

Organizational Theory and Decision Making

Part I: Foundations and Boundaries of Organizations

Christian Zehnder
Department of Management
HEC, University of Lausanne
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Part I.A: Transaction Cost Economics

Video 4:
Vertical Integration

Key Takeaways from Video 2

- If contractual incompleteness and specific investments exist in combination, there is a risk of hold-up
 - a trading party faces the danger of being forced to accept disadvantageous terms when renegotiating the contract
 - the reason is that specific investments create dependencies that a partner can try to exploit
- Hold-up may create two types of inefficiencies
 - Ex-ante: Parties underinvest to avoid being held up later
 - Ex-post: Parties fight about the distribution of revenues and/or fail to reach an efficient agreement

This video:

How can we avoid or at least mitigate the hold-up problem?

TCE: The Role of Vertical Integration (1)

- So far, we have understood that complex transactions can lead to complicated problems between parties who trade with each other on the market (the hold-up problem)
- It seems intuitive that some problems can be avoided if the two parties merge their businesses and form a firm
- But why exactly is it that vertical integration might help when firms suffer from haggling costs and hold-up?
- It is tempting to simply assume that firms avoid bargaining and hold-up by using authority (see Coase 1937), but ...
 - ... why should people behave in a different way within a firm than across firms?

TCE: The Role of Vertical Integration (2)

- Simply assuming that people's behavior changes after a merger is unsatisfactory
- In fact, some researchers have argued that it is wrong to assume that there is more authority in firms than in markets

- Alchian and Demsetz (1972: 777)

"It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. I can "punish" you only by withholding future business or by seeking redress in the courts for any failure to honor our exchange agreement. That is exactly all that any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products."

TCE: The Role of Vertical Integration (3)

- Oliver Williamson (1991) strongly disagrees with the view of Alchian and Demsetz:

“That is exactly wrong: firms can and do exercise fiat that markets cannot.”

“[...] whereas courts routinely grant standing to firms should there be disputes [...], courts will refuse to hear disputes between one internal division and another [...]. Access to the courts being denied, the parties must resolve their differences internally. Accordingly, hierarchy is its own court of ultimate appeal.”

“[...] parties to an internal exchange can work out their differences themselves or appeal unresolved disputes to the hierarchy for a decision. But this exhausts their alternatives.”

TCE: The Role of Vertical Integration (4)

- Is vertical integration the perfect solution that resolves all incentive issues?
- The answer is NO: Integration creates its own problems
 - Agency problems: How to motivate employees?
 - Coordination problems: How to best structure hierarchy?
 - Abuse of power: How to avoid rent seeking?
 - Limited adaptation: How to keep the process flexible?
 - Together Williamson has termed these difficulties “Bureaucracy costs”
- Integration is subject to a trade-off

TCE: The Role of Vertical Integration (5)

