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IN THE BEGINNING THERE WERE MARKETS?

Frederick C.v.N. Fourie, University of the Free State, Bloemfontein, South Africa.

Abstract

In this chapter the author argues that the transaction and contract approaches have definite limitations in analyzing the nature of, and relation between, firms and markets. These limitations flow from the exclusive focus on the role of transactions and the inter-individual nature of these exchanges.

It is demonstrated that the generic firm, the firm as such, cannot be distinctively characterised exclusively in terms of market transactions. Therefore the distinguishing mark of the firm as such (as against markets and as against other organizations) cannot be the supersession of the price mechanism. More particularly the existence of the firm as such cannot be explained by transaction cost arguments. The employment decision of a firm cannot be explained by transaction cost considerations either. Lastly, not only transactions (exchanges), but also rivalry relations within markets are relevant in the determination of the boundary of the firm.

An alternative approach has as starting points (a) the intrinsic, generic dissimilarity between the firm and the market, and (b) the real existence of the firm as a cohesive, durable institution. This is shown to provide consistent characterizations of the differences between firms and markets, between internal and external relations, and between employment, integration and subcontracting. More basically the author warns against trying to explain everything in terms of market relations, and argues that exclusively individualistic explanations that disregard the existence of real societal structures encounter debilitating problems.

THE relationship between individuals, markets and firms must be rated as one of the most basic questions in the transactions cost and (Old, New and neo-) institutionalist literature.

In the transaction cost approach of Coase (1937) and Williamson (1973; 1975; 1981; 1985) the starting point is that the transaction is the ultimate unit of analysis, that "in the beginning there were markets", and that firms emerge and therefore exist in order to internalise, and therby economise on the cost of, market transactions between individuals. The nature of the firm therefore is understood through the prism of the market, which serves as ultimate and overarching point of reference, indeed as the most elemental building block of theoretical understanding of social institutions. Prominent topics in the transaction cost approach have been the reasons for the existence and growth of firms as well as the nature of the firm as opposed to the market, including the distinctions - if any - between employment, subcontracting and integration. Some of the most pertinent contributions are the work of Williamson on markets and hierarchies, and of Alchian, Demsetz, Jensen and Meckling on the role of inter-individual contracts (cf. Putterman, 1986; Cohen, 1979; Cheung, 1983; Fama, 1980).

The assumption that "in the beginning there were markets" (Williamson 1975:20; 1985:87) raises an issue which has become critical in the debate (Putterman 1986:18), and which will be pursued throughout this paper. The question is whether it is methodologically legitimate and constructive (and successful) to attempt to explain the typical and distinguishing inner nature of the firm exclusively in terms of another, typically different relation, i.e. the market (transactions, contracts). Secondly, and relatedly, whether the singular focus on inter-individual transactions, found especially in the contracts approach, is appropriate. A broader question is whether the transaction costs approach as such is fruitful in the determination of the nature of firms and markets. These issues will be illuminated by critically analysing the contributions mentioned above.

1. The nature and emergence of the firm

A first question is whether the transaction approach provides a clear indication of the distinctive nature of the firm - not so much of particular, existing examples of firms, but of the firm as a distinctive societal institution, the firm as such. That is, the quest here is for the intrinsic, generic nature of the firm. The starting point for this issue is Coase (1937), critical analysis of which also provides the first indications of the limitations of the transaction approach.

1.1 The firm as market superseder

Coase uses an internalization-of-external-transactions argument to explain the nature, existence and growth of firms. He makes two basic observations:

(a) Firstly, that one can distinguish (but also observe the parallels) between the allocation of resources in the economic system as a whole (i.e. by the price mechanism) and within the firm (by a manager). Thus he observes that "outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market, while within a firm these transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production" (1937, p. 388).

(b) Secondly, asks Coase, if the market can coordinate production, why then do firms exist or emerge in the first place? Arguing that exchanges will be brought under the coordination of the firm whenever the cost of using markets exceeds that of using authority and direction, Coase concludes that firms exist because there are costs of using the market mechanism.Therefore "the distinguishing mark of the firm is the supersession of the price mechanism" (Coase, 1937, p. 389). Correspondingly the expansion of the firm is defined as the internalization of additional external transactions, with the equilibrium boundary of the firm being determined by marginal transaction cost calculations. (The larger part of Coase's paper is in fact devoted to the growth and boundary issue).

While the observation that both markets and firms appear to have some coordination function is important, useful and perfectly legitimate, the attempt to go further and use this insight to derive and specify the typical, intrinsic nature of the firm runs into serious difficulties. This can be illustrated by considering the case of one-person firms.

1.2 The one-person firm and related problems

If the firm emerges because it is a less costly way of handling the exchanges and transactions necessary to direct and coordinate production, then the existence of such production must logically precede the emergence and existence of the firm.

Although there is no consensus on exactly what a firm is, the management of some production (and/or distribution) process appears - both intuitively and in most textbook definitions of the firm - to be central to the nature of the firm. From this two lines of argument follow.

If one argues that even the smallest production unit, a producing individual or artisan, is in principle (if only seminally) a firm, then such production can only take place if firms already exist.Then the firm cannot emerge as a market-replacing institution to begin with. In this case Coase's definition and explanation of the firm in terms of market transactions is logically untenable.

On the other hand one may argue that any producing individual cannot be regarded, without further ado, as a firm (also see section 3.5). For instance, while it is true that Coase's idea is presented and has been interpreted as a general definition and existential explanation of the firm, Hodgson (this volume) argues that one must assume that Coase has in mind what Marx calls `the capitalist firm', i.e. a firm in which the capitalist owners own the product of the property, and hire and control labour power under a contract of employment. According to Hodgson, this definition of a (capitalist) firm would exclude the one-person firm. That would seem to protect Coase against the criticism voiced above.

