LECTURE 7.1

FIRMS AND MARKETS

MARKETS AND FIRMS

Markets provide a decentralised allocation mechanism

- Prices aggregate demand and supply side information
- Prices balance opportunity cost of sellers and willingness to pay of buyers
- Markets effectively use dispersed knowledge
- Provide incentives for innovation and adaptation

Markets are a form of collective intelligence. They are a powerful information system that is not easily replicated

MARKETS AND FIRMS

Within the firm, authority determines resource allocation

- The price mechanism is (usually) suspended
- Decisions are more centralised
- Authority structures determine the extent of decentralisation

Why are firms needed?

MARKETS AND FIRMS

Markets don’t always allocate resources efficiently:

- Market power: economies of scale and natural monopoly
- Public goods
- Externalities (e.g. network externalities or technology spillovers)
- Moral hazard
- Adverse selection

MARKETS AND FIRMS

Firms can use both centralised and decentralised decision making

- Use central and local knowledge
- Coordinate decisions as needed
- Innovate and adapt

MARKETS AND FIRMS

An organisational architecture (structure) is defined by a set of implicit and explicit contracts:

- Specifies decision rights via job descriptions.
- Uses performance evaluations
- Uses compensation schemes to reward (and punish) decision makers.

A key choice in organisation design is whether to centralise or decentralise decisions

- What are the costs and benefits to centralisation?