Differences between at and tce on corporate governance

Business, Corporate Governance

Explain the similarities and differences between AT and TCE on corporate governance and criticize AT using TCE's perspective Both AT and TCE share considerably the same assumption, they believe that market mechanism will not work all the time because of bounded rationality, opportunism, and moral hazard. The two theories also believe that there is no perfect contract and both rely endogenously on the board of director as a control instrument.

Even though AT and TCE both share these similarities, they analyze them from different perspectives. The unit of analysis in AT is individual level, while it is transaction in TCE. The focal cost of AT is the residual loss that causes from bounded rationality, opportunism, and moral hazard, while it is maladaptation of governance structure in TCE. Furthermore, the focal contractual concern of AT is ex ante, while it is ex post in TCE. AT focuses on relationship between principals (shareholders) and agents (CEO).

Due to the fact that the principals want to maximize their return, while the agents want to maximize their wealth, power, and prestige, so the interests of the two parties are not aligned. The agents are able to fulfill their interests without necessary fulfilling the principals'. To guard against such bounded rationality, opportunism, and moral hazard from the agent, board of director is appointed to link the imperfect relationship between principals and agents. The board of director has the right to monitor, ramify, and sanction the decision of the agent to fiduciary protect the principals' interest.

Apart from appointing the board of director, nexus of contracts is utilized to provide ex ante incentive alignment and minimize inefficiencies in the contractual structure of the firm that arise form the unaligned interests. TCE focuses on the alignment of the governance structure in order to minimize the transaction cost as much as possible. Its focal contractual concern is ex post governance structure so they strive to reduce the transactions cost by integration rather than focusing on incentives. TCE also assume bounded rationality, opportunism, and moral hazard as AT, but TCE focuses on transaction level instead of individual level.

Apart from the assumptions of bounded rationality, opportunism, and moral hazard, two variables must be concerned in order to decide the appropriate governance structure. These variables are namely uncertainty, and asset specificity. The level of uncertainty is dependant on the length of the transaction and often is a part of bounded rationality. Longer length of transaction often leads to higher uncertainty. Asset specificity, contrary to uncertainty, is better for longer length of transaction. This is due to the reason that, the transactions cost is lower in a higher specific asset.

If the level of asset specificity and uncertainty are high in both parties, vertical integration is suitable in minimizing the transactions cost, but if the level of uncertainty is low while the asset specificity is high in both parties, long term contract is more suitable. Board of director also exists in TCE, but for different purpose than in AT. The role of the board of director in TCE is to safeguard the firm against financial lost from by financially look after the firm rather than monitoring the agents’ behavior.