THE ORGANIZATION OF THE FIRM

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- In Chapter 5 we saw how a manager can select the mix of inputs that minimizes the cost of production. However, our analysis in that chapter left unresolved two important questions. First, what is the optimal way to acquire this efficient mix of inputs? Second, how can the owners of a firm ensure that workers put forth the maximum effort consistent with their capabilities? In this chapter, we address these two issues.

MANAGER’S ROLE

- Procure inputs in the least cost manner
- Provide incentives for workers to put forth effort
- Achieve optimum quantity inputs at the very lowest cost

METHODS OF PROCURING INPUTS

Spot Exchange This is an informal relationship between a buyer and a seller in which neither party is obligated to adhere to specific terms for exchange. The buyer and seller are basically anonymous and there is not a legal relationship between the buyer and seller. This is your typical purchasing of consumer goods and services. For example,

Real World Example When you go to the grocery store to buy a gallon of milk, you are not required to meet any special terms to purchase the milk. You pay the cashier for the milk and you go on your separate ways.

The key advantage with spot exchange is that the firm gets to specialize in doing what it does best, which is producing the final product once it receive the inputs. Spot exchange is often used when the inputs are standardized, and you can purchase the inputs from many suppliers with equal quality. With the milk example, there are many places you can buy a gallon of milk, and the quality of the milk is the same regardless if you buy it from 7-11, Ministop, SM Grocery, or a gas station convenience store.

- Contracts Unlike spot exchange, this is a formal and legal relationship between a buyer and a seller that obligates both to exchange at specified and agreed upon terms. The agreement identifies what each party will be responsible for and defines the time requirement, and a contract is used for both tangible goods as well as services rendered. Like spot exchange, contracts allow the firm to concentrate on what it does best. The buyer gets to focus on producing the final product and acquires the inputs needed for suppliers.

  Real World Example Juan Dela Cruz owns a corn farm. He wants to sell his corn to a local grocery store. Dela Cruz contacts the store owner and begins negotiation on a contract to sell the corn. Dela Cruz says he will provide 100kgs of corn to the store per week for Php20/kilo for the next 12 weeks. The store says those terms are unreasonable and counters with 150kgs of corn per week for Php15/kilo for 10 weeks. After discussing the terms for a while, both parties agree to the 130kgs of corn per week for 10 weeks at Php17/kilo. After 10 weeks, McGregor and the store owner will discuss if they want to continue the relationship. This example shows that creating a contract takes at least two parties and both parties must receive some gain or they will not participate and agree to the terms.

- Vertical Integration This occurs when a firm decides to produce not only the final product but at least one of the inputs that are needed for the product. Firms may choose to take this direction because they no longer have to rely on other firms to provide the desired inputs. The firm must now learn to manage both the production of the final product and the product of the inputs.

  Real World Example Apple’s iPhone and iPad’s hardware itself is not typically manufactured by Apple, but is outsourced to contract manufacturers such as Foxconn or Pegatron who build Apple's branded products to Apple's specifications.

  Companies decide vertical integration is the best approach when specialized investments generate high transaction costs and when inputs are too complex or the economic future of the input is so uncertain that writing a contract proves too costly and time consuming. Vertical integration has some disadvantages too. By taking this approach, firms lose the gains in specialization it realizes when the inputs are purchased for a supplier.

TRANSACTION COSTS

Costs associated with acquiring an input that are in excess of the amount paid to the input supplier.

Ex. If an input supplier charges a price of Php300 per unit but requires you to furnish your own trucks and drivers to pick up the input, the transaction costs to your firm include the cost of the trucks and the personnel needed to “deliver” the input to your plant.

There are some less obvious, To understand these “hidden” transaction costs, we must distinguish between transaction costs that are specific to a particular trading relationship and those that are general in nature. The key to attain this distinction is the notion of a specialized investment.

- When specialized investments are required to facilitate an exchange, the resulting relationship between the parties is known as a *relationship-specific exchange.*

  -A type of exchange that occurs when the parties to a transaction have made specialized investments.

