LECTURE 6.5

PROPERTY RIGHTS APPROACH

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Control over non-human assets defines the firm:

- Emphasises the contingent nature of relationships: it is not possible to write comprehensive contracts that cover all contingencies
- Property rights determine incentives when contracts leave gaps
- *Hold up* leads to inefficient decision making before and after contracts

PROPERTY RIGHTS APPROACH

Example of hold up: A and B have a profit opportunity.

1. A decides whether to invest $6m in the project.
2. If A invested, A and B can earn combined profits of $10m.

Suppose A and B negotiate a contract before A invests. What might the contract look like?

Suppose A and B negotiate a contract after A invests. What might the contract look like?

Understanding the property rights are critical for identifying the incentives of agents when comprehensive long-term contracts cannot be written. That is, the residual rights of control over assets will have implications for asset usage and division of surplus in a relationship.

PROPERTY RIGHTS APPROACH

Strengths:

- Helps explain boundaries of the firm – complementary assets should be located within a firm to avoid hold up problems and reduce potential incentive problems.

Weaknesses:

- Doesn’t really incorporate information about separation of ownership and control.