1. Introduction

The topic of this book can best be introduced by reproducing the conversation one of us had with his father (also an economist) many years ago: ‘Daddy, why is it that when the public works department repairs a road you see twice as many people taking twice as much time as a local contractor?’ Even though exaggerated (as any youth would do to stress a point and catch his father’s attention), the question relates to one of the most fundamental issues in the dismal science known as economics, studied since its inception about two centuries ago. Why do commercial organizations tend to be so much more efficient than organizations in the public domain? In this book, we aim to offer an answer to this question that differs from the one commonly given.

The father’s answer followed generally accepted wisdom. ‘The contractor tries to earn as much money as possible. The more roads his firm repairs, the more money he gets. So he urges his people to work as fast as possible. He has to pay his workers: so the fewer people he has on the job, the more money he can keep for himself. The public works supervisor gets his salary irrespective of how many potholes are filled: so why would he bother to press the workers on? And he probably gets a higher salary the more people he supervises.’ Of course, this answer was rather simplistic; if he had wished to do so, the father could have supplied a far more elaborate answer. In a more adult presentation, he probably would have introduced the word ‘profit maximization’ as the principal explanation of the difference in productivity of the public works department vis-à-vis the private contractor. Scholars, whether approaching the subject through agency, public choice or organization theories, ultimately arrive at precisely this very same point: commercial organizations maximize profits, and public organizations do not. In other words, the primary objective of commercial organizations is different from that of public organizations. Commercial organizations are more efficient because they want to be as efficient as possible in their
search for maximum profits, which is something that does not drive the behavior of public organizations.

Chapter 2 includes a more precise presentation of what constitutes an organization, and what distinguishes a public organization from its commercial counterpart. It also includes some thoughts as to the meaning of the word ‘efficient’ and the reason why ‘efficiency’ is so important. An elaborate, but still stick-figure, presentation of the historic debate about the difference in performance of public versus public organizations can be found in Chapter 3.

The father’s answer falls short on two points. First, it does not take into account that most activities in the market are not controlled by their owners, but by professional managers. The roles of owner and manager are split. The profit motive often plays a secondary role from the manager’s perspective. In fact, the structure of management incentives (but not the level) in private enterprises is often comparable with that of bureaucrats in the public sector. When professional managers are powerful, they often take actions entirely contrary to those that would serve the interest of the owner; in other words, profit maximization is not their focus at all. Second, privatization (transferring an organization from the public sector into private hands) very often does not result in an increase of efficiency. Hence, introducing the profit motive often does not have the claimed efficiency-enhancing effect. Again, profit maximization fails to play its central role.

Ample proof of both anomalies, and therefore of the absence of this automatic causal relationship running from an organization’s private status to efficiency enhancement, is provided in Chapter 4.

Because nearly all productive activities take place in organizations, their efficiency (and effectiveness) determines the eventual outcome for a society in terms of wealth and well-being. Therefore, finding a solution to these anomalies should be of prime concern in the discipline of economics. Standing on the shoulders of a number of giants of economics, such as Ronald Coase, János Kornai, Joseph Schumpeter, Herbert Simon and Oliver Williamson, and inspired by the biologist John Kerr (the discoverer of apoptosis1 in biology), we propose a radically different approach to the matter.

Our starting point is that in studying the private sector one
notices its extraordinary dynamics. Even under stable technological and market conditions, established large and small firms are continuously failing, often being replaced by new entrants. All the time, firms are folded into other firms, and small firms are spun off from larger firms. Under dynamic conditions, the pace of replacement accelerates. The process of replacement never stops. Even in good times, many firms go bankrupt, or are a weak prey for corporate predators. Even in bad years, countless firms are continually being started, and many incumbents survive the struggle and prosper. It was Joseph Schumpeter who recognized the importance of this dynamic process. He coined this process ‘creative destruction’.

Illustrations of and statistical evidence regarding organizational entry and exit are presented in Chapter 5.

Failure has many causes. These can roughly be classified as being of external or internal origin. The first to mention naturally is a drop in overall demand, in other words a Keynesian recession. Other external causes, differing in their impact on sectors and regions, consist of significant changes in the markets of production factors and/or products, in technologies, or in the political and sociological environment. These changes vary in the impact they have on the structure and culture of the organization. And, of course, organizations differ in their capabilities to adapt successfully to the environment. But, in the end, all organizations are unable to adapt because of the nature of the change they are confronted with, as there are limits to the degree of organizational adaptability. As Schumpeter (1911, p. 66) wrote, ‘it is not the owner of stage-coaches who builds railways’. The damage caused by environmental change can be irreparable.

However, organizational failure also takes place in completely stable environments. Many in academia and practice are very familiar with the Peter Principle and Parkinson’s Law. Hannan and Freeman (1984), Mintzberg (1989) and Daft (1997) developed other interesting theories describing the effect simple aging often has on the functioning of an organization. Office warfare is another environment-independent cause. Management failure can have devastating consequences. New theory, central to the message of this book, has identified uncontrollability as a cause of loss of efficiency. Uncontrollability is defined as the organizational state in which
control falls below a certain level such that the principal cannot take any remedial action because diagnosis is not possible, relevant information being unavailable. It is plausible that, ultimately, uncontrollability is inevitable, unpredictable, and irreversible. When these failures cannot be repaired and effectiveness cannot be restored, an organization is left behind with low productivity.

