

Managerial Economics & Business Strategy

Chapter 6 The Organization of the Firm

Overview

I. Methods of Procuring Inputs

- Spot Exchange
- Contracts
- Vertical Integration

II. Transaction Costs

- Specialized Investments

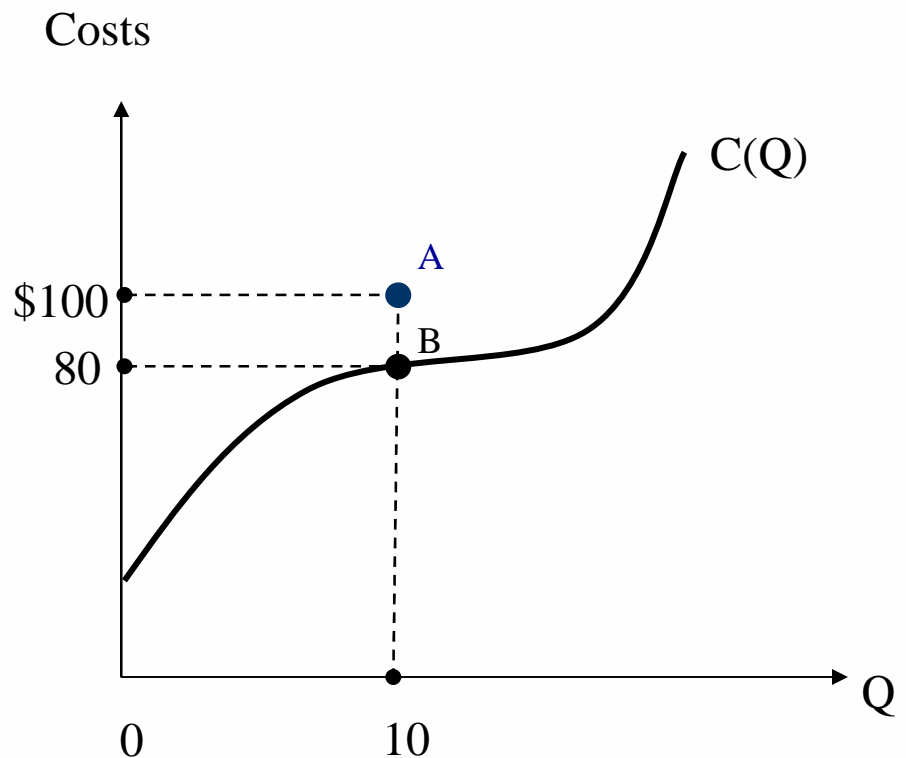
III. Optimal Procurement Input

IV. Principal-Agent Problem

- Owners-Managers
- Managers-Workers

Manager's Role

- Procure inputs in the least cost manner, like point B.
- Provide incentives for workers to put forth effort.
- Failure to accomplish this results in a point like A.
- Achieving points like B managers must
 - Use all inputs efficiently.
 - Acquire inputs by the least costly method.



Methods of Procuring Inputs

- **Spot Exchange**
 - When the buyer and seller of an input meet, exchange, and then go their separate ways.
- **Contracts**
 - A legal document that creates an extended relationship between a buyer and a seller.
- **Vertical Integration**
 - When a firm shuns other suppliers and chooses to produce an input internally.

Key Features

- Spot Exchange
 - Specialization, avoids contracting costs, avoids costs of vertical integration.
 - Possible “hold-up problem.”
- Contracting
 - Specialization, reduces opportunism, avoids skimping on specialized investments.
 - Costly in complex environments.
- Vertical Integration
 - Reduces opportunism, avoids contracting costs.
 - Lost specialization and may increase organizational costs.

