A factor for firm formation economics essay

Firms are all around us and are the main expressers of economic activity in the modern capitalistic world. We observe firms being created, growing, evolving, expanding into new areas by merging with others but also remaining stable, declining, getting acquired and sometimes declaring bunkruptcy. It is clear that firms' activities vary a lot and as a result, multiple studies regarding them have been undertaken during the course of the years. This essay's purpose is to address the, perhaps, most important element associated with a firm's existence, its formation, and especially the conditions and the reasons under which firms tend to form.

But first, in order to be able to explain the circumstances and the factors that lead into the successful formation of a firm, a definition of it will be given. According to Jensen and Meckling, ' a firm is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations' (1976 p. 311). The feature of the firm that makes it unique, though, is its ability to supersede the price mechanism, one of the pylons on which the whole economic theory is based, with decisions taken by the firms' agents upon real-life situations and which, in most cases, deviate from what the economic theory through the price mechanism dictates (Coase 1937 p. 390).

Of major importance in this essay is the attempt to present, describe and evaluate the existence of transaction costs, which is a key aspect of Coase's, Arrow's Williamson's and Di Maggio's analyses of the reasons why firms are formed. However, although it is crucial in understanding the genesis of a firm and its explanatory capability is invaluable, economising on transaction costs theory does not provide a sole explanation of it and other factors must be taken into account in order for us to have a clearer picture of the situation. The purpose and length of the essay does not provide the possibility to elaborate in a thorough and complete way about those factors, but technological advances and entrepreneurial spirit and creativity will be outlined and briefly explained. Moreover, for a successful firm creation to take place, there are many conditions that need to hold true, some of which will be presented in the following analysis. These are: widely understood rules when it comes to governing a firm, and analytical planning before the actual formation of the firm.

Transaction Costs Theory: Both a condition and a factor for firm formation

As argued by the title given above, the transaction costs theory can be seen as both a condition and a factor on which a successful firm formation relies, depending on how the reader perceives the situation. The existence of transaction costs is a condition for firms to arise, but the process by which the economic agents economise on transaction costs is probably the most crucial factor that drives firm formation and that is why it will be analysed separately from the other conditions and factors.

The main reason for a firm's formation is the cost of using the price mechanism by which the economic system is being run (Coase 1937 p. 390; Arrow 1969 p. 70). Or, according to Williamson, ' a firm is the product of a series of organisational innovations that have had the purpose and effect of economising on transaction costs' (1981 p. 1537). More specifically, organising production through the price mechanism enables an obvious transaction cost of finding out what the current prices of interest are. Even if specialist “ price finders” existed, this type of cost would not be totally eliminated (Coase 1937 p. 390). As it can be understood, this more realistic theory contradicts with the theoretical model of the economy, in which there is perfect price information to all agents.

But what is understood of transaction costs and what actions do firms take in order to reduce them? Transaction costs are mainly ‘ the costs of deciding, haggling, arranging and coordinating actions that constantly take place in the market’, as Paul Di Maggio has argued (2001 p. 8). Furthermore, they include the creation of contracts for each separate transaction that occurs in the market. As firms are created, these contracts are not eliminated but they are greatly reduced, since the founder-manager of the firm does not have to create contracts for every single transaction in which his/her company participates, as implied by the economic theory. Through this procedure, multiple costs are avoided, because the so called marketing costs are strictly reduced. For example, only one contract per employee is needed, in which the relationship between him and the firm (and its agents) is clearly stated. That will include the amount and the way of payment, the working hours and the certain limits within which the employee will have to “ obey” the employer (Coase 1937 pp. 390-393). Further methods that firms use in order to minimise transaction costs are the introduction of repetitive and predictable activities for their employees, by giving duties to them through a clear job description, eliminating the possibility of negotiations about the allocation of tasks. As a result, employers have more time to deal with important issues and decisions concerning the firm. In addition, the fair treatment to employees provided by the firm’s environment guarantees the reduction of transaction costs, since there is a specified reward-punishment system that everybody abides by, that results to immediate elimination of conflicts (Di Maggio 2001 pp. 8-9). Regarding the same topic, Williamson has argued that pre-contract negotiation and task and deliverables specification will reduce the necessity for periodic interventions to check the progress of the contract's execution and its successful completion (1981 p. 1544).

Another crucial question about the transaction costs touches upon the reason of their existence. Related to it are two behavioural assumptions: bounded rationality and opportunism. According to the bounded rationality theory, people are less competent in calculations and are not able to account for every issue that is contract-related and therefore are transaction costs created. Moreover, people are opportunistic and unreliable, because they, many times, act having just their personal interest in mind. Consequently, it is possible that they are going to behave in a non-trustworthy and irresponsible way (Williamson 1981 pp. 1544-1546). As it has been presented above, a key factor for a firm's formation is the deviation from the economic model that portrays humans as perfectly rational beings that make right choices and have no flaws.