However, while all producing individuals may not be regarded as firms, that does not eliminate the possibility of the one-person firm. One simply cannot decree that upon reduction of its personnel to one (e.g. through automation or retrenchment) a firm ceases to be a firm (even a capitalist firm). One must accept the one-person firm as a conceptual possibility and indeed as an often encountered empirical reality (also historically).

For example, in South Africa a recent innovation in corporate law has been the creation of the so-called closed corporation, which is something between a partnership and a corporation, with fewer mandatory accounting and auditing procedures, and intended to encourage the small business sector. A significant number of these closed corporations - which are formally constituted as separate corporate business entitities legally distinct from the private financial assets of the persons involved - are one-person establishments. Moreover, this lead is being followed in a number of industrialised countries.

Such one-person firms cannot in all circumstances be conceptualised as coming into being to supersede transactions between persons or firms, or as existing because of the costs of using the market mechanism. The one-person firm cannot in general have the supersession of the price mechanism as distinguishing characteristic.

The important point is not to guess what Coase meant, but to ask to what extent his concept can be used to construct a general definition of the intrinsic, generic nature of the firm - the common element distinguishing all firms, in all shapes, sizes and forms, capitalist or non-capitalist. Furthermore, and critically, if the Coasean framework cannot capture the generic nature of the firm as such, as a matter of course it cannot capure the generic nature of specific variations, versions or forms - e.g. the capitalist firm - either.

1.3 What do markets do? Do markets produce?

A more general insight regarding the relation (or distinction) between firms and markets is that firms can exist without markets, i.e. without barter or trade. However, a market, unlike a firm, cannot produce. Therefore market relations can only link firms (producing units). Barring the theoretically moot case of producing individuals that are not firms, or the hypothetical possibility of a mulititude of non-firm (self-employed) producer-individuals, market relations are nothing but relations between already existing firms (or between such firms and customers). Typically, without firms that produce there are no products to be transferred and allocated by market transactions. Thus markets and firms are not alternative modes of production, but are inherently and essentially dissimilar.Therefore the firm as such cannot derive its inner nature from the market, or from superseding the market.

Therefore, although some firms may in practice be formed or adapted in order to eliminate or avoid market (exchange) transactions, the emergence and existence of the firm as such - of all firms - cannot be explained by transaction cost considerations. Accordingly the supersession of the price mechanism cannot be the distinguishing mark of the firm - that has to be sought elsewhere (see Fourie, 1981). Therefore Coase's analysis simply cannot provide the distinctive characteristics and intrinsic nature of the firm as opposed to the market - or, for that matter, as opposed to other social organisations. (Actually the latter is an important point, for the attribute of the supersession of the price mechanism, i.e. the allocation of resources via non-contractual internal interrelations, can also be found in non-firm, non-economic organisations such as universities, schools or churches.)

The important distinction here is that between the generic nature of a social institution, and the variable positive forms that it can assume under various circumstances whilst retaining that intrinsic generic nature that makes them all identifiable as, say, firms. Therefore, what Coase's analysis can explain, and most effectively, is the existence of, and especially the particular characteristics (but not intrinsic nature) of, more complex or more developed forms of the firm, which include those which have already internalized formerly external relations or production units, or those that explicitly came about in order to economize on transaction costs. (This would of course also include Hodgson's `capitalist firm'.) Such firms and markets may perhaps be viewed as different modes of internally and externally coordinatingrelations between producing units (which may, in the market case, be either producer-individuals, one-person firms or multi-person firms). For these forms of the firm Coase's characterization is an apt (albeit partial) description of certain pertinent aspects. However, as a general definition and depiction of the distinctive, intrinsic, generic nature of the firm as such - of all firms - it does not hold.

1.4 The market: transactions and rivalry relations

Another problem with Coase's analysis is his exclusive focus on the exchange relations within markets. However, exchange relations and markets are not equivalent. Markets do not only comprise exchange (transaction-type) relations, but are more complex, structured phenomena also encompassing rivalry relations - e.g. those between sellers (see Fourie 1991 for a comprehensive analysis of the structure and nature of the market).

Therefore, the incentive to form or expand firms in order to eliminate the irritations and friction of markets do not only relate to market transaction (or exchange) relations. Just as often the incentive to form or adapt firms may lie in the elimination of rivalry relations between competitors. In eliminating such relations (e.g. by a merger) the objective of economising on exchange or transaction costs is not directly at issue, and expansion of the firm does not amount to the internalisation of external transactions. Yet such mergers are (and always have been) an important method for the creation of new firms.

Again, Coase's analysis is not universally applicable, in this case not even to reasons for the emergence and form of specific firms (including capitalist firms). This confirms the circumscribed (although still significant) import of his analysis, in this case largely due to an unthinking equating of the market as a whole with exchange relations.

1.4 Markets and hierarchies/firms - which first?

The complexity of the market as economic phenomenon also has relevance for the question of the chronolocial order in which markets and firms (hierarchies) appeared historically. Obviously the scene is set by Williamson's assertion that "in the beginning there were markets".

This phrase suggests an individualistic, atomistic type of argument, akin to that often used in a Hobbesian (natural law-type) social contract depiction of the presumed emergence of the State. Such an approach may want to see a market-coordinated community of self-employed producers/individuals as the `natural' state, with transaction costs leading to the spontaneous, social contract-style emergence of the firm out of this sea of inter-individual market transactions. This indeed seems to be in the mind of many a theoretical economist working on transaction costs.

However, as is the case with the individualistic social contract theory of the emergence of the State, this sea-of-individuals scenario is contrary to the historical development of society. Historically, the development of more individualistic inter-individual relationships were preceded by periods in which communal relationships (sibs, ancient villages and medieval cities, guilds or religious communities) dominated society. The individualistic `natural state' picture and emergence story is a myth. For example, as a business history such as Chandler (1979) illustrates, historically the development of the firm as separate business unit was closely associated with an emancipation process from within the family community (i.e. small, family businesses becoming independent firms), and not from isolated individuals.