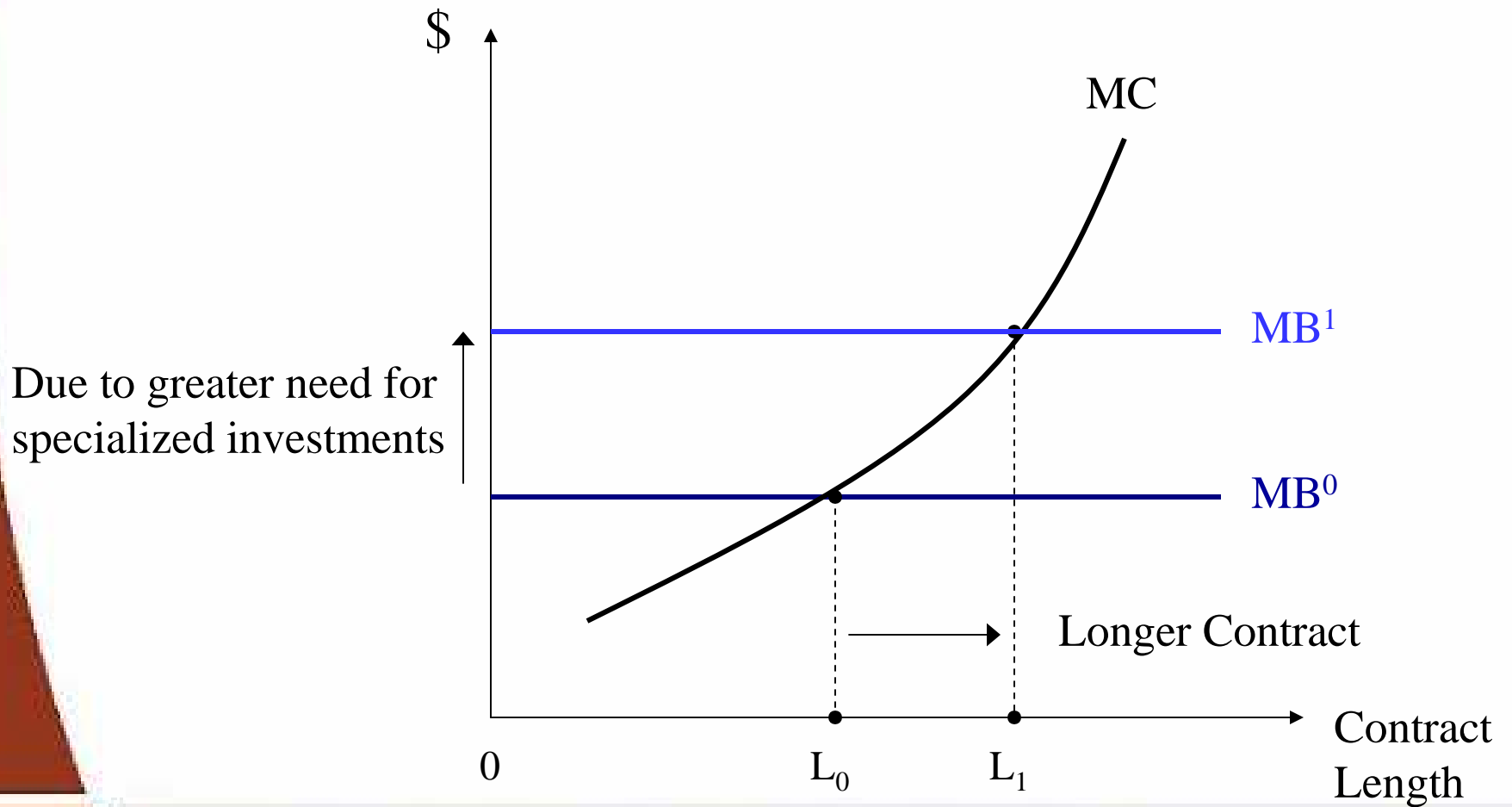
Transaction Costs

- Costs of acquiring an input over and above the amount paid to the input supplier.
- Includes:
 - Search costs.
 - Negotiation costs.
 - Other required investments or expenditures.
- Some transactions are general in nature while others are specific to a trading relationship.

