

Transaction Cost and Theory of the Firm



Why Might.....

U McDonald's form a close relationship with their meat suppliers as opposed to buying from the cheapest "supplier of the week"?

U Michigan cherry growers create a cooperative to freeze cherries?

U Frito-Lay contract directly with potato growers?

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Determinants of Structure

U *Exogenous view*

- Scale economies
- Regulatory frameworks

- Firms optimize given the structure

U *Endogenous view*

- Private optimization
- Social optimization

- Structure reflects **overall** cost min

- **Transaction cost approach**

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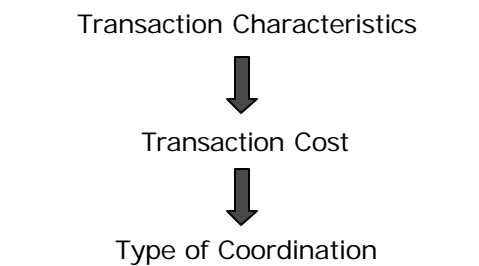


Why do Firms Exist?

- U Coase/Williamson:
 - Y The boundary of firms is determined by transaction costs
 - Cost of using the market vs. cost of integration
 - Economies of Specialization vs. Diseconomies of integration



Reacting to the Cost of Exchange



Sources of Transaction Costs

- U Economic uncertainty
- U Bounded rationality
- U Opportunism



Economic Uncertainty

- U Characteristics of trading partners
- U Prices of goods and services
- U Product quality
- U Product availability

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Bounded Rationality

- U Economic players are limited in their ability to process information and make decisions
- Y Incomplete contracts
- Y Information asymmetries

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Opportunism

- U "Self-interest seeking with *guile*"
- Y Imperfect commitment
- Y Taking advantage of other parties in the transaction

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Transaction Characteristics

- U Frequency
- U Degree of Complexity/Uncertainty
- U Degree of Asset specificity



Types of Asset Specificity

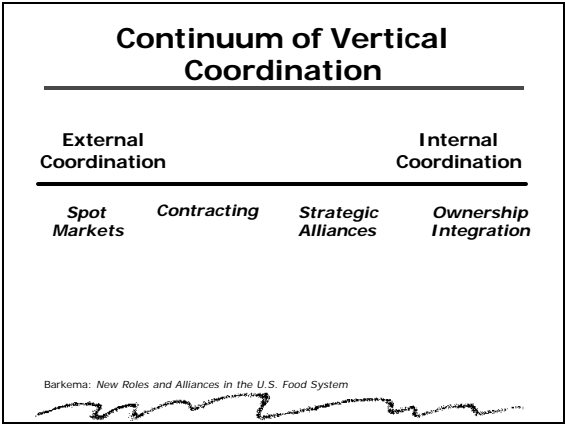
- U Site
- U Physical Capital
- U Human Capital
- U Dedicated Assets

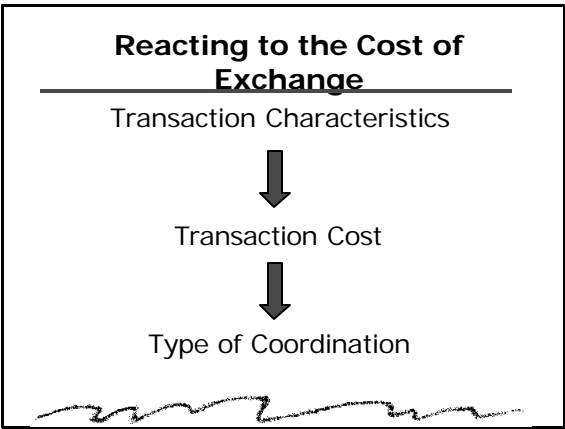


Bringing the Transaction into the Firm....

- U Costs
 - Y More "activities" in AgriFood system = More complex planning
 - Y Giving up "economies of scale" advantage in production cost
- U Gains
 - Y Access to information--technology, demand data, product characteristics
 - Y Control over input supply--quantity, quality, timing







- ### Integration
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- ✓ Relieves Hold Up/Moral Hazard Issues
 - ✓ *Holdup*...asset value is contingent upon upstream/downstream market access
 - ✓ F&V vs. grains
 - ✓ *Moral Hazard*...value of asset is contingent upon upstream/downstream behavior that is hard to observe/monitor
 - ✓ Employee vs. Owner
 - ✓ First handlers contribution to quality
 - ✓ What is the cost of integration?
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TC Economics in Agriculture

- ✓ Explanation of likely governance structures
 - ✓ Cooperative vs. Investor owned firm
 - ✓ Anti-Trust issues
 - ✓ Market power vs. efficiency
 - ✓ Tyson cattle case
 - ✓ Culture and Legal infrastructure impact on institutions



TC Economics in Agriculture

- ✓ Explanation of *rigidity* based on asset specificity
 - ✓ Unwillingness to adapt
 - ✓ Cost reduction vs. flexibility tradeoff



TC Economics in Agriculture

- ✓ Designing Food System Institutions
 - ✓ Market reform
 - ✓ What institutions best offer credible commitment?
 - ✓ Sustainable markets



TC Economics in Agriculture

- ✓ How do technological changes impact TC?
- ✓ "Apple" transport computer
- ✓ E-coli "sniffer"
- ✓ Veterinary advances in swine/poultry
- ✓ How do governance structures respond?



Limits of the Theory

- ✓ Still weak in predictive ability
 - ✓ Partly because many TC's are commodity-specific
- ✓ Lower TC as only criterion for private governance choice
- ✓ Ignores 3rd party effects
- ✓ Private optimum vs. social optimum