That would seem to settle the point, especially if one adds that the development of more individualistic inter-individual relations required the prior development of the civil (i.e. inter-individual) law sphere, which in turn was preceded by the emergence and existence of the State. Then there also is the more general remark of North (1981:41) that the view of the firm as a substitute for the market "ignores a crucial fact of history: hierarchical organization forms and contractual arrangements in exchange predate the price-making market".

Despite this I would want to caution against the dangers of getting into an either/or type of argument regarding the chronology. "Which first?", is perhaps the wrong question to ask, simply because the relation between various types of societal phenomena is much more complex than a simple linear progression - especially because in history these phenomena (institutions, organizations, etc.) themselves went through different phases of differentiation and development, varying from seminal forms to more complex forms. In the process the link and interwovenness between phenomena - and notably between exchanges, markets and firms - also differentiated and developed (see Fourie 1991). Typically, firms and markets are unbreakably interwoven - especially the less trivial, non-seminal forms found in a modern, differentiated economy. The internal, production relation of a firm has as necessary external correlate the external market relations. Similarly, the existence of external inter-relations that constitute the market are inextricably linked to the internal relations of the firm.

For analytical purposes the critical insight is that the existence and development of firms and markets are unbreakably correlated (see Fourie 1991). An analysis of the historical details of the unfolding of this correlated co-existence indeed can be most enlightening. Given the structural richness involved in such an analysis, a "which first" question may be quite misleading, if not simply banal.

In any case, what is clear is that one should not attempt to use such a (hypothetical) individualistic rational reconstructionist model to derive the inner nature of the firm. That is where Coase went so wrong:

1.5 The market as seminal unit of analysis?

Superficially the source of the limitations of Coase's analysis is his failure to consider the entire spectrum of positive forms of the firm, and the one-person firm in particular. Although his concern may have been the typical `capitalist firm', as Hodgson argues, and although in some societies the one-person firm today may be a relatively unimportant empirical phenomenon, there can be no arguing that a definitive logical and empirical test for a general conceptualisation or definition of the firm as such is its ability to accommodate all positive forms of the firm that occur and have occurred historically and in different economic systems. Limiting one'a analysis to one particular form, e.g. the `capitalist firm', as Hodgson argues, is much too restrictive and indeed may prevent important insights, notably if one's objective is to ascertain the intrinsic, the generic with regard to the firm.

But the one-person firm is not the real issue. More fundamentally Coase's weakness does appear to lie in his attempt to derive and explain the typical and distinguishing inner nature of the firm exclusively in terms of another, typically different relation, the market. While the insight that both firms and markets appear to have some co-ordinating function, is important - so that Coase may rightly depict markets and (some) firms as alternative ways in which production activities are coordinated - the nature of the firm cannot uniquely be described as market-replacing or market-simulating. Considering that markets cannot produce, one cannot really say that the firm, where production plays such an essential and typifying role, only exists to supersede the market (i.e. because of market failure). Remarkable as Coase's insight may be, pursuing it as a general way of understanding the inner nature of the firm as such may stretch the analytical content and applicability of that insight to such an extent that eventually the exercise may obfuscate rather than clarify, may hide that which is unique behind the less-distinctive (also see Kay, this volume).

A key question is the following. If the nature of the firm is not to be derived from, or explained exclusively in terms of, the market, what exactly is its relation to the market? The challenge is to discover the intrinsic dissimilarity between firm and market amidst the apparent similarity in terms of coordinating functions.

To achieve this, the difference between within-firm and between-firm (i.e. market) relations must be analysed.

2. Within the firm and between firms

If markets can at most link firms, market relations necessarily are external to any firm (whose production is internal to that firm). A clear conceptualization of internal and external relations is important, as is apparent when one considers the differences between the following: the employment relation (the employer-employee relationship), subcontracting, and vertical or horizontal integration (internalization).

2.1 Employment versus integration

One fundamental step towards delineating the bounds of the firm as well as the difference between firm and market, is a clear definition of employment and employeeship. An indication of problems that can arise in this context is provided by the critical analysis of contributions of Oliver E. Williamson.

In his pioneering focus on hierarchies Williamson (1973; 1975) expands on the internalization argument of Coase. He begins by noting that "the transaction is the ultimate unit of microeconomic analysis" (1975, pp. xi;20). Assuming that "in the beginning there were markets" with ubiquitous contracting, he explores how the choice between handling a transaction in a market vis-à-vis within a firm (a hierarchy) hinges on transactional factors. He discusses three contexts:

(a) The labour market:
Given "autonomous contracting between individuals", these are impeded by transactional factors (bounded rationality paired with uncertainty, opportunism paired with small numbers, and information compactedness). This is the reason "for workers to be joined in simple hierarchies" (1975, p. 56; emphasis added). Hierarchy, which embodies authority and subordination, can overcome transactional impediments. Therefore "simple hierarchy ... can be regarded as substitutions of internal organization for failures in the labour ... markets" (1975, p. xvi; emphasis added).

(b) The employment relation:
Four alternative modes of "labour contracting" between employer and employee are considered: contingent claims contracting, recurrent spot contracts, the Simon authority relation (Simon, 1957, pp. 184-85) and the internal labour market (Williamson, 1975, pp. 72-81). Of these only the latter, being within a hierarchy, is free from transactional difficulties.

(c) Intermediate product markets:
Given technologically separable production units and the exchange of components between them (under contingent claims or recurrent spot contracts), the same transactional factors impede these alternative types of sales contracts. This induces the merger of the production units into a hierarchy. Thus vertical integration "can be regarded as (the) substitution of internal organization for failures in the ... intermediate product markets" (1975, p. xvi; also pp. 56; 82 et seq.) and moreover as the extension of the employment relation to include department managers (for example a former inside contractor) (1975, p. 4).

