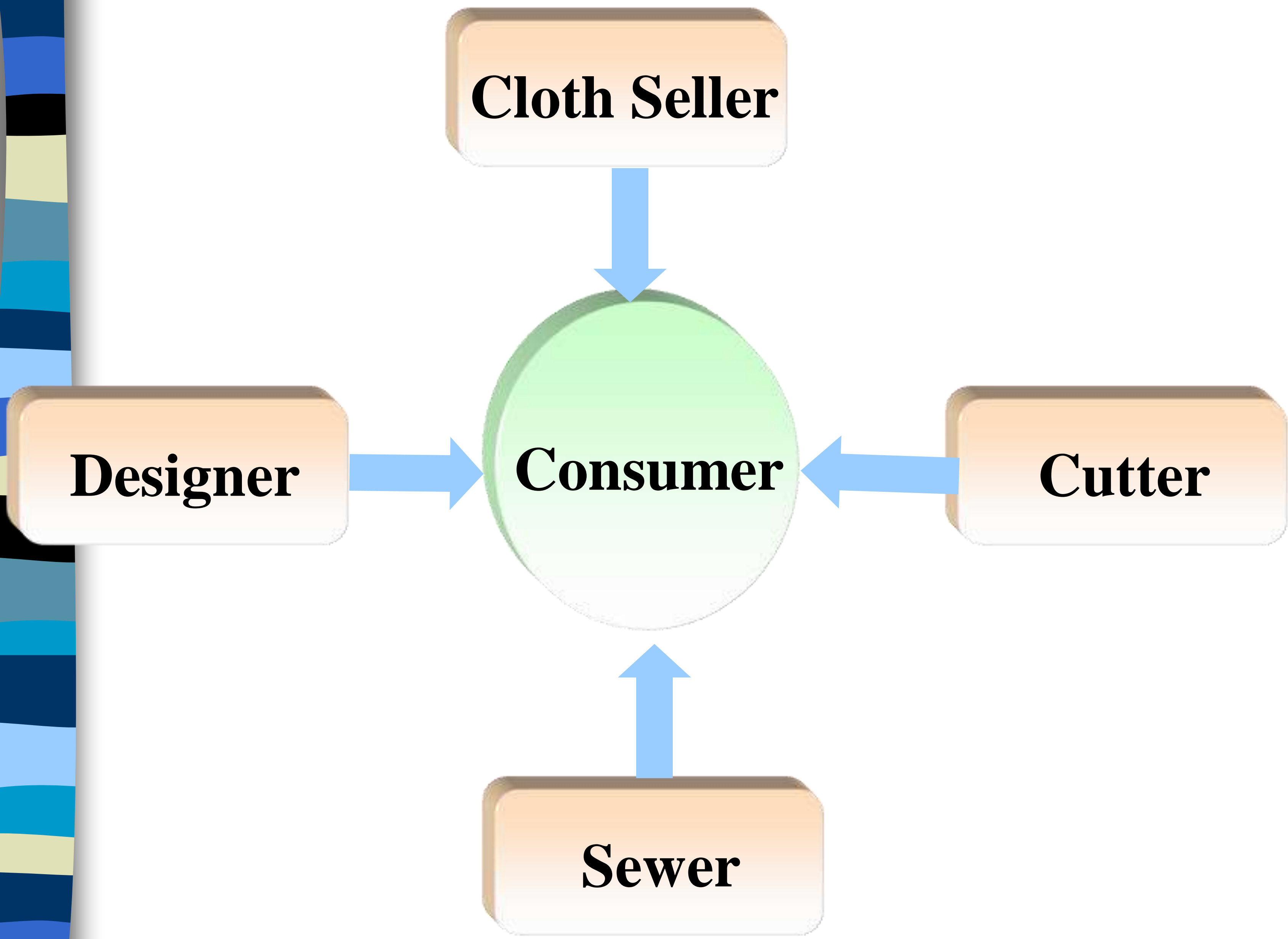
- a set of transactions* coordinated by authority instead of by the market.

*a transaction takes place whenever a good or a service is transferred from one party to another

Why Do Firms Exist?

- Some transactions are co-ordinated by markets
- Some transactions take place inside firms
- The firm is the *supersession of the market mechanism*
- The firm is that *set of transactions which is co-ordinated by managerial authority instead of the market*
- Why does this happen?

