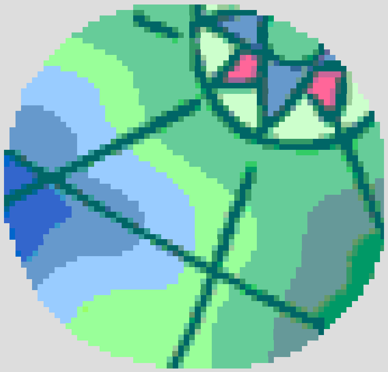
Managerial Economics & Business Strategy

Chapter 6

The Organization of the Firm



Michael R. Baye, *Managerial Economics and Business Strategy*, 5e. ©The McGraw-Hill Companies, Inc., 2006

Overview

I. Methods of Procuring Inputs

- Spot Exchange
- Contracts
- Vertical Integration

II. Transaction Costs

- Specialized Investments

III. Optimal Procurement Input

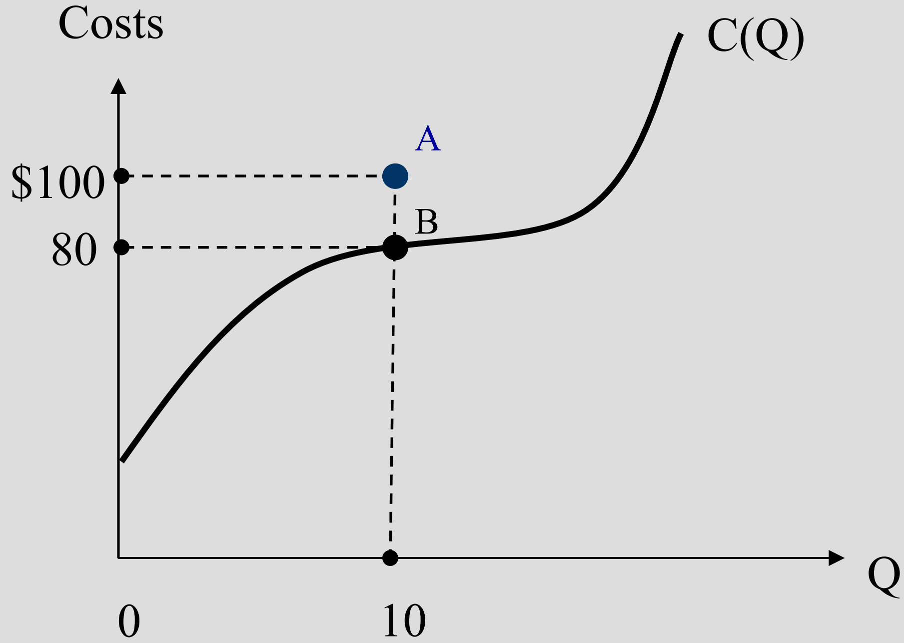
IV. Principal-Agent Problem

- Owners-Managers
- Managers-Workers

Michael R. Baye, *Managerial Economics and Business Strategy*, 5e. ©The McGraw-Hill Companies, Inc., 2006

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.

Michael R. Baye, *Managerial Economics and Business Strategy*, 5e. ©The McGraw-Hill Companies, Inc., 2006