The question is whether Williamson actually succeeds in providing a consistent and clear distinction between (i) employing an individual within a firm, (ii) subcontracting and (iii) integrating a production unit on the opposite side of a market relation. First of all, Williamson appears to use the term employee to encompass both internal workers (members) of a firm and external subcontractor-individuals.This is untenable, especially because he sees relations with the latter as labour contracting. Furthermore, it does not provide a distinction between what is inside and what is outside the firm.

Secondly, situation (a) describes workers joining in a hierarchy to overcome transactional failures in the labour market. If Williamson is describing the emergence of a firm along Coasean lines, his analysis suffers from the same flaws. Furthermore, here the firm (hierarchy) replaces labour markets (defined as transactions between workers). If he is describing the merger or integration of one-person firms, it is difficult to see why do he treats it separately from (c), and why he calls it a labour market situation. If he is describing an employment process, why treat it separately from situation (b)?

One must conclude that here Williamson fails to provide the necessary distinction between employment, subcontracting and integration. This evidently is because he, ironically, does not clearly distinguish markets and firms (i.e. hierarchies; also see Kay, this volume). In his analysis these simply become different degrees or classes of coherence between workers in the labour market, and this clouds his distinctions. (He also fails to distinguish workers/individuals and one-person firms.)

2.2 Employment vs. subcontracting: the contract approaches

A different approach to these matters is to ask whether one should at all try to distinguish firms and markets, whether they are not so similar that firms really should be regarded as quasi-markets. Indeed, it has been argued that the entire exercise of drawing firm-market contrasts is misplaced (cf. Putterman, 1986, p. 18; Klein, 1983, p. 373). To consider this question is is useful to contrast employment proper (i.e. of a worker within a firm) with subcontracting (in the market).

2.2.1 *Alchian and Demsetz - and the grocer*

The seminal contribution in this regard is Alchian & Demsetz (1972), who compare the relation between a grocer and his employee with that between a client and his grocer:

> "The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. I can `punish' you only by withholding future business or by seeking redress in the courts for any failure to honour our exchange agreement. That is exactly all any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products. What then is the content of the presumed power to manage and assign workers to various tasks? Exactly the same as one little consumer's power to manage and assign his grocer to various tasks...
>
> To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like telling a grocer to sell me this brand of tuna rather than that brand of bread ...
>
> I have no contract to continue to purchase from the grocer and neither the employer nor the employee is bound by any contractual obligations to continue their relationship. Long-term contracts between employer and employee are not the essence of the organization we call a firm" (1972, p. 777).
>
> "The employee can terminate the contract as readily as the employer, and long-term contracts, therefore, are not an essential attribute of the firm" (1972, p. 783).
>
> "My grocer can count on my returning day after day and purchasing his services and goods ... and he adapts his activity to conform to my directions to him as to what I want each day ... he is not my employee (1972, p. 777).

In essence Alchian and Demsetz argue that there is no fundamental difference between these two relations on the following points: the role and presence (rather absence) of authority and punishment, the voluntary and contractual nature of the relations, the equivalence of assigning tasks and continuously renegotiating contracts, and the relevance of the term of the contract (long versus short). The only substantial difference is that, with respect to employment relations, one party, the employer, is in a centralized position in the contractual arrangements with other "inputs" (employees), and that there is team use of inputs in the (by assumption) joint-input production process. (Indeed, they argue that firms exist in order to exploit the advantages of such team work: the "team process" induces "the contractual form called the firm".)

Internal criticism shows the following. Firstly, their definition of the firm as a contractual team of inputs can only be valid, if at all, for multi-person firms and not for one-person firms. Conversely it has been pointed out in the literature that their definition cannot explain large complex hierarchical firms either (Williamson, 1981, p. 1565). Therefore it cannot serve a a general conception of the firm.Secondly, the centralized position of one party in internal contracts is just as true for the contractual relationships between their illustrative grocer and all his customers and suppliers. This leaves the (intra-firm) relationship between grocer and employee indistinguishable from the (extra-firm) relationship between grocer and customer or supplier. Everything is reduced to market relations.

This causes a dilemma for these authors. Given their viewpoint, on what grounds can they themselves call one person employee and another supplier or (inside or outside) contractor (or customer), i.e. how can they distinguish between employment and subcontracting? In the absence of a clear distinction between internal and external relations such terms cease to have legitimacy.

2.2.2 Jensen and Meckling

These kinds of problems are most apparent in an equally seminal paper by Jensen and Meckling (1976), who treat the firm under the theory of principal-agent relationships. Like Alchian and Demsetz they emphasize the contractual nature of firm relationships: "contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc." (1976, p. 370). They do so, however, in a stricter way which concentrates exclusively on the contractual aspect. The firm is viewed, as are organizations in general, simply as a legal fiction which serves "as a nexus for a set of contracting relationships among individuals"; it is an "artificial construct under the law" which allows the organization to be treated as an individual (1976, pp. 310-11). For them there is only a multitude of inter-individual contractual relationships. All structures or organizations are artificial. Accordingly "the behaviour of the firm is like the behaviour of the market, i.e. the outcome of a complex equilibrium process" (1976, p. 311).

This view implies truly no distinction between internal and external relations of the firm, as the authors readily admit (claim?): "Viewed this way, it makes little or no sense to try to distinguish those things which are `inside' the firm (or any other organization) from those things that are `outside' of it (1976, p. 311).

However, a denial of any difference cannot be made as easily as that. The inevitable consequence of dissolving everything into a series of inter-personal transactions is to eradicate any distinction between institution and non-institution, between firm and market. As a general theory of the distinctive nature of firms and markets this approach must fail. If everything is reduced to an ocean of inter-individual market relations, one cannot legitimately talk about the firm nor about the market, cannot distinguish managers, employees or outsiders, cannot talk of owning a firm, residual claims on a firm, the inside or outside equity of a firm, factors exogenous to an organization, etc. - terms Jensen & Meckling use all the time. Therefore their view is inconsistent with concepts they themselves use and cannot avoid using.

