

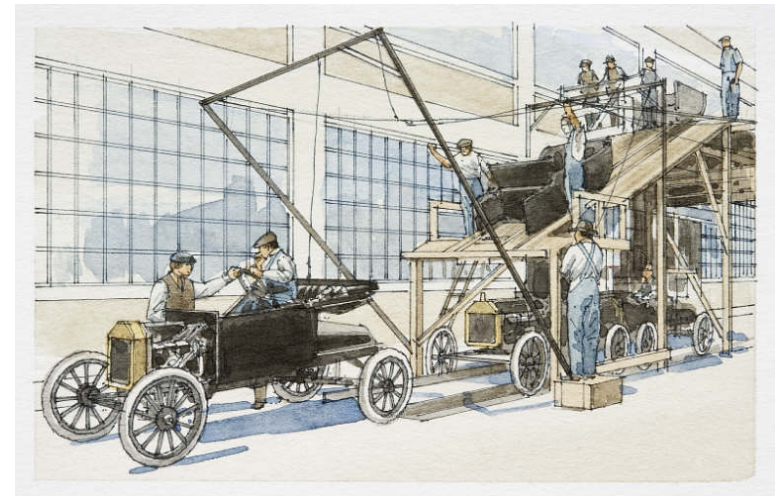
Big Business and the Market: Friend or Foes?

# 1. The Nature of the Firm

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# About the course

## ▶ “Big business”

- Popular culture
- The “Occupy” movement
- “America’s Most Persecuted Minority”?
- A balanced view

## ▶ Structure

The Nature of the Firm

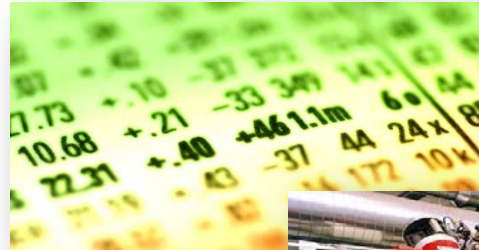
- The Nature of the State
- Power and Market: How Government Affects Business
- Waltonomics: The Rise of Mass-Market Merchandisers



# What is a business firm, anyway?

## ▶ The market economy

- Private property
- Exchange and prices
- Production



## ▶ Production

- Inputs and outputs
- The division of labor
- Uncertainty and entrepreneurship



## ▶ The organization of production

- The business firm: entrepreneur + alienable assets
- The firm as a nexus of contracts
- Ownership structure and organizational structure

## ▶ What's optimal? What the market decides!

# What do we mean by “big” business?

- ▶ Size?
- ▶ Ownership structure?
- ▶ Coziness with the state?



# Firm size

## ▶ The scale of production

- Economies of scale and scope
  - ▶ Making better use of fixed factors
  - ▶ Increased division of labor
- Limits of scale
  - ▶ Agency and information costs



## ▶ Why firms, not networks of independent contractors?

- Coase (1937) and transaction costs
- Example
  - ▶ Production process with 10 factors of production, sold to 10,000 customers
  - ▶ Firm producing internally:  
 $10 + 1,000 = 1,010$  transactions
  - ▶ Network of independent contractors:  
 $10 \times 1,000 = 10,000$  transactions



Ronald H. Coase  
(1910–)

# Firm size: limits

## ▶ Incremental limits

- Relative magnitudes of external and internal transaction costs
- Examples of **external transaction costs**
  - ▶ Searching for trading partners
  - ▶ Discovering the relevant prices
  - ▶ Negotiating and enforcing agreements
- Examples of **internal transaction costs**
  - ▶ Providing incentives
  - ▶ Monitoring employees
  - ▶ Gathering information
  - ▶ Calculating costs and benefits
- Limits to entrepreneurial judgment

## ▶ Ultimate limit: need for economic calculation (Klein, 1996)

- Applications to large firms, cartels

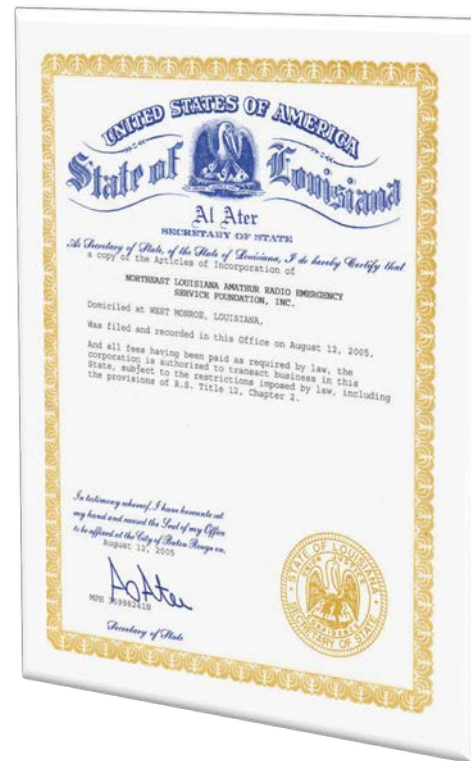
# Ownership structure

## ▶ Alternative legal forms

- Proprietorship
- Partnership
- Patron-owned cooperative
- Limited-liability company
  - ▶ Privately held
  - ▶ Publicly traded

## ▶ Choosing among legal forms

- Tax and regulatory considerations
- Incentives and governance
- Cost of capital
- All have economic benefits and costs!



# Benefits and costs of organizational structures

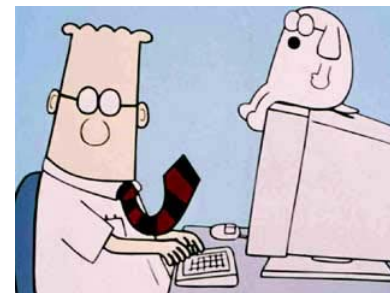
## ▶ Corporations

- Benefit: access to capital
- Cost: separation of ownership and control
  - ▶ Note on delegation
  - ▶ Internal and external control mechanisms

## ▶ Partnerships and cooperatives

- Benefits: buy-in, potential harmony of interests
- Costs
  - ▶ Free-rider problem
  - ▶ Horizon problem
  - ▶ Portfolio problem
  - ▶ Control problem
  - ▶ Influence-cost problem

## ▶ Note on the Dilbert problem





# Organizational structure

## ▶ Assigning decision rights

- Decentralization
- Specific (tacit) knowledge and delegation (Hayek; Jensen and Meckling, 1990)
- Benefits and costs
- The role of information technology

## ▶ Compensation and evaluation

- Incentive pay
- Risk aversion
- Tradeoffs
- Note on “every man his own firm”



F. A. Hayek (1899–1992)

# Takeaways

- ▶ Business firms – entrepreneurs owning and controlling productive assets – are a natural part of the free market.
- ▶ A complex, advanced market economy will have many types of firms – large and small, hierarchical and egalitarian, specialized and diversified, corporations and cooperatives, proprietorships and partnerships, etc.
- ▶ There are economic advantages to “big” businesses and corporations, depending on the circumstances!
- ▶ In the mixed economy, things are much more complicated. . . .

More to come!