Causes of organizational ineffectiveness – many of them well known to people with professional experience – are identified and analyzed in Chapter 6. Chapter 7 is devoted to the new organizational failure theory of uncontrollability. Chapter 8 provides evidence that uncontrollability does, indeed, abound in organizational practice.

As Schumpeter explained, referring to processes of creative destruction, one key mechanism to deal with ineffective organizations is environmental selection. Here, the private sector tends to be very different from the public domain, but not intrinsically so. On the one hand, the least effective commercial organizations usually fold and are replaced, but this is *not always* the case. On the other hand, in the public domain, ineffective organizations usually survive, but *not always*. Hence, the essential difference between mortal and immortal organizations, though roughly coinciding with the difference between private and public, is not fully in sync with this distinction. So, what is the underlying mechanism that determines when selection does or does not work to sort effective from ineffective organizations?

By focusing on obligation satisfaction instead of profit maximization, this issue can be clarified. For now, we take financial obligations as our example. Any organization, whether commercial, public or non-profit, must have sufficient cash to pay the bills. Maintaining liquidity is essential for survival: liquidity is as essential to organizational life as energy is to biological life. A commercial organization that does not satisfy consumers’ expectations will lose its customers – its primary source of cash. However, if the government decides that an organization cannot be allowed to fold, and hence supplies it with sufficient funds, it will survive, whatever its lack of effectiveness. Most public organizations permanently rely on public funds, disbursed whatever the degree to which they satisfy their ‘consumers’ expectations. There exist notable exceptions, though. For instance, in many countries the cash distributed to schools depends, directly or indirectly, on the number of pupils. If
parents are dissatisfied with the quality of a school, and alternatives are available, a school will lose pupils and thereby funding. Such schools are ‘mortal’. The same is true, mutatis mutandis, for ineffective hospitals in areas where alternatives are available and if funded on the basis of patient numbers. Therefore, the decisive criterion is not whether the organization is public or private, but rather the extent to which an organization relies on public coffers to restore or maintain its liquidity. Many years ago, Kornai made precisely this point in a seminal article (1986), which unfortunately seems to have been largely ignored, probably because he applies his logic to the Communist context. However, sheltering from the financial consequences of ineffectiveness – not the private or public character of an organization – conveys effectiveness in a capitalist context, too.

A thorough analysis of this difference between the private and public sector is provided in Chapter 9. In Chapter 10, we will describe what happens when an organization, left to its own devices, succeeds in restoring its effectiveness, and when such repair is feasible and when it is not.

A significant counter-argument can be made at this stage. If sheltering ineffective organizations comes at a cost, the cost (both economic and social) of allowing existing organizations to fold and replacing them with new ones is also far from trifling. So, a cost–benefit analysis is called for, as the costs of replacement could be still higher than those associated with the subsidies for ineffective organizations. However, one does not always use a sledgehammer to destroy an organization; in fact, more often than not a surgeon’s scalpel can do the job nicely, by which the failing organization is carefully dissected and many parts are incorporated in other organizations. In this case, far less damage is done than the word ‘destruction’ implies. In effect, the economic system then does exactly the same thing as a human body that, if everything is in working order, carefully dissects failing or superfluous cells, and reuses the remains. It is estimated that in a healthy human body between 50 and 70 billion cells die each day through this mechanism. Cell death is a normal feature of a healthy organism. In precisely the same way, organizational death is a normal feature of a healthy society. This can be referred to as the process of economic apoptosis.

An elaboration of the phenomenon of the process of economic apoptosis, and its costs and benefits, is presented in Chapter 11.
Theoretically, one could envisage a society in which all organizations are exposed to the rigor of market selection. At its head would be a government that, if ineffective, can be removed – for instance, by elections. All other organizations would depend on their clients to cover their needs of cash, whether the client is the consumer or the government and whether the organization operates in the private or public domain. Societies organized in this manner do not exist for two reasons. First, politics usually ends up protecting existing organizations against their potential replacements, because much power is invested in the former and little in the latter. Second, the transaction costs associated with applying this ruthless mechanism are often prohibitive.

A more extensive analysis as to why all activities cannot be organized through market mechanisms is given in Chapter 12.

So, our key argument is that, in the long run, all public organizations will operate at a low level of productivity, the exceptions being found in those sectors in the public domain where market selection and the associated organizational dynamics are allowed to play out. The average superiority of organizations operating in the market unsheltered by the state compared to average public and other sheltered organizations is thus explained without resorting to arguments of profit motivation and ‘freedom’. Milton and Rose Friedman’s ‘Free to choose’ may have to be supplanted by ‘Free to fail’ as the crucial explanation of the superior efficiency and effectiveness of commercial and voluntary organizations.

NOTE

1. Programmed cell death.