The untenability of this approach is borne out by the fact that it is inconsistent with the historical order of events. Legal contracts became possible only after the dissolution of primitive undifferentiated society into a differentiated society with different institutions - and notably the State whose public legal order makes such contracts possible and enforceable. However one wishes to interpret history, the existence of meaningful contracts requires the existence of a public legal order which in turn presupposes the emergence and existence of at least the State (and by implication other institutions). But this is contrary to Jensen & Meckling's own view that all structures, including the State, are actually non-existent and but a legal fiction masking a multitude of purely inter-individual contractual relationships. Their denial of the real existence of structures like the State thus precludes the very contracts which are at the core of their argument.

3. Internal and external relations: an alternative view

3.1 Sources of failure: the market and individualism

As suggested before, the four contributions share a key feature which simultaneously is a common source of problems. What it amounts to, albeit in varying degrees, is the theoretical hegemony of the market concept - a tendency to define everything in terms of, or reduce everything to, market transactions. Starting with Coase they progressively posit an increasing extent of similarity between market relations and within-firm relations. Coase finds a common element in a process of resource allocation, but flounders when attempting to explain the nature of the firm entirely in terms of the market - the firm is reduced to a proxy for, or a simulation of, the market.Williamson places even less emphasis than Coase on the difference between markets and hierarchies. In his "employment relation" both categories are seen as forms of employment in the labour market - any difference is only a matter of degree, blurring any distinctiveness between firms and markets. Alchian & Demsetz as well as Jensen & Meckling find the common element in the contractual nature of inter-individual market relations, a correspondence between firm and market so absolute that any real difference is denied: inter-individual markets (contracts) become the only relevant economic entities.

More specifically these approaches cannot explain or consistently accommodate a number of elements which appear to be essential in the determination of the distinctive nature of firms and markets. These elements are:

- All the kinds and forms of firms and markets. All these authors have a problem with this: some, for example Coase, cannot accommodate the one-person firm, while others acknowledge only "producing individuals" (one-person firms?) and nothing more.
- What is inside versus what is outside the firm. This is the critical question that Coase, Williamson and the other authors are attempting to face up to. The former two do acknowledge some distinction, although their analysis is not entirely successful. The other authors deny the importance of and need for this distinction. This causes their predicament, as shown above.
- The relation between individuals and structures (institutions, organizations). Both Coase and Williamson seem to accept the real existence of organizations or hierarchies. While Coase does not focus on individuals as such, Williamson has trouble distinguishing a one-person firm and an individual. The other authors cannot, given their premises, do anything else but deny the real existence of organizations to a lesser or greater extent; hence they cannot clarify the relation between individuals and such organizations.
- The unity and durability of firms vis-à-vis the absence of any durable unity in inter-individual or market relationships. Especially Alchian & Demsetz and Jensen & Meckling fail to explain and take this into account when they reduce all organizations to a series of market transactions.

On the whole the result of conceptualising the firm exclusively in terms of the market - i.e. as a market-analogue - is that in the end no uniquely different attributes if the firm can be identified. If the firm is nothing but another variant of the market, but a quasi-market, the firm as societal institution has not been, and cannot be, uniquely typified. The distinctiveness of the firm is obscured behind certain apparent similarities with the market. In addition severe logical and historical inconsistencies are encountered.

The tendency to reduce everything to market relations is closely linked to a highly individualistic approach to the theoretical analysis of society - the dominance in economics of "methodological individualism" (Boland, 1982). Especially Alchian & Demsetz, and Jensen & Meckling adopt a strictly individualistic explanation of all "structures" when they attempt to analyze exclusively in terms of simplest elements, the elementary interactions between autonomous individuals (atoms). Without any regard for any structure or "societal form" within which individuals may operate, they effectively deny the existence of societal structures like firms. In a sense they only acknowledge one-person firms or, actually, producing individuals, the existence of multi-individual firms to the contrary. This leads them straight into dilemmas and inconsistencies.

3.2 The alternative: the firm as a durable, cohesive structure

The results above lead one to shy away from efforts to consider firm and market as mere alternatives, as birds-of-a-feather equivalent ways of organizing economic activity, and to argue for the acceptance of the reality of firms as separately recognizable, cohesive societal structures and as something quite different from market relations. Without in any way denying the pivotal role of individuals and inter-individual interaction within these structures, such a view recognizes firms as cohesive, durable institutions with members (individuals) who are bound together in a solidary whole which has a durability of existence amidst changes in membership. It implies that in their capacity as members of such a whole, individuals do not have a detached, linked-only-by-market-transactions existence.

This is accepted for at least three reasons. Firstly, its intuitive appeal: if such institutions did not really exist, if they were fictitious, if there were only a multitude of individuals, why is it that one can observe and immediately recognize them as firms? Obviously there are people (individuals) everywhere, but why are one and all intuitively aware of these and other institutions as institutions? And let it not be argued that the real existence of organizations/institutions is not at issue here. The ultra-individualistic views of Alchian, Demsetz, Jensen and Meckling deny exactly that. As shown below, had they in fact accepted such existence and its consequences, their analyses would be rid of much weakness.

A second reason for adopting this stand is the dilemmas and inconsistencies revealed by internal criticism of views that do deny the real existence of any structure. This strongly suggests that there is a reality that cannot be disregarded at will or forced into a favoured intellectual framework - in this case extreme individualism. Thirdly, and conclusively, the simple step of accepting the existence of the firm as a cohesive institution at once suggests a way out of most of the difficulties highlighted before. The basic points, to be elaborated below, are these:

- The firm's internal relations can be defined as those between members (including managers) and/or sub-units within the firm. This allows one to distinguish, as a correlate of these internal relations, market relations as an external exchange relation between firms (or firm and customer/supplier)
- The main distinction of the market relation is that it does not unite the participants into a cohesive whole, but leaves them to interact independently in cooperation, neutrality or antagonism.This interaction - or "co-ordination by the market" - remains external to any institutional whole such as the firm. Also, such a two-participant non-cohesive relationship guarantees no continuity amidst changes in participants. Any change in participant implies a new relationship, implying recurring formation and disintegration of such relationships.
- When such an external, market relationship is internalized by a firm (as in Coase's analysis) its character changes to a within-firm, i.e. an intra-whole relation, with the initially separate firms or units becoming bound together and co-ordinated within one institutional whole. Such co-ordination as exists is distinctively characterised by the cohesiveness and durability of the firm as institution (see below).

