Transaction Cost Approach & Organizational Structure

- Origins
- Similarities and Differences with Information Economics Approach
- Coase
  - Nature of the Firm
  - Problem of Social Cost
- Agency Theory

Origins

- Information economics--
  - Central question is optimal ex-ante contract design
  - Methods--Constrained maximization and characterization of the optima
- Assumes bounded rationality
- Business Management (e.g., Chester Bernard—“The Functions of the Executive”) - ongoing resource allocation within firm characterized by feedback loops
- Coase: Applications of economics to address what is the domain of management
### Matching behavioral assumptions to economic theories

#### Self-Interest Orientation

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Source: Adapted from David M. Kreps, *A Course in Microeconomic Theory*

### Implications

- Institutions matter to economic outcomes
- Design of institutional rules is a function of the nature and distribution of transaction costs
- Institutional design is endogenous

Implications!
The Nature of the Firm

- Why are there firms?
- Why are there markets?
- What determines the boundaries of the firm?
- What is the domain of management?

“The distinguishing mark of the firm is the suppression of the price mechanism.”
The Nature of the Firm (cont’d)

- Why are there markets?
- What determines the boundaries of the firm? Application of marginal analysis
- What is the domain of management?
- Management as a factor of production?

The Nature of the Firm (cont’d)

- Nature of transaction costs
  - Ex ante, including price discovery
  - Ex post, including monitoring/enforcement
  - Roots only in imperfect information? What else?
The Nature of the Firm
(cont’d)

- Eventual extensions by Williamson and others
  - Nature of transaction costs determines the prevailing governance structure
  - Cf. Information economics approach on contracting
  - Implications for anti-trust analysis

The Problem of Social Cost

- Why the title?
  - Critique of Pigouvian treatment of externalities
  - Focus on role of rules in maximizing value of total output
The Problem of Social Cost (cont’d)

- Part I: The Coase theorem
  - What does the theorem say?
    - Initial distribution or rights irrelevant to outcome
    - What is crucial is that rights be clearly defined
  - Reciprocal nature of externalities
  - What are its basic assumptions?
    - Zero transaction costs
    - Complete markets
    - Zero wealth effects

The Problem of Social Cost (cont’d)

- Implicit modeling style—Ask the question how a single firm would organize the activity
- Conclusion: “Unrestricted contracting mimics integration by a single firm”
The Problem of Social Cost (cont’d)

Part II: What happens when transaction costs exist:
- Initial distribution of property rights matter
  - Why?
  - Optimization with transaction costs leads to different outcome depending on your starting distribution of rights, not only in terms of distribution but also the level of output
- In dealing with externalities, now need to compare costs of market failure with those of government failure

The Problem of Social Cost (cont’d)

- Existence of transaction costs protects the position of those with the initial distribution of rights. Transaction costs protect the status quo
- “Institutions matter” for the path of economic growth.
- North and others extend the argument to say that institutions evolve as a function of the nature of the transaction costs