

Organizational Theory and Decision Making

Part I: Foundations and Boundaries of Organizations

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Part I.A: Transaction Cost Economics

Video 2:
The Hold-Up Problem (Theory)

What have you seen in the previous video?

- Complexity implies that contracts are incomplete

- ☐ Limited foresight
- ☐ Limited problem-solving capacity
- ☐ Limited communication abilities

→ Regular renegotiation is necessary

- Complex transactions often require specific investments

- ☐ A specific investment is most valuable with the current partner
- ☐ As a consequence, the investor becomes dependent on the partner

→ Renegotiation is complicated if the parties are dependent on each other → taking advantage of power position

TCE: Hold-Up - Definition and Premises

- The combination of incomplete contracts and relationship-specific investments leads to the so-called hold-up problem

Definition of the Hold-Up Problem

The hold-up problem arises as a consequence of contractual incompleteness. The term is used to describe a situation in which a trading party faces the danger of being forced to accept disadvantageous terms, after it has sunk a relationship-specific investment.

- The hold-up problem can have severely negative effects on the efficiency of transactions

TCE: Implications of Hold-up (1)

- Hold-up creates two types of potential problems

- Ex post problems

Renegotiation of contracts itself may be inefficient

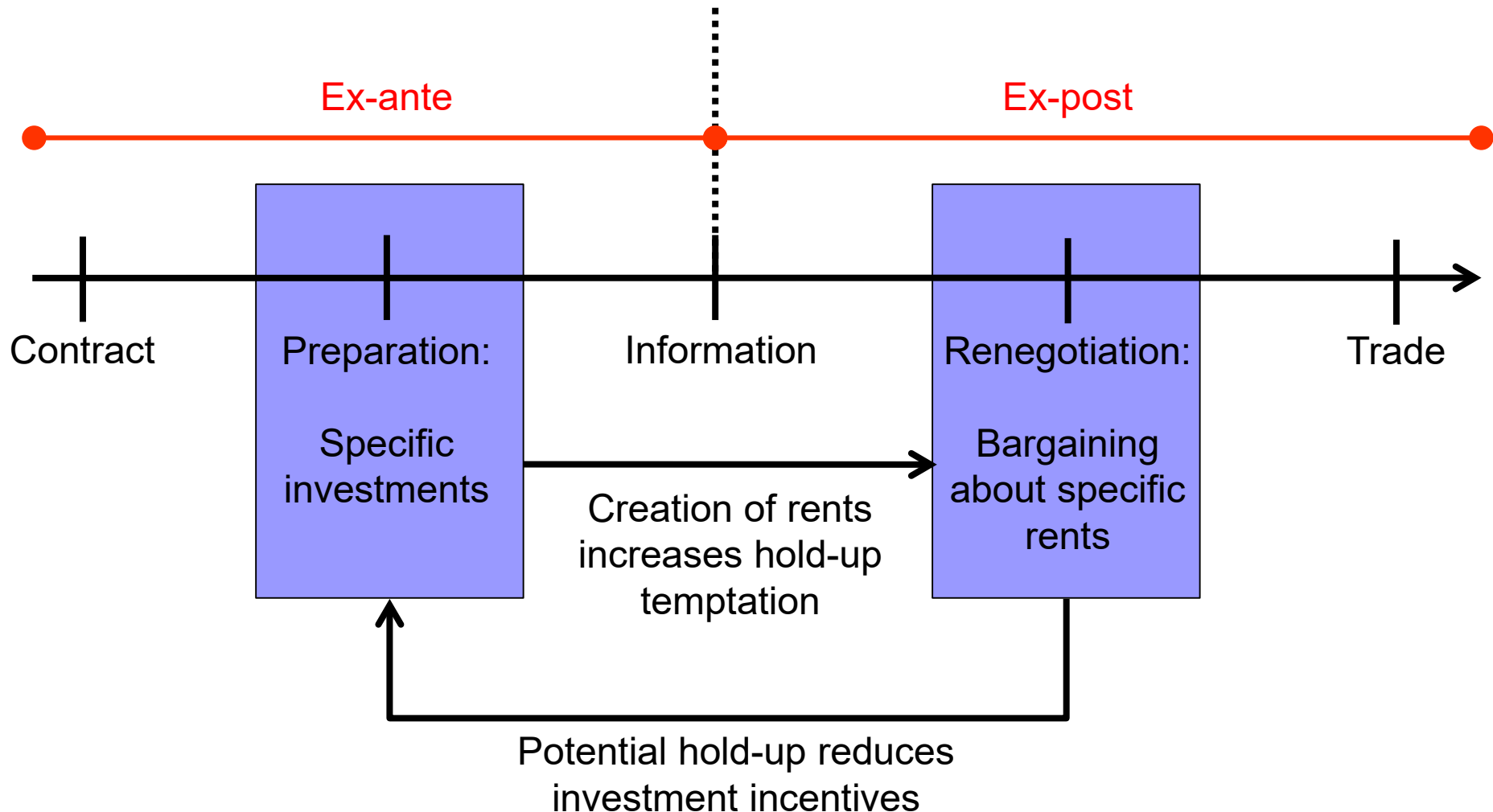
- Bargaining costs (haggling / time consuming arguments)
 - Failure to reach efficient agreement (asymmetric information)

