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Reply to comments

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The 13 responses to my article are of high quality and suggest many fascinating directions for further research in the economics of organizations. I will not try to reply to all of them, in view of their number, but omissions should not be taken as criticism or that I think the response is not a contribution. I shall strive for brevity.

I begin with a general point in response to Steven Medema. He asks whether my turn to organization economics represents a deviation from the 'Chicago School' of economics with which I have been associated (and have associated myself). The answer is 'yes', though not because organization economics is not real economics. It is rather that a hallmark of the Chicago School has been its faith in the self-regulating character of markets. Of course some 'market failures' are recognized, such as cartelization and harmful (and sometimes helpful) externalities, but the Chicago School evolved in opposition to the 'liberal' (in the conventional US sense of the word) economics associated with schools like Harvard, MIT, and Berkeley, which were too quick to find market failure and oblivious to government failure, and so recommended excessive government regulation of the economy. Orthodox Chicago economists would have hesitated long and hard before acknowledging that there was a problem of overcompensation of corporate executives, or that the recent financial crisis was due in part (though I think only a small part) to a loss of control within large financial institutions because they had expanded rapidly as demand for credit grew as a result of the low-interest policy that the Federal Reserve under Alan Greenspan followed in the early 2000s.[1] The creation of complex and perhaps inadequately understood debt securities was a response to that demand.

Moreover, being methodologically austere, Chicago School economists would have hesitated to give nonpecuniary incentives a strong role in the economic theory of organizations, such as prizes and awards, mentioned by Bruno Frey, or dedication to the organization's goals in a 'high commitment' organizational

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1 See Posner (2009). The loss of control manifested itself in inadequate supervision of traders, loan officers, and other executives at the operational level of the firms, resulting in insufficient control of risk and excessive reliance on high-powered incentives, as John Roberts discusses in his response to my article.

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culture. And they would I think have thought it a considerable paradox that the kind of 'low powered' or 'muted' incentives stressed by John Roberts could play an important motivating role in a business firm.

Increasingly I have come to believe – this is a theme of my recent book on the financial crisis[2] – that orthodox Chicago School economics leaves too much out in modeling human behavior, and that the emphasis that John Maynard Keynes in the *General Theory* placed on the motivations for hoarding, on 'animal spirits' (confidence or optimism) as a spur to investment, on the economic effects of irreducible uncertainty,[3] and on the greater resistance of workers to nominal than to real wage reductions is indispensable to an understanding of the business cycle. I also think that the housing bubble that precipitated the global financial crisis of 2008 undermines the efficient-markets theory – which had already taken very hard knocks from the benavioral-finance literature – and also the rational-expectations hypothesis, which like the efficient-markets theory now seems to have rested on a dangerously exaggerated belief in the ability of investors and consumers to acquire and process necessary information.

And while on the subject of our economic situation, I note that Roger Koppl's interesting discussion of forensic science laboratories has a potential application to the credit-rating agencies (mainly Moody's, Standard and Poor's, and Fitch) that are getting some of the blame for the failure of the market to recognize the riskiness of mortgage-backed securities and related debt securities. The agencies are hired and paid by the debt issuers, and this creates a conflict of interest analogous to the conflict of interest created by the fact that crime labs typically are part of law enforcement agencies. Koppl is also correct to point out that a weakness in the use of arrests, convictions, and sentences as criteria for evaluating the performance of law enforcement personnel is that it is difficult to weight the criteria by the probability that the arrest, conviction, or sentence in a particular case was unlawful and may have imposed heavy costs on an innocent person. This problem amplifies the social costs of the conflict of interest of the crime labs and undermines the objectivity of the performance criteria used by law enforcement agencies.

I see the rise of organization economics as part of a broader movement toward an economic theorizing that is somewhat more informal, less austere, and less committed to a narrow concept of 'rational choice' than the traditional Chicago School economics. I do not, however, go to the other extreme from rational-choice economics and embrace 'behavioral economics' wholeheartedly. I accept many of its findings, particular in its behavioral-finance branch. But I am troubled by the behavioral economists' tendency to use loose words such as 'irrational' and 'unfair.' Although this is not the place to explain my reservations, I do not

2 See note 1 above.

3 Also an emphasis, ironically, of the American economist Frank Knight—the founder of the Chicago School of Economics.

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for example consider 'momentum trading' irrational, and so I do not consider the housing and stock market bubbles that led the economy into its present unhappy state to have been the result of irrational behavior. Banks and homebuyers had been told by government officials (like Ben Bernanke when he was chairman of the Council of Economic Advisers in 2005) that the rapid and steep rise in housing prices was not a bubble; this was the consensus view, though there were a few dissenters; and while I think many bankers and homebuyers alike were aware that there was a risk that housing prices would fall, it was for most of them a risk that, *ex ante*, was worth taking.

