A review of Theories of the firm

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Abstract

The theory of the firm consists of a number of economic theories that explain and predict the nature of the firm, company, or corporation, including its existence, behaviour, structure, and relationship to the market Firms exist as an alternative system to the market-price mechanism when it is more efficient to produce in a non-market environment. For example, in a labor market, it might be very difficult or costly for firms or organizations to engage in production when they have to hire and fire their workers depending on demand/supply conditions. It might also be costly for employees to shift companies every day looking for better alternatives. Similarly, it may be costly for companies to find new suppliers daily. Thus, firms engage in a long-term contract with their employees or a long-term contract with suppliers to minimize the cost or maximize the value of property rights

Key words: Firms, Employees, Environment Theory **etc.**

Introduction

The First World War period saw change of emphasis in economic theory away from industry-level analysis which mainly included analyzing markets to analysis at the level of the firm, as it became increasingly clear that perfect competition was no longer an adequate model of how firms behaved. Economic theory until then had focused on trying to understand markets alone and there had been little study on understanding why firms or organizations exist. Markets are guided by prices and quality as illustrated by vegetable markets where a buyer is free to switch sellers in an exchange. The need for a revised theory of the firm was emphasized by empirical studies by Adolf Berle and Gardiner Means, who made it clear that ownership of a typical American corporation is spread over a wide number of shareholders, leaving control in the hands of managers who own very little equity themselves.

Transaction cost theory

According to Ronald Coase, people begin to organise their production in firms when the transaction cost of coordinating production through the market exchange, given imperfect information, is greater than within the firm. Ronald Coase set out his transaction cost theory of the firm in 1937, making it one of the first (neo-classical) attempts to define the firm theoretically in relation to the market. One aspect of its 'neoclassicism' lies in presenting an explanation of the firm consistent with constant returns to scale, rather than relying on increasing returns to scale. Another is in defining a firm in a manner which is both realistic and compatible with the idea of substitution at the margin, so instruments of conventional economic analysis apply. He notes that a firm's interactions with the market may not be under its control, but their internal allocations of resources are: “Within a firm, market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur who directs production.” He asks why alternative methods of production, could not either achieve all production, so that either firms use internal prices for all their production, or one big firm runs the entire economy Coase begins from the standpoint that markets could in theory carry out all production, and that what needs to be explained is the existence of the firm, with its "distinguishing mark the supersession of the price mechanism." Coase identifies some reasons why firms might arise, and dismisses each as unimportant: if some people prefer to work under direction and are prepared to pay for the privilege if some people prefer to direct others and are prepared to pay for this if purchasers prefer goods produced by firms. Instead, for Coase the main reason to establish a firm is to avoid some of the transaction costs of using the price mechanism. These include discovering relevant prices, as well as the costs of negotiating and writing enforceable contracts for each transaction. Moreover, contracts in an uncertain world will necessarily be incomplete and have to be frequently re-negotiated. The costs of haggling about division of surplus, particularly if there is asymmetric information and asset specificity, may be considerable.

If a firm operated internally under the market system, many contracts would be required. In contrast, a real firm has very few contracts, such as defining a manager's power of direction over employees, in exchange for which the employee is paid. These kinds of contracts are drawn up in situations of uncertainty, in particular for relationships which last long periods of time. Such a situation runs counter to neo-classical economic theory. The neo-classical market is instantaneous, forbidding the development of extended agent-principal relationships, of planning, and of trust. Coase concludes that “a firm is likely therefore to emerge in those cases where a very short-term contract would be unsatisfactory” and that “it seems improbable that a firm would emerge without the existence of uncertainty”. He notes that government measures relating to the market tend to increase the size of firms, since firms internally would not be subject to such transaction costs. Thus, Coase defines the firm as "the system of relationships which comes into existence when the direction of resources is dependent on the entrepreneur." We can therefore think of a firm as getting larger or smaller based on whether the entrepreneur organizes more or fewer transactions. The question then arises of what determines the size of the firm; why does the entrepreneur organise the transactions he does, why no more or less? Since the reason for the firm's being is to have lower costs than the market, the upper limit on the firm's size is set by costs rising to the point where internalizing an additional transaction equals the cost of making that transaction in the market. In practice, diminishing returns to management contribute most to raising the costs of organizing a large firm, particularly in large firms with many different plants and differing internal transactions, or if the relevant prices change frequently. Coase concludes by saying that the size of the firm is dependent on the costs of using the price mechanism, and on the costs of organisation of other entrepreneurs. These two factors together determine how many products a firm produces and how much of each

Reconsiderations of transaction cost theory

According to Louis Putterman, most economists accept distinction between intra-firm and interim transaction but also that the two shade into each other; the extent of a firm is not simply defined by its capital stock, notes that a rigid distinction fails because of the existence of intermediate forms between firm and market such as inter-firm co-operation. Klein (1983) asserts that “Economists now recognize that such a sharp distinction does not exist and that it is useful to consider also transactions occurring within the firm as representing market (contractual) relationships.” The costs involved in such transactions that are within a firm or even between the firms are the transaction costs. Ultimately, whether the firm constitutes a domain of bureaucratic direction that is shielded from market forces or simply “a legal fiction”, “a nexus for a set of contracting relationships among individuals" is "a function of the completeness of markets and the ability of market forces to penetrate intra-firm relationships"