As a bottomline, Coase's writing about firm growth and expansion should be mentioned, according to which ' firms grow as their entrepreneurs undertake additional transactions – exchange transactions that are co-ordinated through the price mechanism' – and ' try to expand until the costs of organising an extra transaction within the firm, equals the cost of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm' (Coase 1937 p. 393, p. 395). This is important because we are able to grasp how the second major challenge that firms' founders face, the growth of their firm, after, of course, the successful formation of the firm, is illustrated based on the transactions theory described earlier.

Conditions under which firms are formed

Apart from transaction costs, there are also other conditions that need to hold true in order for a firm to be successfully constituted. A set of widely understood and fairly applied rules is essential, because they deter employees from using firms to seek their personal interest and urge them to contribute to achieve the firm's goals. Perhaps the most important rule has to do with the hierarchy of the organisation, that is who gives orders to whom and who has the last call, when decision-making is involved. Secondly, clear admission and promotion criteria need to be established, so that firm's transparency is maintained, and lastly routines for the performance of work need to exist, in order for deliverables to be easily checked in terms of integrity. Generally, rules within a firm serve a double role by specifying who does what work and by dictating which behaviours are worth rewarding and which punishing (appraisal – punishment system) (Di Maggio 2001 p. 8).

Of major importance, when it comes to explaining the circumstances under which a firm is brought to life, is the planning that the entrepreneur(s)-founder(s) of the firm has/have to do before he/she/they can actually start building it, since a business plan, according to Delmar and Shane, ' turns abstract goals into concrete operational steps' and therefore is crucial for both a firm's existence and success. What is meant with the term business planning is the effort that firm founder(s) need(s) to make so that he/she/they gather(s) the appropriate information about a business opportunity and the action of finding and understanding how this information will be used to give birth to a new organisation that will try and make use of this opportunity (2003 p. 1165). Through business planning the founder(s)-manager(s) of the firm is/are going to be able to spot and capitalise in a more efficient and risk-free way on the reduction of transaction costs. Without planning, a firm can not in most cases fulfill its ultimate goal, survival, and the most sought after one, profit maximisation.

Factors that drive firm formation

Why is a firm created and what are the key factors that lead to its formation are two closely related questions that will be discussed in this section of the essay. One of these factors is technology and its regime that, according to Shane, includes four dimensions – ‘ age of technical field, tendency of the market towards segmentation, effectiveness of patents and importance of complementary assets in marketing and distribution’ – which affect the trend for inventions to be exploited through new firms’ formation (2001 p. 1188). This formation is the reaction of potential entrepreneurs when they observe that specific domains of tecnology exploitation are profitable. Concluding, technology is crucial because it has become the main reason for innovation and that is the force that drives firms to the creation of new products, services and processes (Chandler 1959 p. 25).

Yet another factor that leads to firm formation is the creativity that a person shows, when he/she observes an opportunity to make profits through the creation of a product or provision of some kind of service. This creativity is referred to as entrepreneurship and is associated with spirit, vision and alertness to business opportunities that a person needs to possess (Lee, Florida and Acs 2004 pp. 889-890). Whether someone possesses the gift of entrepreneurship or not, is determined by regional variation and characteristics such as population size, industrial structure, human capital capacity and financing availability (Armington and Acs 2002 p. 37). A useful claim about entrepreneurship was made by Stuart and Sorenson who argued that firms' founding rate is affected by social ties and the entrepreneurs' need to reside near resources that they find necessary to mobilise (2003 p. 229). Finally Schumpeter, when talking about his concept of creative destruction, he underlined the responsibility that independently owned firms bear for ' reforming or revolutionising', another indicator of the importance of entrepreneurship for firm formation as well as growth (1942 p. 132).

Conclusion

To sum up, although there is no doubt that the firm is ' an important and complex institution', according to Williamson there seems to be disagreement when it comes to examining the conditions and the reasons that underlie its formation (1981 p. 1537). However, much of firms' formation literature and analysis relies on the existence of transaction costs and the firms' attempts to economise on them. The deviation from the market's theory of organising the economic activity to the firm's alternative one, brings upon the two behavioural assumptions – bounded rationality and opportunism – that introduce reality into the model and cease portraying human beings as perfectly rational. Apart from transaction costs, more conditions and firm formation factors are described in order for the analysis to be more complete within the length limit of this essay. Lastly, since the firms will always be in the centre of the economic activity, and as the state of the world and people's behaviour change through time, it is possible that when similar analyses are to be conducted in the future, new findings regarding the reasons and the conditions under which firms arise, will be discovered that might as well change our perspective.