Indeed, in certain respects, organization economics is antithetical to behavioral economics. Organization economics helps us to see that some apparent irrationalities are rational once one looks inside the 'black box' of an organization and sees the play of self-interest bringing about results that, while individually rational, disserve the organization's goals. For example, it seems 'irrational' for an investment company to sell underperforming stocks in its portfolio disproportionately at the end of years and quarters. But the likely reason for this behavior is not that the manager thinks that the calendar determines stock performance; it is that his performance is likely to be reviewed by his customers at yearly or quarterly intervals, and he will face embarrassing questions if his portfolio contains underperforming stocks. There may well be excellent answers to the questions, but rather than trying to offer what may strike an unsophisticated customer as excuses, the manager may be better off quietly selling the stocks before his annual or quarterly review.

But I am happy to consider the full range of human motivations in analyzing human behavior, in the spirit of Keynes, and I agree with Bruno Frey (though he thinks I disagree) that what he calls 'extrinsic' and 'intrinsic' motivations (apparently the distinction is between, on the one hand, for example, money and other rewards or awards bestowed by an employer, and on the other hand subjective rewards, such as identification with and therefore satisfaction from advancing the goals of one's employer) need not be complements. They can be substitutes, and often are, as I had tried to make clear in the article in my discussion of the motivations of intelligence officers.

I take mild exception to Richard Adelstein's suggestion for confining 'organization' to a group that has a single boss, or 'central planner' in his words. Organizations can be close-knit or loose-knit. I would call a drug gang, a secret cartel; the US intelligence community and the federal judiciary, organizations; and within organizations of the same general type, such as business firms, I would distinguish between the type of close-knit organizations typified by the Ford Motor Company and the loose-knit Silicon Valley companies. I agree with Adelstein that there is an element of 'spontaneous order' in the federal judiciary, since the Supreme Court (itself a committee, with a chairman but no CEO), has no authority over the careers of the lower-court judges. But there is hierarchy: the Supreme Court cannot fire federal court of appeal judges,

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but it can reverse their decisions, and we can think of those reversals as orders delivered by a bureaucratic superior to his bureaucratic subordinates. Granted, the hierarchy in a Continental European or Japanese judiciary is much tighter, indeed hardly distinguishable from that of any other government bureaucracy.

On the question of the judiciary as an organization, I note the interesting analysis of *jurisprudence constante* by Barbara Luppi and Francesco Parisi. As it happens, I have discussed that doctrine, albeit very briefly, in a recent book (Posner, 2008). Unlike the Anglo-American doctrine of *stare decisis*, which creates a strong presumption in favor of a court's adhering to a decision in a subsequent similar case, the doctrine of *jurisprudence constance*, found in civil law judiciaries, such as those of Continental Europe, does not create such a presumption until the decision in the first case has been followed in a series of cases. That is, the judge in the second case is not even presumptively obligated to follow the decision in the first case, but if he agrees with it and therefore does follow it, and likewise the judges in a few subsequent cases, then the decision (or line of decisions) has force as precedent, meaning that the mere fact that it was decided as it was will constrain judges to follow it, at least presumptively.

In my book I attributed the difference between the two systems to the fact that Continental legal codes tend to be more detailed than Anglo-American statutes, though what is probably more important is that there is much more uniformity among judges in a Continental system, precisely because of its tighter hierarchical structure; judges who stray from the 'company line' are not promoted. Because precedent plays a lesser role as a source of legal certainty, the Continental judges can allow a decision to ferment for a while before deciding that it should operate to constrain judges in subsequent cases.

Luppi and Parisi suggest another reason for the difference between the systems, although it is complementary rather than contradictory to my analysis. They point out that the tradeoff involved in the choice between the positions of the two systems on precedent is between legal certainty, which is fostered by the Anglo-American system because there is less waiting time before a decision becomes a precedent, and the avoidance of judicial errors, which is fostered by the Continental practice of delaying the recognition of a decision as a precedent until it has commanded at least a preliminary judicial consensus. The difference in how the two systems have made this tradeoff is consistent with my point that the Continental system has sources of legal certainty (detailed codes and a tighter judicial hierarchy) that the Anglo-American system lacks.

In summary, organization economics provides insight into a wide range of practices by firms, government agencies, and other collective bodies – organizations that at first glance seem too disparate to be analyzed in similar terms but which turn out to exhibit significant commonalities when placed under the lens of economic analysis. Organization economics draws on behavioral economics, and psychology more generally, but also as I have argued offers an

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alternative to behavioral economics – a theory of how organizational structure can generate perverse consequences even though the inhabitants of the structure are acting rationally.

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