

Firm in Transition

Topic 3

Theory of Firm & Ownership

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Theory of Economic Organization

What's a firm?

Based on Alchian & Demsetz, Frubotn & Pejovich

Theory of economic organization:

- gains from specialization & cooperative production are greater than gains from integration
- Structure of the organization
 - Long-term contract? Employment...
 - Does not own all inputs
 - Punishment: Do not engage in business any more
 - Continuous renegotiation of contracts...

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Metering

- Metering problem

Organization will make better use of their (input) comparative advantages to the extent that it facilitates the payment of rewards in accord with productivity.

 - How to measure input productivity
 - How to measure rewards
- The classical theory *assumes* existence of such organization or mechanism

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Team Production

- Characteristics
 - unseparable production factors
 - the joint production is greater than from use of separable productions

- Unseparable

$$Z = f(X_i; X_j) \\ \neq Z_i(X_i) + Z_j(X_j)$$

$$\frac{\partial^2 Z}{\partial X_i \partial X_j} \neq 0$$

- Separable

$$Z = Z_i + Z_j \\ = Z_i(X_i) + Z_j(X_j)$$

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Team Production

- Characteristics (summary)
 - Several types of resources are used
 - product is not a sum of separable outputs of each cooperating resource
 - Not all resource belong to one party (agent)
- How to reward members of a team?

Suppose marginal productivity is NOT cheaply observable

Monitoring = costs

No monitoring = shirking, "free-ride"

Personal utility = f(leisure; income)

substitute leisure for non-working, non-pecuniary benefit

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How to monitor?

- Market control
 - hire/fire members of a team
- Full "market" control is impossible:
 - New members should know exactly where they can increase net output of the team
 - This means costless monitoring by outsiders
 - Incentives of a new member to shirk (i.e., use some of the net output for himself); to consume some leisure are same as those of the old member
 - The incentives of members are similar
- Solution:

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Classical Firm

Specialize someone to monitor the productivity

- New Problem:
 - Who will monitor the monitor?
 - Who will guard the guard?
- Market competition as a guard
 - same problem as in case of inputs
- Monitor's pay:
 - How much he can reduce the waste of resources (i.e., reduced efficiency)
 - Examination of ways in which inputs are used is a method of metering the marginal productivity of each member of a team

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Monitor's Rights

- Rights of a monitor
 - Residual claimant
 - proceedings from removed inefficiencies
 - observe input behavior
 - contract inputs
 - alter membership of the team
 - sell these rights

But these rights define ownership of a classical firm

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Firm

Conditions necessary for a firm existence

Productivity can be increased by a team production

- It is economical to estimate marginal productivity by observing the input behavior

Occurrence of these conditions leads to the contractual organization of inputs known as the

CLASSICAL (capitalist) FIRM

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Classical Firm

- Classical firm with
 - joint use of inputs for production
 - several inputs owners
 - one party who is common to all inputs (contracts them)
 - one party who has right to renegotiate any input contract *independently* on other owners
 - one party who holds the residual claim
 - one party who has the right to sell his position

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Types of Firm

- Profit-Sharing Firms
 - LMF, coops
 - No central monitor, members monitor each other
 - small teams
 - the costs of having monitoring are higher than benefits from the increased production
- Socialist enterprise (LMF)
 - political constraints on the profit sharing/division are transferred into full control
- State enterprise (SOE) in CPE
 - state has all the ownership rights
 - In these countries state holds *de facto* ownership rights even in *de iure* private ownership

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Types of Firm

- Corporation
 - shareholder companies
 - the right of control is transferred to a smaller group which can effectively exercise the control
 - Several thousand people cannot make decision
 - freeriding of shareholders
 - "Fire" the firm in case of disagreement
 - Sell shares on the market
 - continuous voting
 - "Fire" management when majority of shareholders disagrees

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Types of Firm

- Non-profit firms
 - No right on the residual
- Partnership
 - non-employee status
 - long-term acquaintances
 - share the same utility function
 - know each other well => monitoring is not costly
- Employee Unions
 - employees are willing to hire a monitor to detect performance/contracts even if the monitor keeps some of the funds for himself

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Changes in the theory of firm

- New theory of production
 - Individuals seeks their own interest s.t. existing structures
 - Transaction costs are >0 in almost all cases
 - More than one pattern of property rights can exist
 - Profit maximization is not automatic
 - Might be different types of an objective function
- If the firm is sacrificing profits (no matter how defined or measured) for anything else - prestige, good public relation, quiet life, security, etc. - then it is not profit but UTILITY maximizing agent