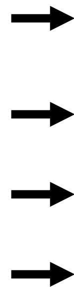

Cloth Seller
Designer
Consumer
Cutter
Sewer

Transactions inside a firm

Factor Market

Product Market

Factor of Production



FIRM

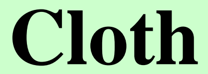
Entrepreneur

Product

(Goods & Services)

e.g. a shirt

Consumers



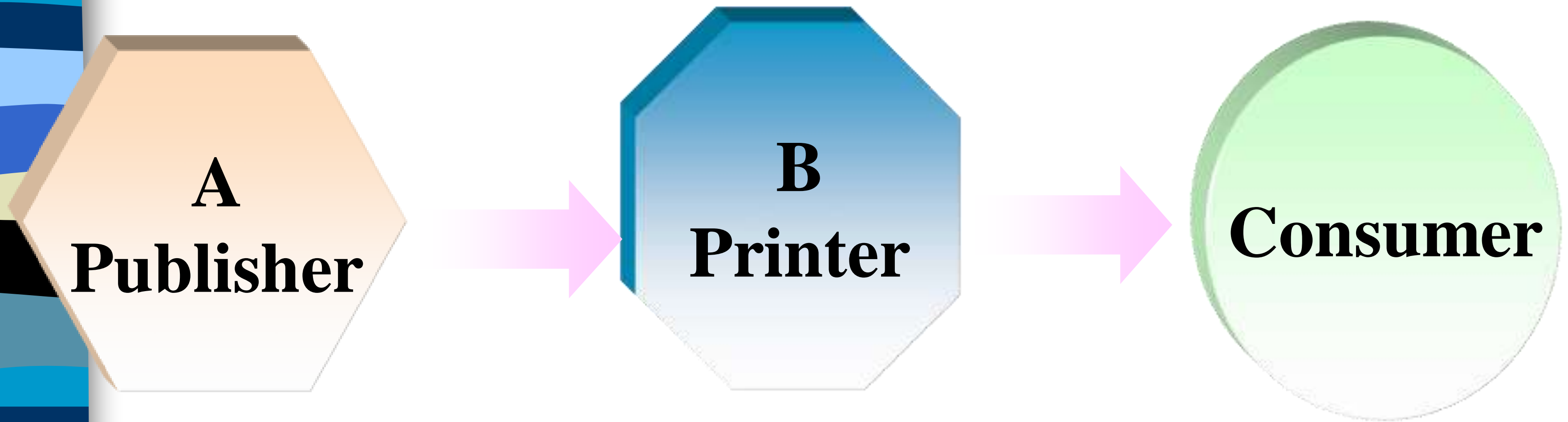
Designer

Cutter

Sewer

Product

Market Transaction



Vertical Integration
A
Publisher
B
Printer
Consumer

- Began with Ronald Coase (1937)
  - – firms come into being because in some circumstances they reduce the cost of doing transactions
- Developed most by Williamson (1975, 1986)
  - – identifies the circumstances under which different forms of ‘transactional governance’ are most efficient

Transaction Cost Analysis

The "Coasian" Analysis

- transaction cost problem; firm supersedes market

- transactions are "normally" done through markets; market is the default

- some transactions are done inside firms

- transactions are done in a firm when the costs of transacting on the market is higher than costs of transacting in the firm

- A transaction takes place when a good or a service is transferred from one party to another
- Direct costs arise in respect of:
  - locating buyers and sellers
  - acquiring information about their availability, quality, reliability and prices
  - negotiating, re-negotiating and concluding contracts
  - co-ordinating the agreed actions of the parties
  - monitoring performance with respect to fulfilment of contracts
  - taking action to correct any failure to perform
- Opportunity costs arise in respect of:
  - inefficiencies if inappropriate equipment used
  - failure to adapt to changing conditions

- information and measurement costs
- negotiation costs
- contracting costs (ink costs, legal costs)
- monitoring and enforcing costs, etc.

What decides whether a transaction takes place through the market or inside a firm?

Answer:

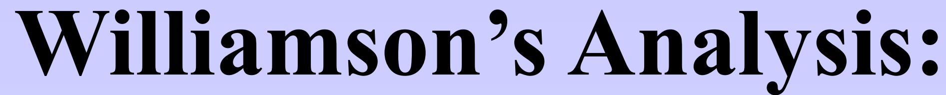
TRANSACTIONS COSTS

Coase suggested the costs of transacting inside a firm rise with:

- As firm becomes larger marginal cost of transacting increases
- managerial diseconomies arise
- larger firms may pay more for resources
- physical distance
- dissimilarity of transactions
- rapidly changing environment

Transactions will be organised in the least-cost way

- Identifies the key characteristics of a transaction
- Identifies the different types of "governance structure" that are available
- Matches the governance structure to the key characteristics


Williamson's Analysis:

- bounded rationality: imperfect information; therefore contracts must be incomplete.

