

# Transaction cost economics and vertical boundaries of firms



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Businesses, though self-motivated, are social mission and their services to continue allocation of economic resources to best serve the end-user rests on their successful and profitable operations. Therefore, the firms keep trying to reduce their risks and uncertainty arising within the interaction of firms in a market and ensure a continued provision of good and services not only for their production facilities but also to the consumers. One of the answers in this regard comes from the choice of firms to integrate in the vertical chain of their market.

A market refers to an arrangement whereby different firms are strategically dependent upon one another in order to procure their raw material from their suppliers and sell their final product to the customers. All activities taking place from the procurement of raw material to the sales comprises the vertical chain in the market (Coase 1988, pp. 38; Niehans 1987, pp. 678; Cheung 1983, pp. 21).

In such integrated markets comprising interdependent firms goods and services get transferred across the entire vertical chain. Transaction costs, whereas, are all the expenditure that incur along the vertical chain. Thus, these costs are elementary to all trades and investments and may include both the internal as well the external costs of firms. These costs bear critical and revolutionary impact on the firms ' marginalization' and ' substitution' decisions (Coase 1988, pp. 38; Niehans 1987, pp. 678; Cheung 1983, pp. 21).

Transaction costs have assumed such an important place in the modern-day business world that it is argued that they explain why firms exist or in other

word they determine the structure of firms which are motivated by the principles of self-interest and opportunism especially to the extent firms will embrace vertical integration. Thus, the concept of opportunism is central to the concept of Transaction cost economics and is conducive to economic activity (Williamson 1979, pp. 234).

Opportunism defines active markets which serve as platforms where individual firms buy and sell and compete. The concept of opportunism, nevertheless, dictates that firms interact with each other on the platform of the market in ways to maximize their gains within the paradigms of their strengths and weaknesses. Thus, there are always incentives for the firms to capitalize on their strengths and curtail their weaknesses through inter-firm interactions which give rise to undertaking of mutual activities by firms resulting in three key characteristics of transaction costs: (1) there exists strong mutual interdependence among firms when they reach a contract, (2) every firm tries to snatch the biggest piece of the share and (3) it is often difficult to put each and every contingency enforceable in the contract (234).

The existence of transaction costs, hence, forms the institutional basis for the explanation of vertical mergers. Thus, according to Williamson firms rarely integrate for technological reasons rather most of the drivers of such changes are economic in nature, mostly relating to anticompetitive effects of vertical integration. The vertical integration, thus created, often results in preservation of a complex contracting relationship. However, the root causes of vertical integration can be traced to transaction costs and the conditions of asset specificity (Ben Porath, 1980, pp. 4; Winston 2000, pp. 4).

Assets specificity takes place when firms develop their core competencies by investing in general purpose or specific purpose assets. The assets specificity may take several different forms in terms of site specificity, physical asset specificity, human asset specificity, dedicated assets and brand name capital. The specific purpose assets, nonetheless, are normally durable assets that happen to possess greater risk because their use is dependent majorly upon the life of contracts and there are lesser alternatives courses of action where these assets can be put to use. Consequently, the value of specific assets falls in transactions other than the purpose for which they are meant. Resultantly, a seller is unable to sell a specific asset to a buyer with a purpose not suitable for the use of the asset (Williamson 1985, pp. 55).

In order to avoid the fall in the value in specific assets, there arises a need for vertical integration which enhances the chances of the continuation of the purpose for which a specific asset is meant. As a consequence of the continuity of relationships, at first, the requirements of acquiring specific assets are reduced. Secondly, vertical integration increases the continuity of specific transactions providing certainty to the life of specific transaction. Thirdly, it results in contractual and organizational safeguards (Ben Porath, 1980, pp. 4). In addition to these, asset specificity becomes important for firms in matters relating to bounded rationality, opportunism and uncertainty. Whereas bounded rationality is the intended rationality of firms but only limitedly so (Simon, 1961, pp. xxiv). All in all, transaction cost economics considers human behavior subject to an economizing rationality without cognitive constraints.