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Property rights

- Property rights approach
 - attempt to formulate empirically meaningful optimization problems by associating the utility function with the individual decisionmaker and then introducing a specific content into the function
 - Different property rights lead to different penalty/reward structures => different decision
 - the behavior of a firm is explained by individual actions within the firm
 - should show the allocation and use of resources in specific and predictable way, otherwise no analytical and empirically verifiable propositions can be made

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Property rights

- Property rights approach
 - the production and trade involve contractual arrangements
 - permission to deal with goods & service, not only exchange
 - The value of any good exchanged depends, *ceteris paribus*, on the bundle of property rights that is conveyed in the transaction

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Right of Ownership

- Right of Ownership
 - = right to
 - use,
 - change its form and substance,
 - and transfer these rights
- Restrictions on the rights
 - from, place and substance
 - service standards,
 - transfer and price of such transfer
 - monopoly regulation
- Restrictions imposed by state, defined by law
 - = legal framework

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Efficiency

- Private Property Rights & Allocation
 - Privately owned resources are allocated (or tend to be allocated) to the highest value used
 - The most valuable contract is utilized
 - transfer of rights ensures that there are parties willing to obtain the rights and they do compete for it
- => efficient allocation

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Externalities

- Causes
 - Market solution is different from those with marginal equivalencies at social optimum
 - Traditional theory fails to account for all effects of property rights
- Solutions
 - Legally sanctioned structure of property rights in existence, i.e. there exists a social action designed to reduce or eliminate the effect of externality
 - Taxes vs. subsidies

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Externalities

- R. Coase:
 - In absence of transaction costs the *composition of output* is independent of the structure of property rights
 - except cases, when the wealth distribution affect demand patterns
 - Idea:
 - Externalities are associated with the costs of exchange, modification, etc. of property rights
 - Whenever the private transactions fails to account for harmful or beneficial effects to the contractual parties or to others, the **market solution is inconsistent with social optimum**

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Remedy to Externalities

- Analysis of externalities suggests:
 - Reduction of transaction costs
 - increase the value of the good
 - will improve the property rights specification, better individual valuation
- Example
 - Parking lot:
 - None
 - FIFO (transaction costs are higher than parking fee)
 - Market (metered)
- How far can the society go to correct externalities?

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Corporations = Profit Maximization?

- Managers are able to pursue their own goals up to certain limits
 - => Divergence from profit maximization
- Different models account for different managerial goals
 - but no general framework
 - => limited applicability
- Reduced ability of owners (shareholders) to terminate certain team/contracts
 - reduced ability of owners to control management

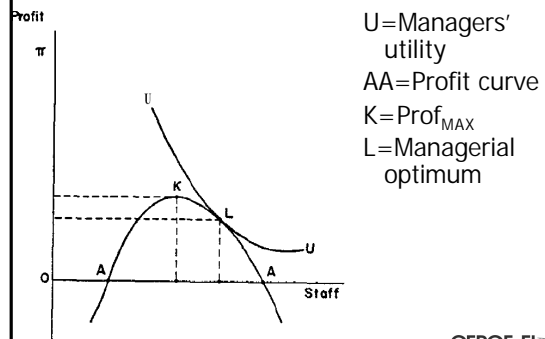
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Managerial Restrictions

- These restrictions do not come from a *legal* situation but form the *costs* of monitoring and enforcing certain policy in the firm by owners
- The greater dispersion of ownership, the greater costs of shareholders to control.
 - => Very strong result if this is true!
- Managers are thus constrained by the cost/benefit analysis of shareholders. Other constraints:
 - Market valuation of stocks
 - Managerial rewards (reward and performance)
 - Competition among managers

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Managerial Behavior



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Other Types of Firms

- Regulated firm
 - legal restrictions on the owners right to residual
 - Natural monopoly
 - Restricted entry (licensing)
 - Society monitors the owner not to expropriate excessive profits
 - Again, cost/benefit analysis of the profit/monitoring
- Socialist firm
 - Managers also pursue their own goals, similar to shareholder/manager relationship
 - as manager/state

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General Conclusions

- Maximized behavior is accepted as a norm
- Institutional framework has to be specified precisely
- Market logic can be used to a great range of problems
- Individual is basis of choice
- Operational and meaningful propositions about the economy

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