Without any pretence of providing insight into all aspects of the distinctive nature of the firm, these results enable important first steps: they preserve a clear difference and distinction between internal and external units/individuals/relations, and paves the way for legitimate and meaningful distinctions between firm and market, inside and outside, employee and supplier, and so forth. This can now be demonstrated.

3.2.1 Employment: authority, voluntarism and the durability of contracts

At this point it is useful to introduce the concept of a voluntary association. Such an organization contrasts with, for example, the family - into which one is born and thus becomes and remains a member independently of one's will - and the State, where citizenship automatically derives from birth and normally cannot be changed arbitrarily, and if at all, only subject to restrictions imposed unilaterally by that State. Membership of a voluntary association always originates from an (implicit or explicit) voluntary contract of membership.

Once the firm is conceived of as a durable, cohesive structure encompassing individuals, one can recognise that the firm in fact is a voluntary association. One can then apply the concept of membership: in this case the contract of membership is a contract of employeeship. This provides a clear definition of an employment or labour contract proper: an employee is internal to the firm, and is a person who has voluntarily entered into a contract of membership with the employer. (He is, of course, simultaneously member of other structures and institutions such as the church, State and family, fulfilling particular functions in each.)

This is why, as observed by Alchian & Demsetz, the employment relation typically displays a voluntary and contractual nature, similar to the market relation. However, a crucial insight is that each actualization of tasks in the continuing employer-employee relationship itself is not, ab initio, per contract. Only the initial establishment of this relationship is.

This concerns the durability or non-durability of employment and market contracts (Putterman, 1986, p.7), and specifically the presence or absence of authority. Since the firm as cohesive structure has a more or less durable existence, membership implies durability in the employment relation - as against a more or less instantaneous non-durable relation in a market exchange. Durable membership implies a durable contract which cover and allow a range of tasks within certain limits - if the firm has to negotiate a separate exchange contract for each task as it arises, no "worker" becomes a member. Whereas such a system of establishing separate exchange contracts implies the absence of any authority and subordination, durable contracts which allow a range of possible tasks imply the presence of authority.A true employment contract therefore enters the individual into a durable societal whole under a single (membership) contract which allows the employer to assign the employee to particular tasks.That is, the employer has authority over the employee.

Alchian & Demsetz, therefore, are correct when they say that an employer has no authority over a person with whom he contracts, spot-contract style, for a single and specific task. However, such a person is not an employee proper, not a member of the firm. What they say amounts to the truism that an employer has no authority over a non-employee, for example a subcontractor. The latter remains external to the firm: there is no durability, no membership and especially no authority in such and other market relationships.

Thus (a) with employment only the establishment is by contract, not each task in the day-to-day variable actualization of the relation that the durable contract allows for and sets bounds for; (b) with market exchanges both the establishment and momentary realization are essentially contractual. The problem in the analysis of Alchian & Demsetz stems from their failure to recognize and incorporate this distinction. Their "employee" is no real employee, no member of the firm. To paraphrase them, to speak of the employer being continually involved in renegotiation of (spot) contracts with "employees" is a deceptive and incorrect way of noting that the employer is managing, directing and assigning employees to various tasks under a single durable membership contract with an implied authority relation.

The fact, noted by Alchian & Demsetz (1972, p. 783), that an employee can readily terminate his membership does not affect this conclusion. The voluntary nature of membership does not imply that it may not be durable nor that the employer may not assign employees to tasks during their voluntarily entered into membership of the firm. In voluntarily accepting membership the employee just as voluntarily accepts the authority of the employer for the duration of his membership. As Williamson notes, the employment relation is associated with voluntary subordination (1975, pp. xv and 54; also Putterman, 1986, p. 7).

3.2.2 Employment, subcontracting and integration

The basic source of confusion regarding employment and vertical integration is that they occur together so often that they are confused with each other. However, the definition of employment that flows from the distinction between firm and market above enables one to distinguish them and at the same time clarify the nature of subcontracting.

Integration in the first instance involves the inclusion, by an integrating firm, of new functions - previously performed by a subcontractor, say - in its range of functions. If a subcontracting firm as such becomes part of this firm, it is a merger as opposed to internal expansion. Both are acts of integration or internalization. New functions require employees to perform them. But only if new hiring takes place (or if there is a merger) do new employment relations concur with integration. Integration as such does not necessarily imply (new) employment. It is but one instance when employment may occur. Similarly employment as such does not imply integration, only membership of an additional individual. In principle these two processes are distinct, even though and even when they occur simultaneously. One internalizes an individual, the other internalizes a firm. This is true, notably, in the case of integrating a one-person firm: such integration can be seen to involve, in principle, both of these different processes.

Moreover, in terms of the internalization of transactions the two processes differ markedly. When a producing unit (firm) is vertically integrated a formerly external exchange relation is simultaneously internalized, with transaction cost considerations most relevant. Employment per se, however, does not comprise internalization of a transaction relation. While employment can be regarded as the internalization of an individual (but not of a one-person firm) the transition is from the absence of any exchange- or transaction relation to the existence of an employment relation. Consequently the decision to employ per se cannot be explained by transaction costs considerations.