Managerial and behavioural theories

It was only in the 1960s that the neo-classical theory of the firm was seriously challenged by alternatives such as managerial and behavioral theories. Managerial theories of the firm, as developed by William Baumol (1959 and 1962), Robin Marris (1964) and Oliver E. Williamson (1966), suggest that managers would seek to maximize their own utility and consider the implications of this for firm behavior in contrast to the profit-maximizing case. More recently this has developed into 'principal–agent' analysis this may arise either because the agent has greater expertise or knowledge than the principal, or because the principal cannot directly observe the agent's actions; it is asymmetric information which leads to a problem of moral hazard. This means that to an extent managers can pursue their own interests. Traditional managerial models typically assume that managers, instead of maximizing profit, maximize a simple objective utility function subject to an arbitrarily given profit constraint.

Behavioural approach

The behavioural approach, as developed in particular by Richard Cyert and James G. March of the Carnegie School places emphasis on explaining how decisions are taken within the firm, and goes well beyond neoclassical economics. Much of this depended on Herbert A. Simon's work in the 1950s concerning behaviour in situations of uncertainty, which argued that "people possess limited cognitive ability and so can exercise only 'bounded rationality' when making decisions in complex, uncertain situations". Thus individuals and groups tend to "satisfied" that is, to attempt to attain realistic goals, rather than maximize a utility or profit function. Cyert and March argued that the firm cannot be regarded as a monolith, because different individuals and groups within it have their own aspirations and conflicting interests, and that firm behaviour is the weighted outcome of these conflicts. Organisational mechanisms exist to maintain conflict at levels that are not unacceptably detrimental. Compared to ideal state of productive efficiency, there is organisational slack

Team production

Armen Alchian and Harold Demsetz's analysis of team production extends and clarifies earlier work by Coase. Thus according to them the firm emerges because extra output is provided by team production, but that the success of this depends on being able to manage the team so that metering problems and attendant shirking can be overcome, by estimating marginal productivity by observing or specifying input behaviour. Such monitoring as is therefore necessary, however, can only be encouraged effectively if the monitor is the recipient of the activity's residual income. For Alchian and Demsetz, the firm therefore is an entity which brings together a team which is more productive working together than at arm's length through the market, because of informational problems associated with monitoring of effort. In effect, therefore, this is a "principal-agent" theory; since it is asymmetric information within the firm which Alchian and Demsetz emphasise must be overcome. In Barzel (1982)'s theory of the firm, drawing on Jensen and Meckling (1976), the firm emerges as a means of centralizing monitoring and thereby avoiding costly redundancy in that function. The weakness in Alchian and Demsetz's argument, according to Williamson, is that their concept of team production has quite a narrow range of application, as it assumes outputs cannot be related to individual inputs. In practice this may have limited applicability, since most outputs within a firm are separable, so that individual inputs can be rewarded on the basis of outputs. Hence team production cannot offer the explanation of why firms exist.

Grossman-Hart-Moore theory

In modern contract theory, the "theory of the firm" is often identified with the "property rights approach" that was developed by Sanford J. Grossman, Oliver D. Hart, and John H. Moore. The property rights approach to the theory of the firm is also known as the "Grossman-Hart-Moore theory". In their seminal work, Grossman and Hart (1986), Hart and Moore (1990) and Hart (1995) developed the incomplete contracting paradigm. They argue that if contracts cannot specify what is to be done given every possible contingency, then property rights matter. Specifically, consider a seller of an intermediate good and a buyer. Should the seller own the physical assets that are necessary to produce the good (non-integration) or should the buyer be the owner (integration)? After relationship-specific investments have been made, the seller and the buyer bargain. When they are symmetrically informed, they will always agree to collaborate. Yet, the division of the ex post surplus depends on the parties' disagreement payoffs, which in turn depend on the ownership structure. Thus, the ownership structure has an influence on the incentives to invest. A central insight of the theory is that the party with the more important investment decision should be the owner. Another prominent conclusion is that joint asset ownership is suboptimal if investments are in human capital.

The Grossman-Hart-Moore model has been successfully applied in many contexts, e.g. with regard to privatization. Chiu (1998) and DeMeza and Lockwood (1998) have extended the model by considering different bargaining games that the parties may play ex post. Oliver Williamson (2002) has criticized the Grossman-Hart-Moore model because it is focused on ex ante investment incentives, while it neglects ex post inefficiencies. Schmitz (2006) has studied a variant of the Grossman-Hart-Moore model in which a party may have or acquire private information about its disagreement payoff, which can explain ex post inefficiencies and ownership by the less important investor. Several variants of the Grossman-Hart-Moore model such as the one with private information can also explain joint ownership

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