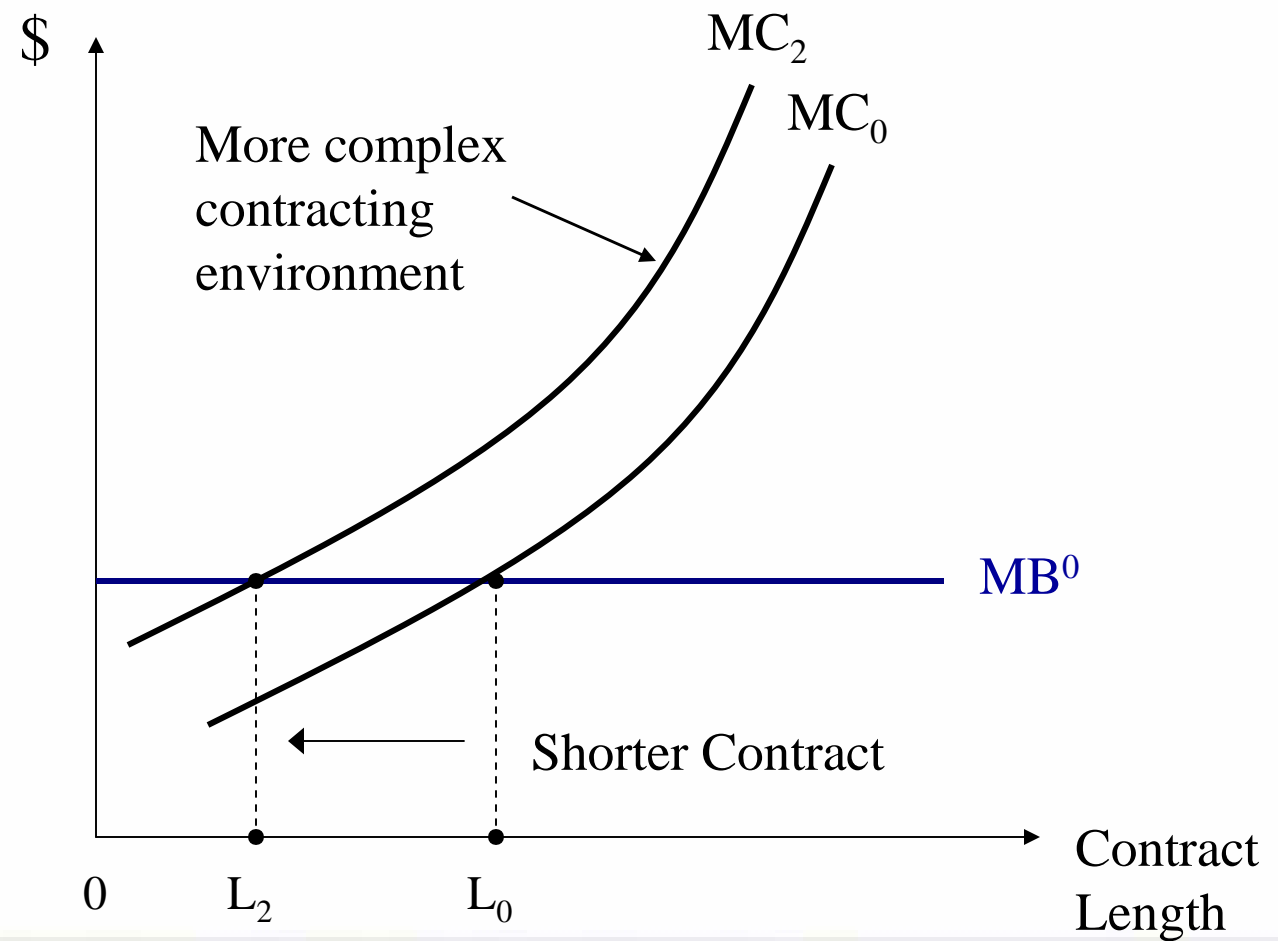
Specialized Investments

- Investments made to allow two parties to exchange but has little or no value outside of the exchange relationship.
- Types of specialized investments:
 - Site specificity.
 - Physical-asset specificity.
 - Dedicated assets.
 - Human capital.
- Lead to higher transaction costs
 - Costly bargaining.
 - Underinvestment.
 - Opportunism and the hold-up problem.