This analysis shows that a likening of employment "under authority" (i.e. within the firm) and employment "in the market" is not meaningful. Employment proper is by nature and in principle within-firm (notwithstanding everyday, non-scientific use of the term as in "employing a subcontractor"). Subcontracting, by contrast, is an external, market relation. This is the main misconception in Williamson's treatment of employment and vertical integration, and explains the inconsistencies outlined before.Once the proper distinctions are used to amend his analysis, it gains considerably in clarity and explanatory power.

Jensen & Meckling do not and cannot provide any distinctions between employment, integration and (sub-)contracting. This is inevitable and intentional, since all but the latter class are defined out of existence. If only inter-individual market exchanges and a multitude of individual producers are acknowledged, the choice between integration and subcontracting does not exist.As a matter of course their analysis excludes the existence of employment proper - all that exists is subcontracting.

3.5 Digression: the one-person firm again

It may be felt that the notion of a one-person firm is not consistent with my own definition of the firm, in particular that a one-person firm is not durable since it dies with the person, that there are not "members bound together", and that it is not an organization.

The durability of firms should not be misunderstood as permanency of existence. What it means is that if the single owner-manager sells the firm to another person, the change in occupancy does not affect the uninterrupted existence of that firm. (This is particularly obvious in the case of an incorporated one-person firm, e.g. in the closed corporation.) Similarly, if the single owner-manager dies, ownership/ management of the business can be transferred to another person whilst that particular firm continues to exist. This contrasts with e.g. a marriage, where a change in partner necessarily destroys the first marriage and necessarily requires the creation of a new marriage. In this sense a marriage does not have durability amidst changes in membership, whereas a firm has.

The absence of multiple membership does not present a problem if one has a developmental perspective on more and less complex forms of the firm, and if one realises that in a differentiated society membership never implies a total subsumption of the whole person, rather his fulfilling a specific function within the context of that particular organization. In the more developed forms of the firm separate persons fulfill the functions of manager, worker and shareholder. By contrast, in simpler forms of the firm, e.g. a partnership, the capacities of manager and worker are situated in one person or persons (he/they act as both manager and worker). That is, whereas in more developed firms these capacities (or functions) are separated out (differentiated) and situate in different persons, in simpler forms they still overlap. Yet these capacities (if not persons) can still be distinguished in these "collapsed" or seminal versions of the firm.

The one-person firm is the ultimate seminal firm, where all capacities/functions overlap and situate in one person - the person (in one capacity) employs himself (in another capacity). Therefore the cohesiveness and bounding together of "members" - or, more accurately, of members in their particular capacities/functions - is automatic. That the latter attribute is somewhat trivial in this simple, polar case does not prevent one from identifying this as a crucial feature in more complex forms of the firm.

In this regard the term "self-employed producer", used e.g. by Hodgson, in itself reveals more than one may suspect. The ironic point is that use of the term "self-employed" is a Freudian slip suggesting that this "person" indeed is implicitly viewed as a seminal firm, with at least two capacities involved, as noted above.

Of course this argument does not imply that all producer-individuals have to be viewed as firms. One must leave room for a non-firm producing individual. Exactly when such a producing activity becomes a firm, is still unsettled. However, the number of persons involved will probably not be decisive, rather the extent to which the particular production activity becomes differentiated from the private (or family) life of the person, i.e. begins to function as a primarily economic entity separate from the (primarily non-economic) family institution.

As for the term organization, the reader probably is used to the use of this term, for example in organization theory, in the context of the problems of managing and coordinating a large number of people. However, in a wider sense the term just denotes the activity of using power to structure, arrange, order and coordinate recources, i.e. using formative (economic) power actively to shape and direct a production process. This may or may not involve people/employees, and in any case is also applicable to the management of (real and financial) capital. In this sense also a one-person firm is an organization, for its foundation indeed is the organization of capital and other resources in a production process.

4. Conclusion

One purpose of this paper has been to highlight the usefulness and limitations of the transaction and contract approaches in analyzing the nature of, and relation between, firms and markets. Essentially these approaches focus on two aspects: the role of transactions (markets, contracts), and the inter-individual nature of these. Both angles have much insight to offer. However, they do have definite limitations. These appear when one attempts to explain firms and markets almost exclusively in terms of inter-individual market relations.

In general it has been shown that:

- The generic firm, the firm as such, cannot be defined or distinctively characterised exclusively in terms of market transactions.
- Therefore the distinguishing mark of the firm as such (as against markets and as against other organizations) cannot be the supersession of the price mechanism.
- More particularly the existence of the firm as such cannot be explained by transaction cost arguments.
- The employment decision of a firm cannot be explained by transaction cost considerations either.
- On the other hand both the decision to integrate and the extent of integration can be explained in this way (as has been done most fruitfully in recent contributions of, for example, Williamson (1985)).
- Not only transactions (exchanges), but also rivalry relations within markets are relevant in the determination of the boundary of the firm.

The development of an alternative approach has as starting points (a) the intrinsic, generic dissimilarity between the firm and the market, and (b) the real existence of the firm as a cohesive, durable institutional whole within which individuals play their pivotal role. One important reason for accepting this viewpoint is that such a perspective clarifies most of the problems and pitfalls exposed earlier, pinpoints the usefulness of transaction insights, and provides consistent characterizations of differences between firms and markets, between internal and external relations, and between employment, integration and subcontracting. Without acceptance of the firm as a cohesive structure these distinctions cannot be drawn consistently.

While much has been said above about what the firm is not, relatively little has been contributed positively about what the distinctive nature of the firm actually is (see Fourie, 1981). However, the establishing the futility of searching for the distinctive nature of the firm in that of another, very different thing, the market, is most useful. It forwarns against non-productive avenues of inquiry, in particular those instinctively most tempting for economists, given the dominance of the market concept in conventional economic thinking. It shows that if the market is to be used at all in the search for the distinctive nature of the firm, its most useful role probably is in determining what the firm is not. That, rather than conceptually trying to model the firm on the market, may be the methodologically most sensible meaning of the expression "using the market as a benchmark". Everything simply cannot be explained in terms of market relations (see footnote 16).

