unconscious cooperation, information from the environment) at all.

3.2 Understanding of relations within the principal/agent theory

Beginnings of the principal/agent theory can be traced back to the 1930s[2], while a particular interest for it was spurred in the 70s and 80s, following the contributions of Alchian and Demsetz (1972), Ross (1973), Jensen and Meckling (1976), Fama and Jensen (1980, 1983). The principal/agent theory stresses rational behavior in a contractual relationship and pursuing one's own interests. An individual's conduct is strongly influenced by the asymmetry of information, as the parties in any contractual relationship have different amounts of information at their disposal. Asymmetric information and pursuit of individual interest gives rise to the problem of opportunism and control, since the agent often does not perform according to the principal's expectations (Fama and Jensen, 1983; Jones 1999). Opportunistic behavior of a manager can be prevented by appropriate agreements and market control. Several authors emphasize that the principal/agent theory pays a relatively fair amount of attention to relations:

[2] Berle and Means: The Modern Corporation and Private Property, New York, Macmillan, 1932.

- Jensen and Meckling (1976) stress that human capital cannot be appropriated, therefore only contractual-relational links are possible between the agent and the principal.
- Leibenstein (1979) and Demsetz (1996) argue that the principal/agent theory views the relations between the individuals in an organization through opportunistic attitude, understood as a negative form of social capital.
- Moe (1984) and Collier (1998) point out that understanding of contractual relations between individuals within the principal/agent theory is based on efficiency.
- Fama and Jensen (1983) emphasize that the main problem of partner organizations is knowledge transfer. Thus, employees that retire are offered ample compensations for passing on their knowledge to their successors. A successful knowledge transfer in partner firms requires a high level of correlation between human and relations.
- The principal/agent theory does not try to reach deeper into the contents of relations between the organization and the environment. Some sort of understanding of the broader environment can be seen through individual’s wish to draws information from the environment in order to make more rational decisions, since individual's position is strongly influenced by information from the environment.

The listed authors have three things in common. First, studying relations in an organization is based exclusively on the drive towards greater efficiency, which implies a continuation of the neoclassical tradition. The sociological aspect of organizational and inter-organizational relations is completely overlooked and the theory is still incapable to fully grasp the concept and the meaning of relations between the firm and environment. Secondly, the principal/agent theory emphasizes understanding of relations on the organizational level, as it focuses on the relationship between the agent and the principal. Thirdly, the authors stress the importance of relations through contractual employment relationship, control, preventing opportunism, trust and knowledge transfer. The problem of relations arises in the background of the principal/agent theory; therefore relations can be understood as one of the key elements of the theory. Due to a deficient understanding of relations especially at the inter-organizational level, the principal/agent theory is incapable to understand it in its entirety, in spite of having a more advanced understanding of relations than the previously discussed theory. By devoting more consideration to relations than the neoclassical theory, the principal/agent theory is gradually moving away from it; thus has enabled a better comprehension of relations.

3.3 Understanding of relations within the transaction cost theory

One of the biggest watersheds in microeconomics was the finding that information in the market cause costs and that their asymmetry influences decisively the conduct of individuals. Neoclassical economic theory of the firm does not consider transaction costs, as it assumes that all information are available at no cost, while the absence of information related problems enables setting up elegant models (Jensen and Meckling 1976; Kay 1984). On the level of a firm, the new institutional school deals with the problem of transaction costs (e.g. Coase, Williamson). Managerial-organizational costs are related to organizing a transaction in an organization, while the market transaction costs relate to the same transaction in a market (Coase 1996). An organization grows to decrease the cost of performing transactions within it, to slow the growth of these costs compared to the market transaction costs, to reduce cost of obtaining information as well as to decrease communication costs within a firm (Coase 1996; Putterman and Kroszner, 1996)[3]. By economizing transaction costs, the transaction cost theory builds on efficiency, on which the choice between the market and the firm is based, as a choice between two modes of

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[3] Williamson (1975) stresses the advantages the organization has over the market: less opportunism, better cooperation, more symmetrical information and less problems with imperfect contracts.

performing economic activity (Richardson 1972; Williamson 1975; Demsetz 1993). The main characteristic and the basic unit of analysis in the transaction cost theory is a transaction, which actually constitutes a relation, as it maintains a particular institutional framework which is a site of economic activity (Burrows and Veljanovski, 1985; Williamson 1975)[4]. Hence, I will explain in this section how thoroughly the relations are understood by the theory:

a) Organizational level: Except for studying the relationship between an employer and employee, transaction cost theory does not give much heed to relations within an organization (Richardson 1972). Today, human capital cannot be appropriated in typical contractual form, as slavery has long been abolished; thus, only contractual relations are possible in the form of relative property / ownership rights (Klein et al. 1996). The employer and the employee establish a relationship for mutual benefit. Several authors have underlined that transaction cost theory only understand the efficiency component of a contractual relationship, which does not enable a complete understanding of relations on the organizational level:

- Leibenstein (1979) and Williamson (1981) stress that" organizational man" is much more complex than "economic man", because employment relation are not based merely on efficiency, but also loyalty, respect and trust.
- Moe (1984), Alchian and Woodward (1988) and Pitelis (1991) believe that transaction cost theory is characterized by viewing relations between the employer and the employee from a neoclassical perspective, while culture and values do not receive much attention.
- Alchian and Demsetz (1972) and Ravix (2002) point out that the theory hardly takes into account teamwork and learning, where the sociological component should not be ignored.

b) Inter-organizational level: Transaction cost theory brings forth the advantages of inter-organizational vertical integration from the perspective of minimizing transaction costs; this way, external or contractual partners become internal partners and transaction costs are internalized (Blois 1972). Vertical integration is understood as a long-term contractual relationship between two firms (Klein et al. 1996). According to Williamson (1971), negotiations are considerably simplified in the case of vertical integrations, which consequentially makes the firm-transaction costs lower than market-transaction costs. Due to a strictly economic approach to transaction costs, the sociological view of inter-organizational relations is overlooked:

- Richardson (1972), Fligstein and Dauber (1989) suggest that inter-organizational links are not based solely on economic efficiency, and that they are not exclusively a choice between the firm and the market (e.g. franchise, strategic partnership).
- Blois (1972) submits that transaction cost theory is unable to understand "quasi integrations", i.e. the case of a large customer on which a company's existence depends.
- Klein et al. (1996) and Jones (1999) hold the belief that vertical integration is quite common when dealing with high uncertainty, small number of partakers and long relations.

c) Institutional level: According to Granovetter (1985), the transaction cost theory understands institutions as effective solutions to economic problems, without regarding the fact that they are a product of a specific environment. Perow (1990) holds that transaction cost theory disregards the broad environment and therefore fails to understand costs that are related to it. Similarly, Pitelis (1991) and Hodgson (1993) argue that methodological individualism precludes the transaction cost theory from recognizing the importance of the broad environment.

Although transaction costs theory presents a new way of understanding the relations (employment relationship, opportunism, vertical integration), the sociological view of relations is still mainly overlooked. The organization's internal structure is largely ignored, as the theory solves the

[4] Commons was the first one to treat transaction as a basic unit of analysis in 1934 (Williamson 1981).

problem of opportunism viewed as a negative form of relations, primarily by contractual employment relationships as the most efficient solutions. The theory is less attentive to relations on the institutional level, but at the same time it also brings forth the understanding of inter-organizational relationship from a perspective of minimizing transaction costs (vertical integration). Due to a strictly economic approach to transaction costs, the sociological view, where inter-organizational relations cannot be understood exclusively based on administrative relations driven by market logic, is mainly overlooked. Theory of transaction costs deals with the problem of relations, however despite that, the theory is still incapable to fully grasp the concept of relations although the theory understands relations better than its predecessors (neoclassical theory, principal/agent theory).

3.4 Understanding of relations within the resource theory

Resource theory emphasizes understanding the organization as a set of resources (Prahalad and Hamel 1990). The goal of entrepreneurial structure is efficient employment and specific combination of all resources in order to create competitive advantages. The size of a firm is therefore not limited only by the market, but by organizational resources. The growth of a firm is a process, and the organization's fundamental feature, the size, is "merely" a consequence of this growth, which implies that there is no such thing as the optimal size of a firm (Penrose 1980; Ravix 2002). This section reveals how deeply the resource theory understands relations on organizational, inter-organizational and institutional level:

a) Organizational level: Penrose (1980) and Knudsen (1995) submit that trust, cooperation, learning and taking responsibility enhance an organization's performance, efficiency and problem solving. Resource theory assumes that organizations are capable of learning and storing knowledge, while organizational routines represent organizational memory and a way of storing knowledge (Penrose 1980; Barney 1991). Cooperation is important in organizations, since contractual relationship alone cannot mediate the transfer of "silent knowledge"; thus, a firm is both an economic and a sociological institution (Penrose 1980; Ravix 2002).

b) Inter-organizational level: Takeover of an organization is a way of acquiring resources that complement existing knowledge (Penrose 1980). However, a takeover requires certain negotiating skills, trust, cooperation and knowledge transfer as the requisite for organization management. In this way, resource theory emphasizes relations on the inter-organizational level, both from economic (e.g. efficiency) and sociological view (e.g. trust, cooperation).

c) Institutional level: According to Penrose (1980), the growth of an entrepreneurial organization depends on internal (e.g. management quality) and external factors (e.g. resources, opportunities). Since knowledge is accumulated in our broader environment, it is essential to be familiar with the framework that the organization is operating in (Teece 1988). Understanding the external factors indicates a understanding of relations on the institutional level, although the environment takes some independence from the organization's decision making (Penrose 1980; Conner and Prahalad, 1996).