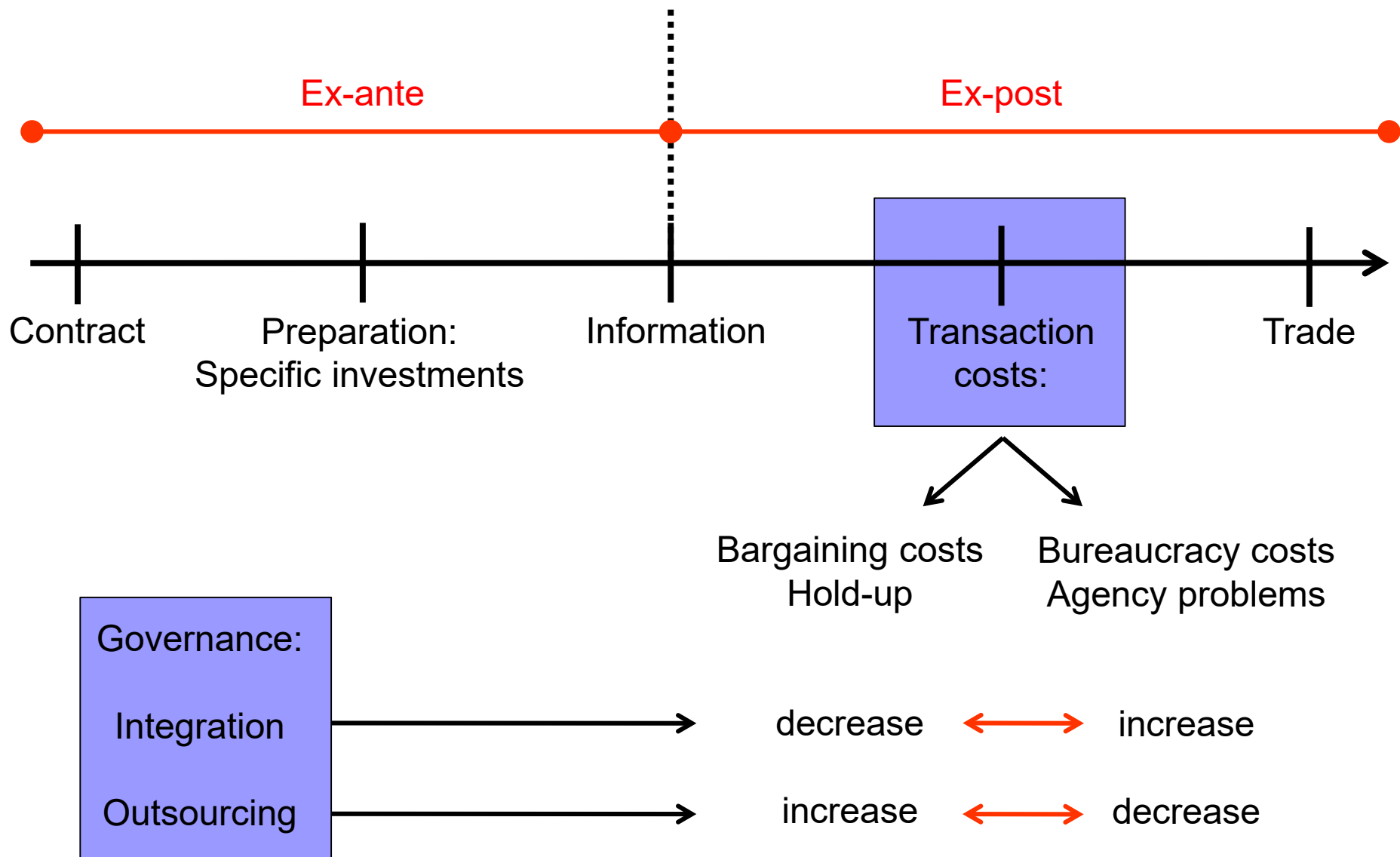
- Transaction cost economics implies that vertical integration has advantages and disadvantages:
- Advantage
 - Vertical integration introduces authority to the relationship
 - This lowers haggling costs and reduces the hold-up problem
- Disadvantage
 - Vertically integrated hierarchies also have problems: Agency problems, abuse of power, coordination problems, limited flexibility
 - These are the so called bureaucracy costs
- TCE: Whether vertical integration is helpful depends on the relative importance of the hold-up problem on the one side and bureaucracy costs on the other side

TCE: The Role of Vertical Integration (6)

Transactions cost economics:

- Vertical integration is likely to be helpful ...
 - ... if relationship-specific investment are important, so that hold-up is a severe danger
 - In these cases it is likely that the advantages of integration outweigh the disadvantages
- Outsourcing / Independent firms are likely to be better ...
 - ... if the parties investments are not specific and can easily be used with other partners
 - In these cases hold-up is not an issue and integration would only lead to motivation problems and a difficult internal organization

TCE: Vertical Integration - Summary



Empirical Predictions

- TCE links costs and benefits of integration to econ. context
 - Identifies the importance of relationship-specific investments as a driver of vertical integration (size of rents)
 - This is important, because it makes empirically testable predictions:
Transactions should take place inside firms, if specific investments are more important

Key Takeaways

- According to TCE vertical integration (VI) has two effects:
 - VI mitigates the hold-up problem: authority reduces haggling
 - VI creates bureaucracy costs: coordination and motivation problems
- TCE makes the following empirical prediction:
 - Transactions should be vertically integrated if contracts are incomplete and relationship-specific investments are important
 - The reason is: In those situation the hold-up risk is large
 - Transactions should be outsourced if relationship-specific investments are not crucial
 - The reason is: In those situation VI would create bureaucracy costs, but there would not be a substantial benefit in return