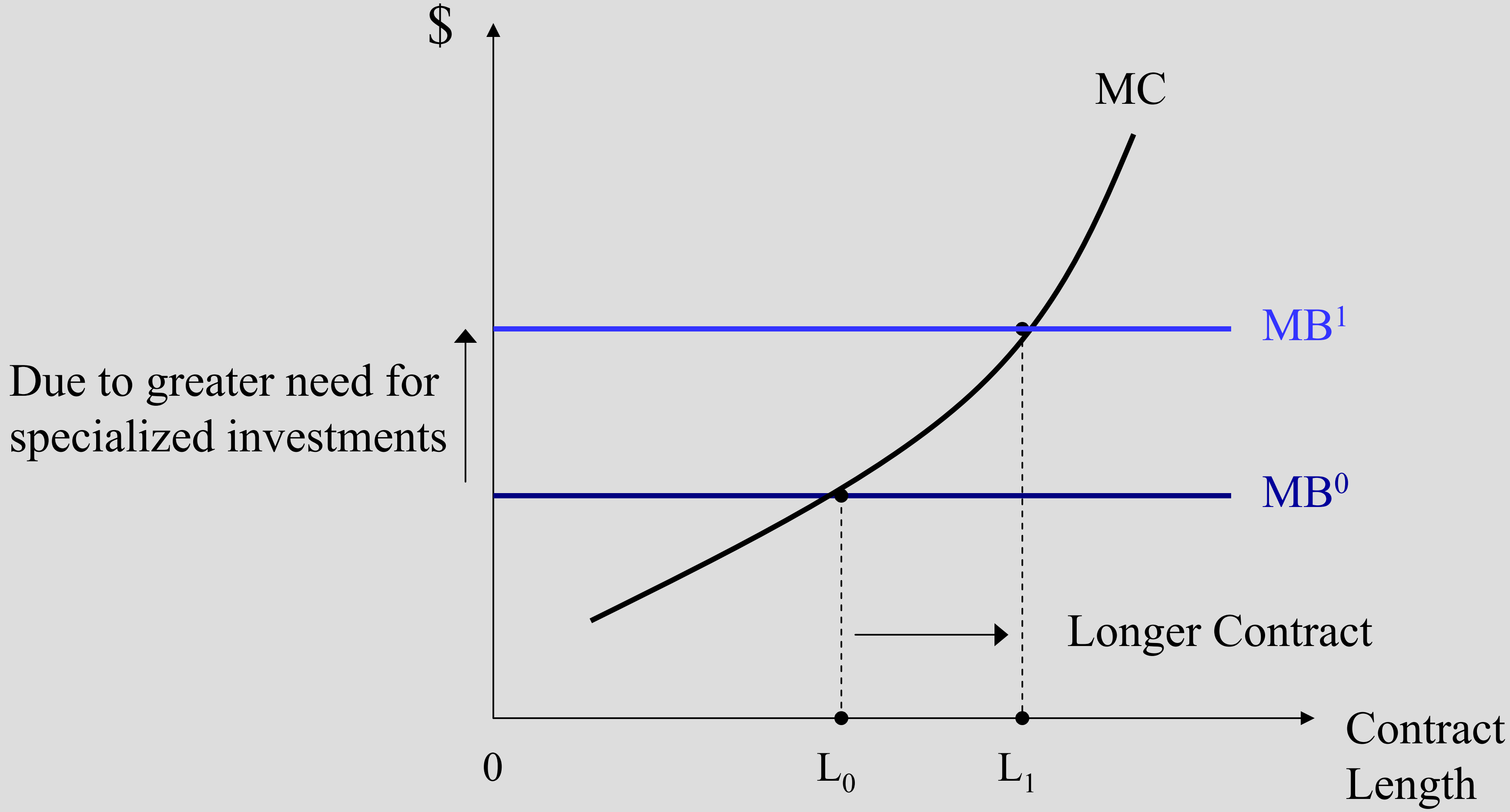
Transaction Costs

- 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

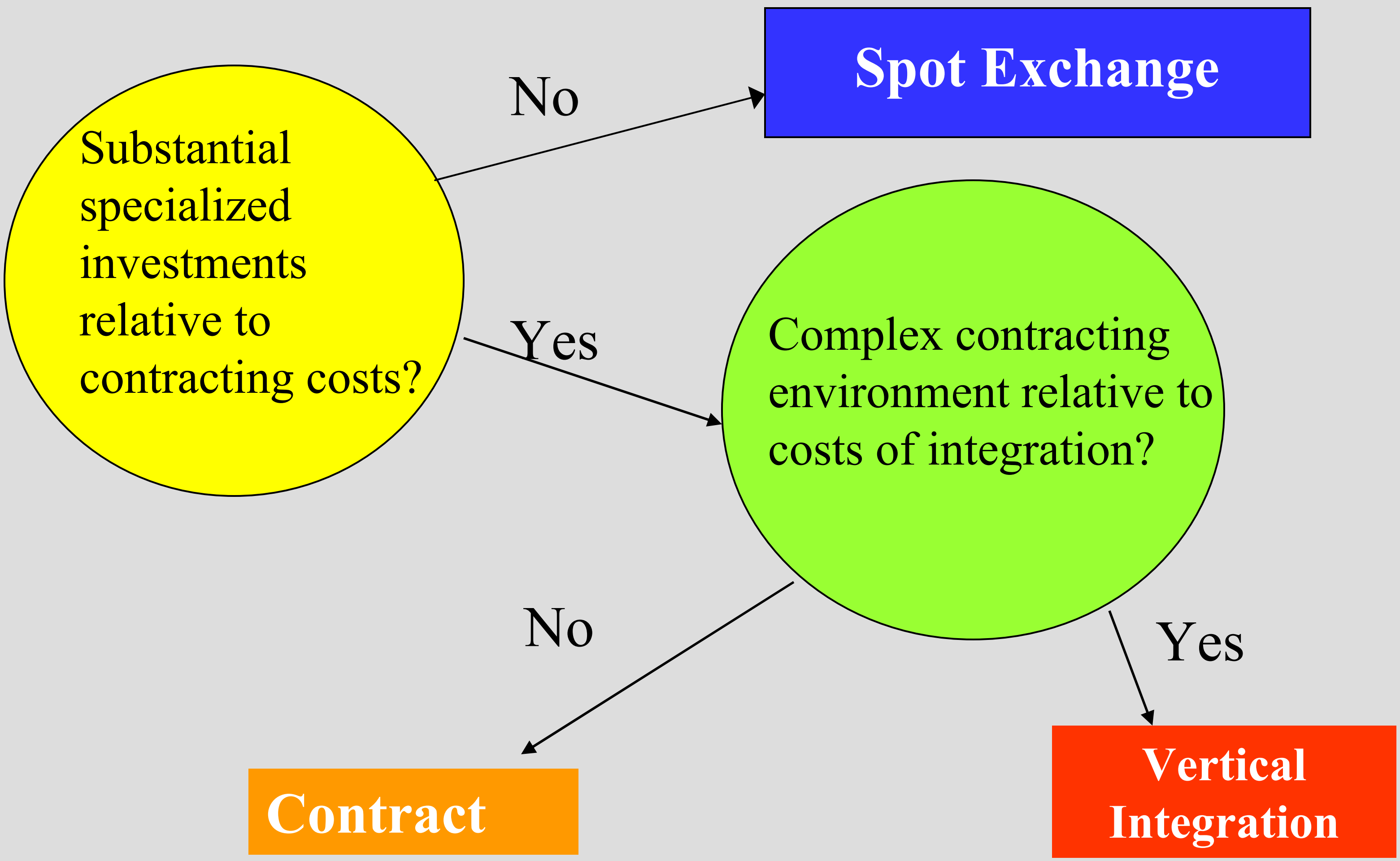
- Investments made to allow two parties to exchange but has little or no value outside of the exchange relationship.
- Types of specialized investments:
  - Site specificity.
  - Physical-asset specificity.
  - Dedicated assets.
  - Human capital.
- Lead to higher transaction costs
  - Costly bargaining.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

Specialized Investments and Contract Length



Michael R. Baye, *Managerial Economics and Business Strategy*, 5e. ©The McGraw-Hill Companies, Inc., 2006

Optimal Input Procurement



Michael R. Baye, *Managerial Economics and Business Strategy*, 5e. ©The McGraw-Hill Companies, Inc., 2006

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.