The Firm.

Technology: Inputs $\implies$ Output

Input & output choice:

PROFIT MAXIMIZATION.

[If firm has market power, also choose prices.]
Do firms maximize profits?

Modern corporate firms: separation of management and ownership.

Decisions based on manager’s objectives.
1. Ownership diffused: many shareholders

⇒ problem of collective action in monitoring

Solution: Board of directors

Problem: CEO may control board.
2. Incomplete information: owners often do not observe

- actions chosen by managers

- exogenous variables that affect firm performance

- personal characteristics of managers.

⇒ AGENCY PROBLEM.
Factors that discipline management:

A. *Incentive Contracts* (internal discipline):

Management shares in profits or stocks: performance based pay.

Problems with incentive contracting:

i) Risk aversion of managers.

ii) Limited Liability of Managers.
B. Labor Market Discipline:

Future employment and wage of managers.

Negative reputation of managers in firms with abnormally low profit performance reduces future employability, salary etc.

Positive reputation of managers of high profit firms helps get fat salaries later.

Labor market provides incentives.
C. *Capital Market Discipline.*

Threat of takeover if firm not making as much profit as it can optimally.

Raiders replace and punish existing management.
D. Product Market Discipline

If product market competition is intense, firms that do not maximize profits are highly likely to go out of business.

Also, competitors provide signals of productivity to firm’s owners so that managers can be better controlled.
Boundaries of a Firm.

Horizontal: Size, Output, Range of products.

Vertical: Stages of production carried out within firm

Economic view of a firm:

Decentralized market relationship between producers

Internalized by a firm.

Why?
1. Economies of scale & scope in production

(more important in determining horizontal extent)
2. Problems with contracting:

- incomplete information

- transaction costs

- post contractual opportunism (*hold-up problem*) in exclusive relationships.
Extent of vertical integration: (Make or buy?)

*Hold-up problem*: 

Reduces incentive to invest in *specific assets* 

⇒ pushes for vertical integration 

However, integrated firm has *agency problems* 

Lose efficiency ⇒ pushes for vertical separation.
Mid-way solutions:

*Franchising:*

Residual profit owned by agent but specific investment made by principal.

*Tapered Integration:*

Subsidiary competes with independent suppliers.
Wide variation in firm performance \((\text{profit rates} = \frac{\text{profit}}{\text{revenue}})\)

Only 20% of this variation can be explained by difference in

- firm size

- type of industry etc.

Also, difference in performance persists over time

\(\Rightarrow \) "sustained competitive advantage"
80% variation attributed to:

* Impediments to imitation:
  - patents
  - firm specific tacit knowledge
  - firm specific assets
  - firm culture.

* Strategy.

* Learning Curve.

* History.