Alongside asset specificity, the nature of contract among firms also gains weight in the discussion of transaction costs economics. Hart and Moore (n. d., pp. 182) thus claim, “ firms are important when contracts are incomplete, and parties make large relationship-specific investments.” However, though the analysis of the incomplete contracts is still not understood well, research carried out so far depicts that everything can not be stated in a contract and as result the contract is termed as incomplete (Buhai, 2003, pp. 1-4).

The incompleteness of contracts is subject to several factors including denotation of ownership, bounded rationality, asset-specificity, financial securities and several other economic factors. Thus, resultantly contractual gaps stems out of these conditions or shortcoming which allows the contracting parties to behave in uncertain ways regarding their decision of make-or-buy (Buhai, 2003, pp. 1-4; Segal, I, 1999, pp. 57).

Before Williamson introduced the concept of transaction cost economics, firms had been focusing on the weighing up of their cost and risks against the benefits of using markets to buy their input as well as sell their outputs. However, the focus has now shifted to transactions costs in order to make decisions in getting hold of firms’ inputs either by making them or buying them from the market. If a firm chooses to create its inputs there occurs vertical integration whereas if it chooses to buy them from the market there occurs vertical separations (Jacobides, Michael G.; Billinger, Stephan, 2006; Tan 2009).

Resultantly, the extent of vertical integration rests on the aggregation of make-or-buy decision of firms in an integrated market (Jacobides, Michael G.;

Billinger, Stephan, 2006; Tan 2009). According to Jacobides, Michael G. Billinger and Stephan (2006) transaction cost economics, vertical scope and bounded rationality become the core considerations in make-or-buy dilemma- with emphasis on the relationship of asset specificity to vertical integration (Jacobides, Michael G.; Billinger, Stephan, 2006).

Recent research, however, signifies the complexity of the boundary decisions which enable firms to decide on in-house production within the confines of their vertical boundaries. The vertical boundaries of firms within an industry are determined by the capabilities of in-house production possessed by individual firms. The individual capabilities are, in turn, determined by the nature and capabilities of the market or the industry as a whole (Macchiavello, 2009, p. 1-4).

In addition to make-or-buy decision and vertical integration firms also exhibit certain intermediate arrangements. According to Dyer (1996) and Powell (1990) there is, therefore, growing recognition of forged alliances or participation in networks to exchange inputs or outputs (qtd. in Jacobides, Michael G.; Billinger, Stephan, 2006). Transaction costs economics theory labels these structures as “ hybrids,” which includes long-term contracts, franchising, joint ventures and the like.

The overall success of firms’ desires to integrates vertically heavily rests on the level of coordination among the firms within an industry. Though vertical integration reaps benefits for firms in terms of reduced costs of transaction along the vertical chain, there are elements which may hamper the incidence of coordination. At first, firms are motivated by opportunism which

may result in breach of coordination. Secondly, in the face of incomplete contracts firms may avail contingent activities jeopardizing the gains from the vertical integration for the other firms (Jacobides, Michael G.; Billinger, Stephan, 2006).

Nonetheless, there are several incentives for the firms to opt vertical integration. These incentives for the firms to coordinate in a vertically integrated setup stem out of the forces like dominance over market procurement, reduced transaction costs (TC) and improved profitability, the fear of expropriation, the desire to increase incentive alignment through integrated ownership, the need for superior monitoring or the inability to educate outside suppliers about desired properties (Jacobides, Michael G.; Billinger, Stephan, 2006). All in all, the vertical integration results in economies of scale, reduced risk and uncertainty as well as increased profits.

## **Conclusion**

Firms compete with one another for resources and share in the market full uncertainty and risk. In order to maximize the gains from its operations, firms often resort to activities that reduce their costs, the level of risk and uncertainty and improve profits. Transaction costs Economics, thus, explain the very reasons how firms evolve and integrates in the face of concerns like incompleteness of contracts, asset specificity, property rights issues etc. However, the extent of the vertical integration rests heavily on the vertical boundaries of the firms as well as vertical scope of the industry.

Nonetheless, vertical integration calls for coordination which is normally a difficult variable to control in the presence of opportunism and self-interest.

However, vertical integration, if managed strategically, does pay off.  
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