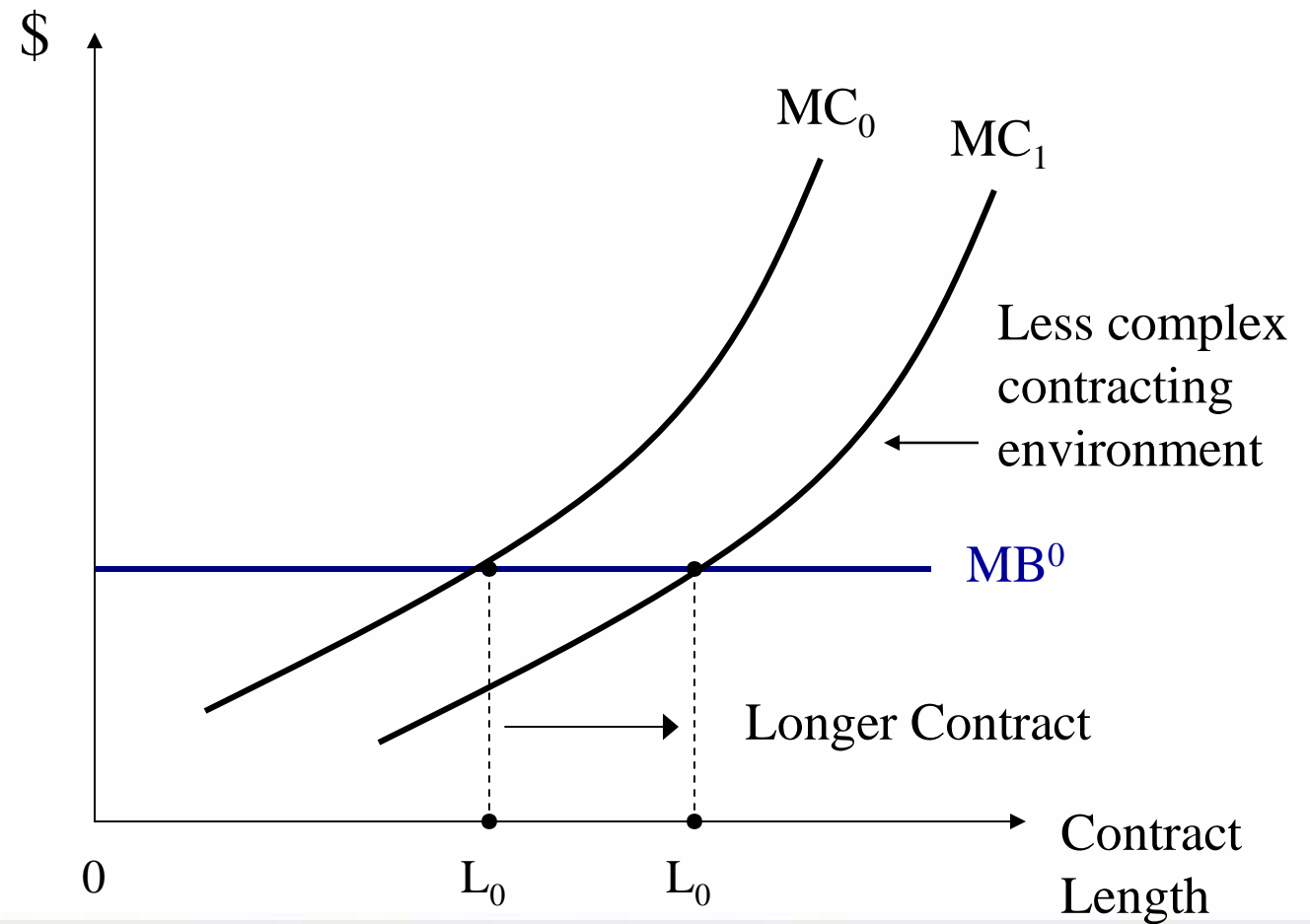
Specialized Investments and Contract Length