- Ex ante problems

Trading parties may anticipate that renegotiation leads to unfavorable outcomes and therefore they refrain from investing in the relationship

- Limited incentives to make relationship specific investments

TCE: Implications of Hold-up (2)



Textbook Hold-Up: Electricity & Coal Mine (1)

- In the US coal burning electrical power plants are located either near coal mines or near cities
- Consider the following example:
 - A coal mine delivers coal to a power plant which is located directly adjacent to the mine
 - Now the mine would like to deliver coal to a second power plant which is located near the next city
 - To this end a rail line from the mine to the city is required
 - The mine approaches a railroad company and tries to convince them to build and operate the rail line

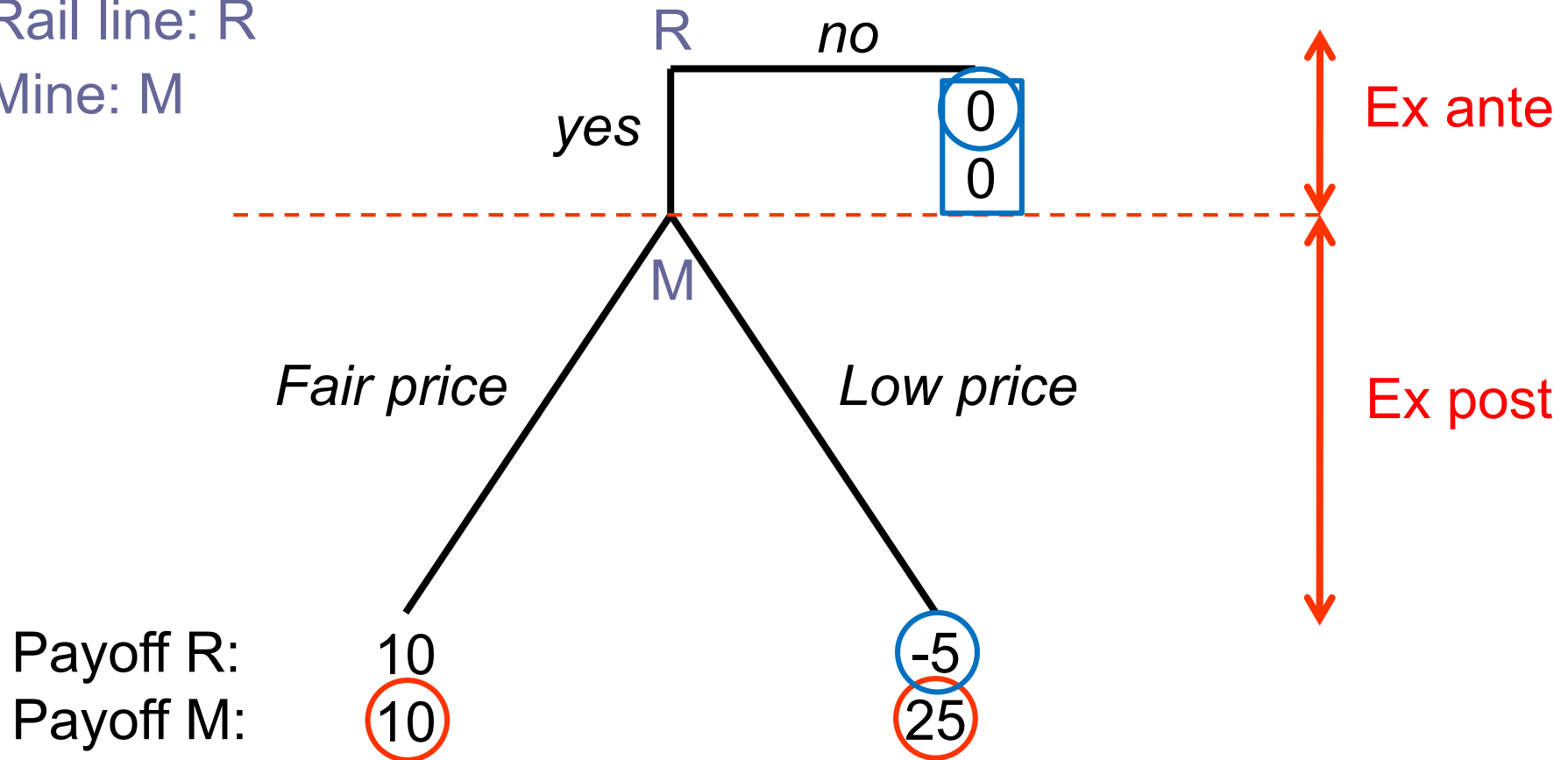
Textbook Hold-Up: Electricity & Coal Mine (2)