Relations on organizational, inter-organizational and institutional level are explicitly emphasized within resource theory. Understanding relations through takeovers, responsibility, negotiations, cooperation, efficiency, learning, trust, mutual decision making and knowledge transfer are examples of how relations emerge in the background of resource theory; these relations are explicitly emphasized. As far as understanding of relations are concerned, the resource theory is the most advanced among the ones considered in the paper, showing best competence to understand them. Organizations are characterized by complex organizational, inter-organizational and institutional relations that cannot be understood exclusively based on administrative relations driven by efficiency. The approach notes that an organization firm is both an economic and a sociological institution, so it deals with economic and sociological factors, which enables it to understand correctly the organizational and inter-organizational relations.

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The previous section revealed that only resource theory fully understands relations on the organizational, inter-organizational and institutional level, while other theories only consider some partial aspects and dimensions of relations. As far as understanding of relations is concerned, the resource theory is the most advanced among the theories considered in the paper, showing best competence to simultaneously understands relations on all three levels.

Neoclassical economic theory of the firm does not any attention to inner organizational structure (black box). Theory mainly understands relations from the prism of economic efficiency, while more recent theories employ information problems to expand the analysis to decision making processes and the inner organizational structure. Methodological individualism and rational behaviour prevent the understanding of relations within neoclassical theory of the firm any deeper than to the level of efficiency.

The principal/agent theory is more sophisticated in understanding relations than its forerunner, the neoclassical theory. However, in spite of employing information problems to expand its analysis to the inner organizational structure, the principal/agent theory hardly pays any attention to relations on the inter-organizational and institutional level and it is therefore incapable to understand relations in their entirety. The principal/agent theory is focused mainly on relations (e.g. opportunism, employment relationship) at the organizational level. By devoting more consideration to relations than the neoclassical theory, the principal/agent theory is gradually moving away from it.

Theory of transaction costs understands relations (e.g. contractual relationships, opportunism, vertical integration) mainly through economic efficiency. Due to a strictly economic approach to transaction costs, the sociological view is mainly overlooked. Nevertheless, the transaction cost theory is comparatively more sophisticated in understanding relations than its predecessors (neoclassical theory, principal/agent theory).

Studying relations within the theory of the firm brings us to a conclusion that it is possible to understand relations as their least common denominator in the background of theory of the firm. Such treatment of relations enables us to define it as a factor of evolutionary changes within the theory of the firm. Contemporary theories of the firm benefit from increasing returns of theoretical findings, as they upgrade and advance the results of their predecessors. The deficiency in understanding relations within the neoclassical theory of the firm spurred the emergence of new theories of the firm (principal/agent theory). Thus, the transaction cost theory is comparatively more sophisticated in understanding relations than its forerunners (neoclassical, principal/agent theory), which makes it more contemporary from the evolutionary point of view. Understanding relations is doubtlessly the most advanced within the resource theory, which makes it therefore the most modern from an evolutionary perspective.

Contribution of a particular theory of the firm in the field of social capital is obviously the best measure of its theoretical development, since every economic theory of organization appears to evolve proportionally to its capability to understand relations. The theory continues to evolve as long as it understands social capital and integrates this understanding accordingly in its theoretical systems. The evolution of theory of the firm clearly indicates that evolutionarily recent theories have a more thorough understanding of relations. As contemporary economic theories of organization continue to include sociological elements, we may observe that relations are becoming one of the key factors of evolutionary changes within them.

5 INSTEAD OF A CONCLUSION

Scientific positivism and the orthodoxy of the neoclassical paradigm fostered a loss of Marshall's numerous valuable ideas, while the duality in the theory of organization was substituted by curves and equilibriums. Neoclassical tradition with its scientific positivism was oriented towards the application of a relatively simple methodological apparatus that gave way to inward theoretical consistency. But our analysis has shown that a deeper comprehension of relations required the dismissal of some, often restrictive, assumptions of the neoclassical theory of the firm. Theoretical analysis in the previous chapters has indicated that the theories of the firm which are more advanced from the evolutionary point of view seem to develop a larger capacity for understanding relations, owing above all to the departure from the neoclassical starting points.

Evolutionary development gives rise to theoretical models with progressively better understanding of relations; however, the concession required for this progress is a lower degree of theoretical homogeneity of the theory itself. There appears to be a trade-off between the benefits (theoretical rigor, inward theoretical consistency) and the costs which appear in the form of failure to comprehend relations. As it progresses through its evolutionary course, the theory of the firm seems to constantly "soften"; consequently, the approaches to theory of the firm are less homogenous, but nevertheless yield increasing returns of theoretical findings with regard to understanding relations.

The evolution of theory of the firm clearly indicates that evolutionarily recent theories show higher competence to understand relations. Theoretical analysis shows that "sociologization" of economic organization theory has driven the discipline away from the orthodox neoclassical theory; thus has enabled increasing returns of their theoretical findings with regard to understanding relations. Contemporary theories of the firm continue to include more sociological (non-economic) elements, which are obviously becoming increasingly important starting points of economic theory of organization. By moving away from the neoclassical organization theory, the theories are becoming considerably more interwoven with sociology.

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