Harold Demsetz

Preferring Reality to Nirvana

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Economist Harold Demsetz died on January 2019 at the age of eighty-eight. Demsetz grew up on the west side of Chicago, earned a B.A. in economics from the University of Illinois in 1953 and an MBA in 1954 and Ph.D. in 1959 from Northwestern University. Although Demsetz spent almost a decade at the University of Chicago in the late 1960s, the great majority of his professional career, before and after Chicago, was at the University of California at Los Angeles. At UCLA, he was the leading intellectual force among a strong group of economists who became known for their free-market brand of economics, which was closely aligned, though different from, the "Chicago School," particularly because of the UCLA emphasis on information and property rights.

Demsetz wrote on a range of topics, almost always taking a position that was contrary to mainstream thought at the time. He had a great gift to be able to see other interpretations of data or other explanations of economic behavior that had eluded the entire profession until he provided his interpretation or explanation. He was a pioneering thinker and great writer.

Our summary of his most important research is far from complete, and we leave out several important papers. Nevertheless, we hope we have provided a glimpse of the insights, power, erudition, and influence of his work.

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The Firm as a Solution to Shirking and Metering

Demsetz's most famous paper, "Production, Information Costs, and Economic Organization" (1972), written with another UCLA giant, Armen Alchian, is one of the most consequential papers in economics—chosen as one of the top-twenty papers in the first hundred years of the *American Economic Review,* the premier journal in the field (Arrow et al. 2011). Alchian and Demsetz examine the ubiquity, variety, and importance of team production and how the firm as an organization arose to solve the problems inherent in team production, such as metering the performance of workers to make sure that they do not shirk.

Alchian and Demsetz take on the challenge to "to explain the conditions that determine whether the gains from specialization and cooperative production can be better obtained within an organization or across markets, and to explain the structure of the organization" (1972, 777). This is a variation on the theme that Ronald Coase discussed in his seminal essay "The Nature of the Firm" (1937), which considers when it would make sense to shortcut market transactions and produce products within the firm. Prior to these analyses, the firm was taken to be a black box into which inputs were fed and out of which efficiently produced products emerged.

Alchian and Demsetz emphasize that the relationship between the worker and the firm is not particularly different from the relationship between a seller and a purchaser. The relationship persists so long as it is in both parties' interests. That said, relationships typically are not ephemeral. We do not find, for example, plumbing contractors arriving each day at a labor hall, calling out for the set of the skilled workers they require for the day's production. Instead, workers and firms enter into arrangements, whether formal or not, that involve significant continuity. Among the good reasons for this process is team production.

Some production involves close active cooperation among a group of workers. The challenging case is where the marginal contributions of individuals cannot be easily determined. These conditions can dictate the sizes of firms, the sizes of teams, and what production occurs inside the firm and what will be acquired from outside suppliers. Alchian and Demsetz offer the example of two workers loading a heavy object onto a truck. The item is heavy enough that a single worker cannot succeed just by working twice as long as it would take two workers to accomplish the same task. Furthermore, if either worker shirks, the task may not be completed efficiently and might not be completed at all.

Given the importance of team production, there is a problem of determining the contributions of individual participants. Alchian and Demsetz emphasize what they call "the metering problem." They write, "Two key demands are placed on an economic organization—metering input productivity and metering rewards" (1972, 778).

An important aspect of Alchian and Demsetz's paper is the understanding that the challenge of metering influences the scope of firms. Evaluating individuals' contributions requires high levels of understanding of a firm's technologies and opportunities. These abilities are apt to be highly specialized to the firm.

Alchian and Demsetz suggest that their understanding of the firm does not contradict Coase's. In particular, they credit Coase's "penetrating" insights that markets do not operate costlessly and that the costs of transacting influences the organization of production and trade (1972, 783).

Property Rights

Demsetz wrote several papers about various aspects of property rights, the most famous of which is "Toward a Theory of Property Rights" (1967). This paper takes the existence of property rights as endogenous and asks what change of circumstances would make it beneficial for a property-rights system to arise. Demsetz argues that a key function of property rights is to internalize externalities.

He hypothesizes that some change in technologies or relative prices would be an underlying cause for property rights to emerge. He illustrates this possibility with empirical data on the emergence of property rights in land among North American Indian tribes after Europeans began to trade with the New World.

The externality, which created important changes for the native North Americans, was a particular form of the tragedy of the commons. Before native North Americans engaged with Europeans, there was no ownership of hunting lands and a theoretical chance that fur-bearing creatures would be overhunted. Because forbearance in any current hunting season was likely to benefit other hunters, hunters had only weak incentives to ensure that enough fur-bearing creatures' offspring would survive to populate the forest in future hunting seasons.

If the hunted animals were in great abundance relative to the demand for their fur, overhunting would not be an actual problem. But after it became evident that Europeans had an insatiable desire for fur, native North Americans began to take the possibility of overhunting much more seriously. Basing his observation on empirical data in the anthropology literature, Demsetz points out that the increased demand for furs was coincident with the creation of a system of property rights in the hunting lands. Demsetz's observation anticipates Elinor Ostrom's important work in this field.

Structure of Corporate Ownership

In "The Structure of Ownership and the Theory of the Firm" (1983), Demsetz takes up the question of whether dispersed ownership was the problem for the control of firms that Adolf Berle and Gardiner Means ([1932] 1967) had claimed it was fifty years earlier. Berle and Means had argued that the lack of control by diffuse owners would allow the managers of the firm to engage in actions that benefited managers while harming the shareholders of the firm. This criticism was and continues to be an important political issue in discussions of the governance of firms. Demsetz points out that ownership structure is a decision variable controlled by the behavior of potential owners and that owners tend to choose concentrated structures when concentration would lead to greater profitability but more diffuse ownership when there was less benefit to concentration. In other words, ownership concentration is endogenous. Demsetz's theory undermines the premise of the "separation of ownership and control" literature by giving it a new interpretation with different connotations.