- opportunistic behaviour: guileful strategic behaviour of individuals to take advantages from incomplete contracts (moral hazard problem)

- why the combination of them will cause problems for the organisation of transactions?

The Characteristics of a Transaction

- **the extent to which <u>complete contracts</u> are possible –** ***note that the term "contract" here refers to any agreement between parties, not just those which are formally written down***
- **the extent to which there is a threat of <u>opportunism</u> on the part of transactors**
- **the degree of <u>asset-specificity</u> or <u>idiosyncratic investment</u> involved in a transaction**
- **the <u>frequency</u> with which the transaction is repeated**

Contracts are Never Complete

- Uncertainty/complexity
- Bounded rationality
- Asymmetric information
  - hidden information
    - leads to **adverse selection**
  - hidden action
    - leads to **moral hazard**

Incomplete Contracts Are Not a Problem in Themselves

- Parties to the contract could agree to treat each other "fair and square" if something unexpected happens
- The problem arises because human beings are ***opportunistic***
  - "self-interested behaviour with guile"
  - cheating
- Before the contract is made
  - strategic misrepresentation - "it will cost me much more to do that !"
- After the contract is made
  - reneging - "I won't do what I promised"
  - hold up - "Pay me more or I won't do it"

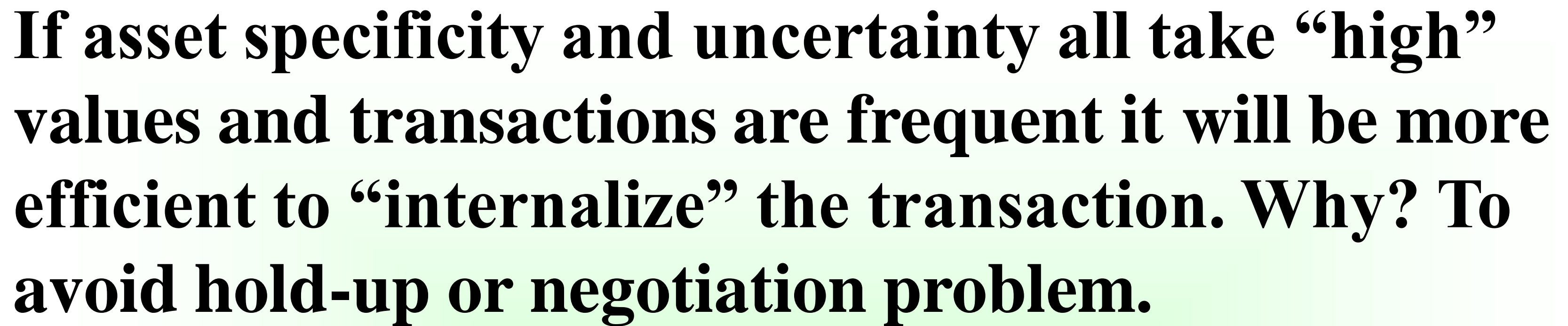
Incomplete Contracts And Opportunism Are Still Not The Problem

- If one party cheats, the other party can simply take their business elsewhere
- A third condition is required before arm's length transactions between independent parties become too expensive
- IDIOSYNCRATIC INVESTMENT
- or
- ASSET SPECIFICITY
- Investment in assets which lose their value if the transaction does not take place with a specific partner
- When there is asset-specificity the parties cannot take their business elsewhere - there is the 'small numbers problem

- Site-specificity
  - the assets are next door to each other
- Physical capital - specificity
  - my machines only work with yours
- Dedicated asset-specificity
  - I installed these general purpose machines to meet your order and I have no other customers
- Human capital specificity
  - my managers only work with yours
- Brand-name specificity
  - I am famous for my TV series

Asset-specificity creates a "small numbers problem" - bilateral monopoly

- If I can only deal with you
- And you are opportunistic
- You may renege or hold me up
- To avoid that danger I buy you and bring you under my authority



If asset specificity and uncertainty all take "high" values and transactions are frequent it will be more efficient to "internalize" the transaction. Why? To avoid hold-up or negotiation problem.

BUT - Internal transactions have their own disadvantages:

1. Internal sources distort procurement decisions

2. Resistance to change

3. Distortion of communication

4. Poor quality of data on cost of internal production relative to market purchase