  Real World Example In Camiguin, several local farmers have turned their farmland into a poultry. Vjandep Bakeshop Commissary, a top manufacturer of the known pastel yema then pays them for their egg, milk and butter produce. This is a Relationship-specific exchange because the farmers give up the opportunity cost of planting variety of crops on the farmland and to turn it into a poultry specifically to exchange the goods with Vjandep Bakeshop Commissary.

SPECIALIZED INVESTMENTS

An expenditure that must be made to allow two parties to exchange but has little or no value in any alternative use.

Real World Example suppose that to ascertain the quality of bolts, it is necessary to spend $100 on a machine that tests the bolts' strength. If the machine is useful only for testing a particular manufacturer's bolts and the investment in the machine is a sunk (and therefore non-recoverable) cost, it is a specialized investment.

In contrast, if the machine can be resold at its purchase price or used to test the quality of bolts produced by other firms, it does not represent a specialized investment.

TYPES OF SPECIALIZED INVESTMENTS

Site Specificity

- *Site specificity* occurs when the buyer and the seller of an input must locate their plants close to each other to be able to engage in exchange. For example, electric power plants often locate close to a particular coal mine to minimize the transportation costs of obtaining coal; the output (electricity) is less expensive to ship than the input (coal). The cost of building the two plants close to each other represents a specialized investment that would have little value if the parties were not involved in exchange.

Physical-Asset Specificity

- *Physical-asset specificity* refers to a situation where the capital equipment needed to produce an input is designed to meet the needs of a particular buyer and cannot be readily adapted to produce inputs needed by other buyers. For example, if pro- ducing a lawn mower engine requires a special machine that is useful only for pro- ducing engines for a particular buyer, the machine is a specific physical asset for producing the engines.

Dedicated Assets

- *Dedicated assets* are general investments made by a firm that allow it to exchange with a particular buyer. For example, suppose a computer manufacturer opens a new assembly line to enable it to produce enough computers for a large government purchaser. If opening the new assembly line is profitable only if the government actually purchases the firm’s computers, the investment represents a dedicated asset.

Human Capital

- In many employment relationships, workers must learn specific skills to work for a particular firm. If these skills are not useful or transferable to other employers, they represent a specialized investment.

IMPLICATIONS OF SPECIALIZED INVESTMENTS

Specialized investments increase transaction costs because they lead to (1) costly bargaining, (2) underinvestment, and (3) opportunism.

Costly bargaining is the process of negotiating pricing between a buyer and a seller of a special input. The parties may behave strategically to enhance their bargaining position.

Ex. An organic farmer plants a specific crop to sell only to a local restaurant. It is a special lettuce that only this restaurant uses for a special organic salad. The normal price for the lettuce is Php500/kgs. The restaurant refuses to accept delivery unless the price of the lettuce is reduced to Php300/kgs. The farmer has no other demand for the lettuce, but the restaurant has no other supplier either.

Underinvestment

Since specialized investments are only good for the relationship between two parties (there is no value in any alternative use), then the parties are likely to under invest.

Ex. If ABC tester company produces a special machine to ascertain the bolt strength of a specific hybrid LED light of LG lighting, the machine is no good for other product testing and the machine cannot be resold since it isn't good to any other company.

Opportunism

After a company makes a specialized investment the other party involved in the exchange will likely try to be opportunistic and take advantage of the situation by raising prices or lowering quantity demands to better their position. The company that made the investment is held up and has little option other than to accept the current state because the specialized investment is no good if the exchange does not take place.

Ex. Wheels, Inc. , makes wheels for airplane. Boeing is in production of a new airplane, but Boeing’s usual wheel supplier ran short on inventory so it calls Wheels, Inc. in a panic if it can provide Boeing with the wheels for the new airplane. Wheels, Inc. tells Boeing that it can provide the wheels but at double the normal price. In this case the seller is acting opportunistic and holding up the buyer.

QUESTIONS?