Demsetz and Kenneth Lehn take this insight further in "The Structure of Corporate Ownership: Causes and Consequences" (1985). This very influential article provides a new analysis of the effect of dispersion of corporate ownership on the performance of the firm. They hypothesize that firms in highly specialized or volatile environments provide a greater return from close monitoring but are also costlier for owners to monitor, leading to greater concentration of ownership. Concentrated ownership, therefore, is the result of economic trade-offs involved with monitoring, not exogenously determined by random events. Thus, Demsetz and Lehn do not expect low-concentration ownership to hinder the performance of firms, contrary to Berle and Means.

Demsetz and Lehn's paper also creates the concept of amenity consumption, wherein firm owners prefer to consume the firm's performance directly rather than converting potential performance into money and consumption from payments from the firm. This concept might explain the performance of sports teams' owners, who sometimes seem more interested in winning titles than in maximizing their team's profits.

These papers have the standard Demsetz trademarks of seeing an issue that everyone had interpreted in one way and finding a different explanation that completely alters our understanding of an issue.

Antitrust

Although antitrust was not the main focus of his energies, Demsetz was a critic of antitrust law. His criticisms of antitrust law are part of his belief that economists often undervalue and improperly understand the efficiency of markets relative to the efficiency of governments. This viewpoint is most clearly demonstrated in what has come to be known as his "Nirvana paper," "Information and Efficiency: Another Viewpoint" (Demsetz 1969), in which he asserts that economists, even leading economists, routinely assume that the government is capable of restoring efficiency in the case of market "failures" while undervaluing the ability of markets.

Demsetz's contributions in this area, though few, were crucial to redefining the subject. From the 1930s on, the structure-conduct-performance (SCP) model developed by Joe Bain and his disciples, dominated the field of industrial organization. The higher profits found in more heavily concentrated industries were taken as evidence of monopoly power. That perspective was the basis for a great deal of public-policy scholarship. The Chicago School's criticism of this paradigm was broad, but a full-frontal assault on the concentration–profit relationship awaited Demsetz's insight into its major weakness.

Many of the criticisms of the Bain perspective centered on potential problems with the measurement of profit using accounting data, such as the expensing of long-lasting investments—for example, advertising or research and development. In such investments, measured accounting profit would be biased. Nonmonopoly explanations had been put forward to explain some business practices that had earlier been claimed to be indicative of monopoly (tie-in sales, predatory pricing, resale price maintenance).

But Demsetz attacks the profits–concentration relationship head on (see Demsetz 1973). He takes the overall empirical concentration–profits relationship as is but provides a nonmonopoly explanation for it. Under the simple assumption that some firms are more efficient than others, he stipulates that more successful firms would grow due to their superior efficiency and would also earn above-normal profits. When an industry begins to be dominated by its most successful firms, the industry in general would earn above-normal profits as long as there is a viable fringe still earning normal or below-normal profits. This situation leads to the industry being more concentrated than normal and more profitable than normal. Demsetz tests this theory by demonstrating that firm size is positively related to profits when industries are concentrated and earn overall high profits, whereas there is little or no advantage for larger firms in unconcentrated and less-profitable industries.

Demsetz's ability to explain the profits–concentration relationship without resorting to monopoly power and his empirical findings on the relationship between firm size and profitability within industries, which are inconsistent with the normal monopoly explanation (wherein all firms in the industry would benefit from high monopoly pricing), was a devastating blow to the defenders of the SCP paradigm, and Demsetz's work was the final nail in its coffin.

Demsetz as a Person

Demsetz had an outgoing personality and a good sense of humor. Although he held some administrative positions during his career and had the personality to be an administrator if he had wished, his interest in research prevented him from spending time on administration. He was seriously pursued to become the dean of the business school at Washington University, which would have allowed him to craft a school consistent with his belief that economics is the fundamental scholarly discipline to understand business. When offered the position, he countered with a condition he thought they would refuse, which was to build a new building for the school. After the Washington University administration agreed to build a new building, Demsetz visited for a semester but eventually said "no" to the deanship. We believe that the thought of taking away time from his research was a fundamental reason for the decision.

Salary considerations wouldn't have been his reason, although Demsetz liked to tell how he left Chicago for UCLA over a difference of $200. After he received an offer from UCLA with an increase in pay, Demsetz's dean at Chicago came back with an almost matching offer, but it was short by about $200. When Demsetz complained that it wasn't a match, the dean said, "But it's only $200. That doesn't mean anything." To which Demsetz replied, "If it doesn't mean anything, why didn't you come up with the extra $200?" Demsetz then went to UCLA, where he stayed for the rest of his career.

Another indication of his wit can be found in his article commenting on the accomplishments of his great friend Henry Manne (Demsetz 1999). On the pay Demsetz received to teach economics to judges and law professors at Manne's famed retreats, he comments, "[T]he teaching generated new income, too. My family is grateful for this. Henry Manne showed considerable skill in setting my compensation. It was too low for me to escape from a debt I had incurred speculating on Treasury bond prices and just high enough to cover many months of margin calls" (256). On his teaching at these retreats, he says, "Law professors and judges have plenty to say on their own, some of it correct. Agitation from what I was hearing, combined with frustration in not being able to get a word in, brought repeated attacks of indigestion. Now, in preparation for a meal with judges and/or law professors, I put a roll of Tums in my pocket" (256). And on the results of the retreats, he says, "Judicial outcomes and the study of the law have been changed, probably forever. Preponderantly, improvement has resulted. Occasionally, a former student renders a decision that suggests the need for a refresher course" (256).

Harold Demsetz will be missed.

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