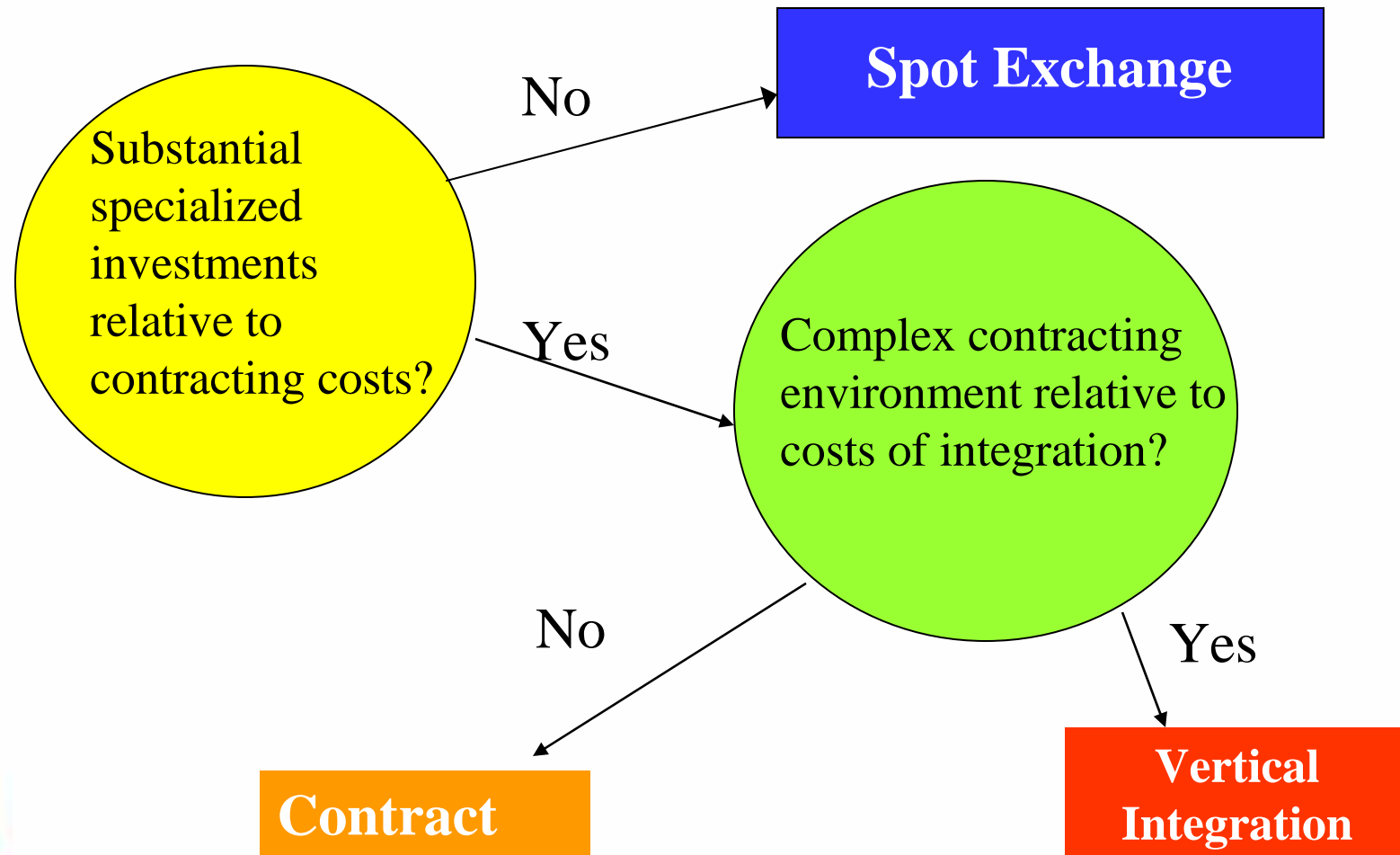
Specialized Investments and Contract Length



Specialized Investments and Contract Length



Optimal Input Procurement



The Principal-Agent Problem

- Occurs when the principal cannot observe the effort of the agent.
 - Example: Shareholders (principal) cannot observe the effort of the manager (agent).
 - Example: Manager (principal) cannot observe the effort of workers (agents).
- The Problem: Principal cannot determine whether a bad outcome was the result of the agent's low effort or due to bad luck.
- Manager's must recognize the existence of the principal-agent problem and devise plans to align the interests of workers with that of the firm.
- Shareholders must create plans to align the interest of the manager with those of the shareholders.

Solving the Problem Between Owners and Managers

- Internal incentives
 - Incentive contracts.
 - Stock options, year-end bonuses.
- External incentives
 - Personal reputation.
 - Potential for takeover.

Solving the Problem Between Managers and Workers

- Profit sharing
- Revenue sharing
- Piece rates
- Time clocks and spot checks

Conclusion

- The optimal method for acquiring inputs depends on the nature of the transactions costs and specialized nature of the inputs being procured.
- To overcome the principal-agent problem, principals must devise plans to align the agents' interests with the principals.