- The railroad company is potentially interested and they start negotiating with the coal mine management
- After the meeting the situation looks as follows:
 - The business has potential: if the coal mine managers keep their promises, the rail line would be profitable
 - However, since the coal mine and the new power plant have not yet agreed on all details, the coal mine is not willing to fix prices with the railroad company at this point, they want to keep it flexible
 - They promise to set a fair price, once their negotiations with the power plant have been settled
 - The problem is that the railroad company needs to start building the rail line before the prices can be fixed
 - Thus, the danger is that the coal mine managers try to offer low prices once the rail line has been built ...

Textbook Hold-Up: Version 1

Rail line: R

Mine: M

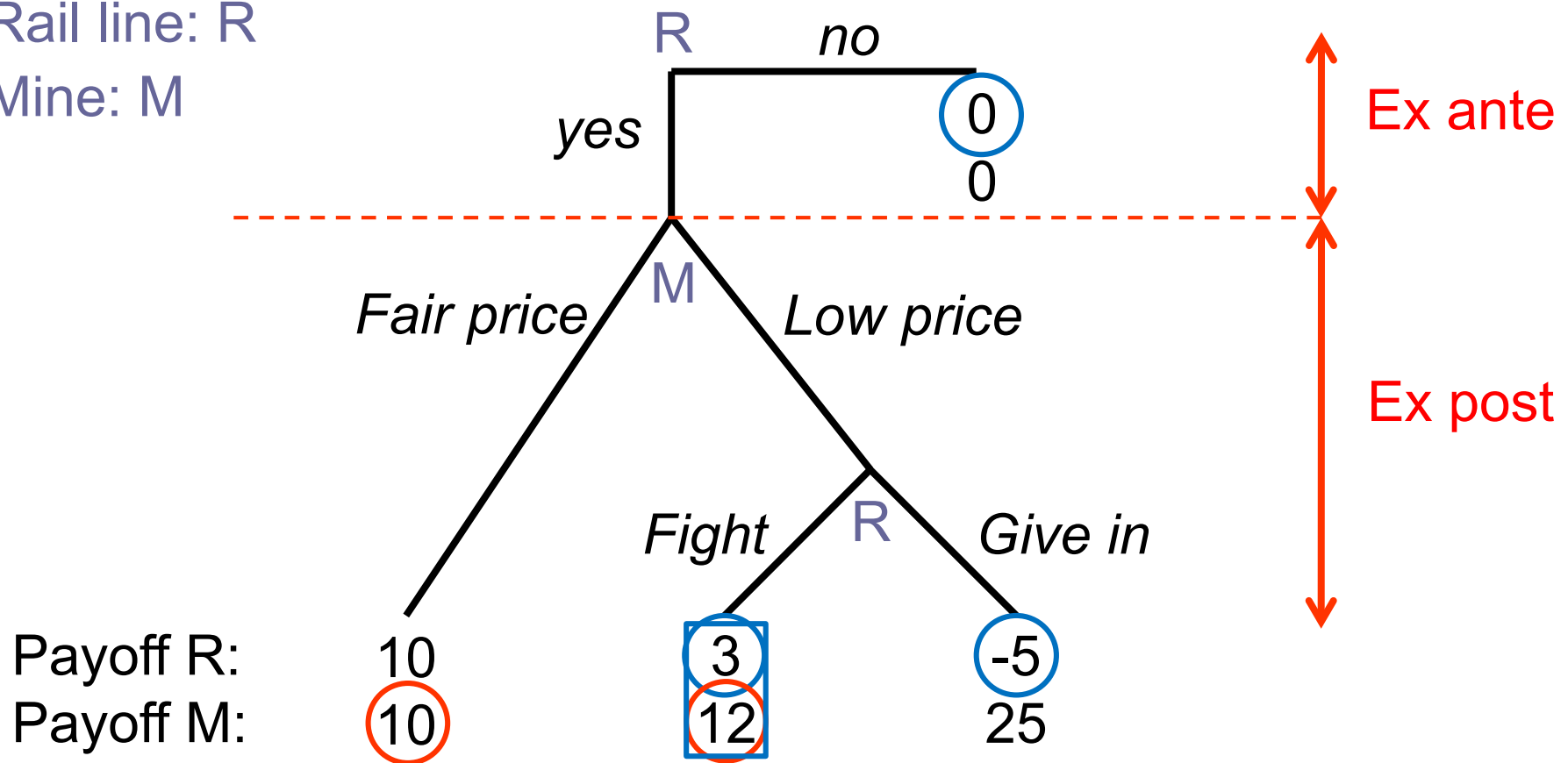


→ Hold-up leads to inefficient ex-ante investments

Textbook Hold-Up: Version 2

Rail line: R

Mine: M

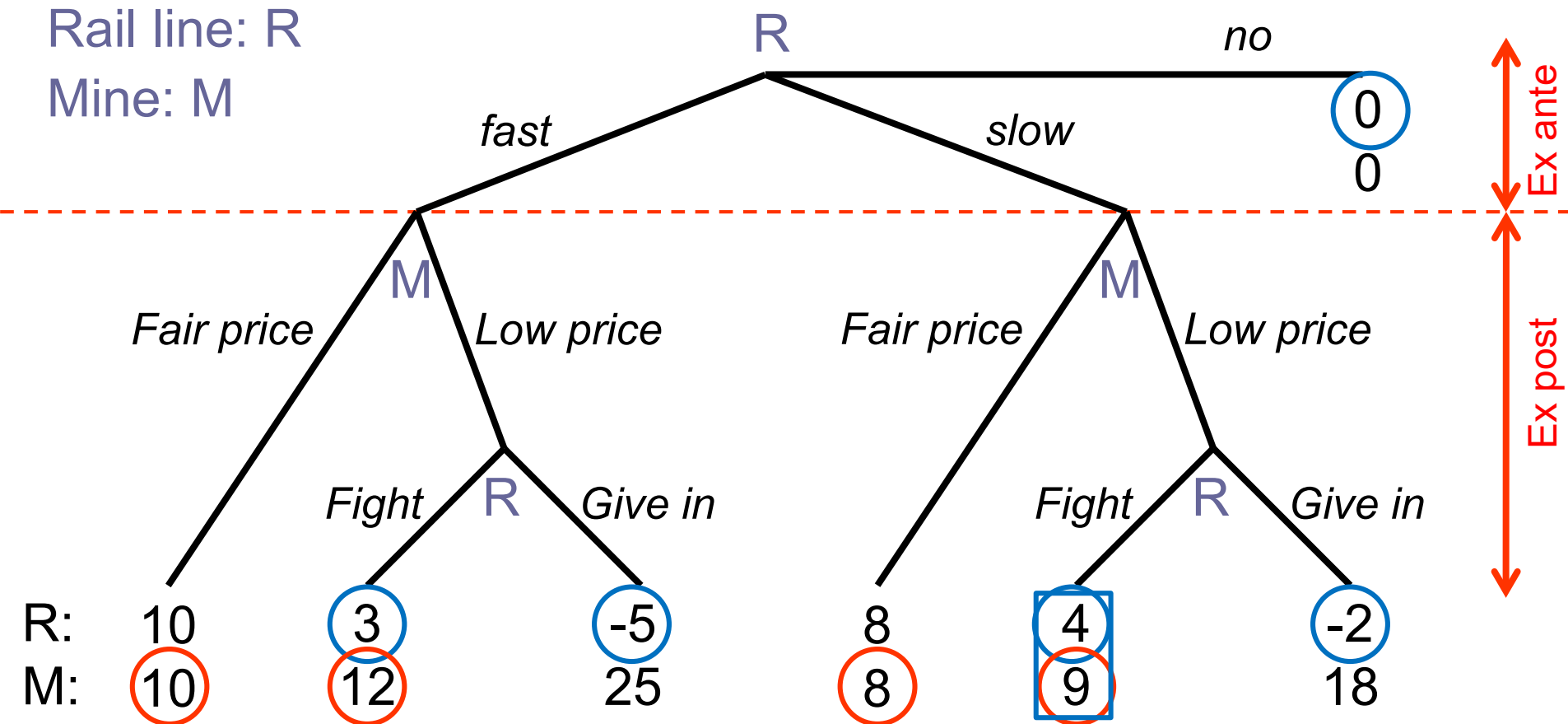


→ Hold-up leads to inefficient ex-post bargaining costs

Textbook Hold-Up: Version 3

Rail line: R

Mine: M



→ Hold-up leads to ex-ante and ex-post inefficiencies

Key Takeaways

- 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