Another, more fundamental methodological inference is that an exclusively individualistic explanation that attempts to disregard the existence of real societal structures encounters debilitating problems. The difficulties encountered severely limit the potential of these approaches to give insight into the nature of the various kinds of relations and structures one finds in society, including - ironically - the place of individuals and markets in these. A less extreme approach is called for.

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Professor of Economics, University of the Orange Free State, Bloemfontein, South Africa.

Williamson (1975; 1985) provides an exposition of the transactional factors underlying the costs of markets. Klein, Crawford & Alchian (1978) provide additional insights.

That leaves as still unsettled the question whether an individual producer or artisan is to be regarded merely as a "producing person" or as a firm, albeit a seminal one; alternatively, when such a "producing unit" becomes a (one-person) firm. This is discussed in section 3.5.

Although Coase himself does not put it this way, Marris & Mueller (1980) have characterized Coasean approaches as viewing markets and firms as alternative modes of production.

In fact, that Hodgson's viewpoint is problematic is also suggested by the fact that even a multi-person partnership where all the partners are both managers and workers, and where there is no real employment relation, would not qualify as a (capitalist) firm. Meanwhile, a business history such as Chandler (1979) shows that the partnership is and was an important form of the (capitalist) firm in e.g. the United States. Also see section 3.5.

In this context the term coordinate should be used, not organise, as Hodgson does (this volume) or direct, as Coase does. Markets cannot organise (or direct), for the latter term denotes, and requires, active decisionmaking capability, power and authority. The market is not a person, and has no such capabilities. The market can at most lead to a rather loose, non-managed, spontaneous linking or coordination of voluntary participants (in which the market power of participants can of course play an important determining role) (see Fourie 1991).

Also see North (1981:42-3), who distinguishes between markets and price-making markets. In this context it is imoprtant to have a developmental perspective on the positive form of markets, i.e. a spectrum of forms from simple, even seminal markets to complex markets. Correspondingly price has various, differentiated functions, depending on the complexity of the market (Fourie 1991).

While Coase does not incorporate all consequences of the difference between within-firm and between-firm relations (see below), he does suggest that they differ in that internalized transactions are carried out using the direction and authority of an entrepreneur-coordinator, while in external (market) transactions coordination is by the price mechanism. The role of authority is discussed below.

He also describes the employment agreement as the substitution of a single incomplete contract for many complete ones with suppliers (1975,p. 4).

For related points of criticism, see Jensen & Meckling (1976, p. 310) and Williamson (1975, pp. 49-50).

They moreover fail to consider inter-employee and inter-subunit relations and transactions, internal to the firm, where there need be no centralized party.

The firm in particular is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals (Jensen & Meckling, 1976, pp. 310-11).

In similar vein Klein (1983, p. 373) has stated that the question concerning the essential characteristic of the firm appears to be unimportant, that it is a fundamental advance to think of all organizations as groups of explicit and implicit contracts.

Coase does preserve some difference since authority is present in the case of within-firm allocation; see footnote 8.

These problems are less apparent in Coase's analysis, but their seriousness in the more extreme versions of Alchian & Demsetz and Jensen & Meckling alerts one to the presence of similar problems in Coase's analysis.

Putterman (1986, p. 24) refers to analysts who indeed are embarrassed by the existence of real institutions and therefore attempt to develop new institutional analyses of highly neoclassical flavour where "markets are found to surface at every pass and markets work" (italics original).

It is not necessarily implied here that all the approaches discussed fail to achieve all these ends. In particular, Coase's analysis, being less extreme, is less vulnerable.

For an analysis of the intrinsic nature of the market, including a detailed analysis of aspects mentioned here, see Fourie (1991).

This is indicated by Coase (1937, p. 39) and Simon (1957, pp. 184-185), and acknowledged by Williamson as well as Alchian & Demsetz - the latter when they argue that recurrent spot contracting, and not durable or long-term contracts, is typifying of the employer-employee relation, and that accordingly authority is absent from the firm.

In the quotation from Alchian & Demsetz above the employee's typing the letter or filing a document are both covered by one membership contract. By contrast buying tuna or buying bread from the grocer implies two different, non-durable exchange relations/contracts.

A so-called long-term sales contract is not a durable exchange relation as such, but only as an agreement to repeat the non-durable exchange at certain intervals. The supplier remains external to the firm, is not a member and is not under the authority of management.

The intrinsic voluntarism of the firm does have implications for the nature of its authority relation, in particular that it is radically different from that of other institutions, notably the State. That the firm does not have physical force or power as foundation of its authority does not imply that the firm does not have any authority relation at all. Such a misunderstanding can explain the denial of Alchian & Demsetz of authority in the firm. See Fourie (1989:156).

His discussion of the "labour" market - individuals being joined in simple hierarchies to overcome transactional impediments - can now be seen to actually concern the joining of one-person firms. It is thus simply another view of integration, not of the labour market proper. His "employment relation" harbours a confusing mix of employment proper and subcontracting: he regards recurrent spot or contingent claims contracting as alternative modes of employment, while they really are alternative modes of subcontracting (market relations). His definition of vertical integration as the extension of the employment relation to include department managers ("inside contractors") confuses employment proper and integration.

The latter is the only real choice facing the firm in this regard. Employment versus either integration or subcontracting are not as such relevant options. Employment merely accompanies integration in some instances and is not the real alternative to subcontracting, even of a one-person firm.

The coincidence of different capacities or functions in one person is the necessary counterpart of the fact that one person can simultaneously be a member of different societal institutions, i.e. have a variety of differentiated functions in different institutional contexts. Again, this so because, in a differentiated society, his membership of one institution never implies a total subsumption, rather his fulfilling a specific function within the context of that institution. It is imperative not to think of the individual in an undifferentiated way.