

Solving The “Selective Intervention” Puzzle Some Thoughts About The Theory of The Firm

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June 7, 2010

This year, the Nobel committee decided to award Oliver E. Williamson for his contribution to the understanding of the boundaries of the firm. What is a firm? What activities should be internalized? Which ones should be externalized? Which ones should be mixed (i.e. internalized and externalized)? What is the specific coordination device that is available in a firm and not on a market? In my opinion, these questions are old and still unresolved and the article written by Jacques Crémer (in the previous issue of this review) is helpful to delineate the challenges still to be addressed.

In this article, Jacques Crémer points out that in order to build a convincing theory of the firm we need to be able to delineate what firms can achieve that markets cannot and inversely, what markets can achieve that firms cannot. Otherwise, the “selective intervention” puzzle applies suggesting that in any situation, a firm can outperform a market. Jacques Crémer suggests that, if a satisfying theory of the firm does not yet exist, many studies are on the right path using a new and common “strategy”, coming from a “change of the description of the role of the principal” that is “the principal does not leave the stage once the contract is written”. I totally agree with this. However, I will argue that this does not come as a surprise once you seriously consider Ronald H. Coase’s papers on transaction costs. The new theoretical paths that improve our understanding of what the firm is and what their limits are, all have in common that they try to incorporate transaction costs in their analysis. This is the main seminal spirit of Coase’s papers and this naturally leads to consider that any contractual issues cannot be resolved when they involve a Principal that would leave the stage once the contract is written.

1 Taking Coase Seriously

Like Jacques Crémer, I used to teach about the Organization Theory. And the first message I tried to pass along to my students was that without transaction costs, organizational issues are irrelevant. That is, from my point of view, they rely on the main value of Coase’s famous articles on the nature of the firm (Coase

(1937)) and the problem of social costs (Coase (1960)). What is central in these articles is not so much stressing the existence of transaction costs: everyone knows that such costs exist. Also, it is not (and this is often very confusing for students) to critique the standard neoclassical theory: every theory is a simplification of the real world and the standard neoclassical theory is no exception and did well to highlight our understanding of the many economic questions concerning the way markets perform. The main value of Coase's articles is to argue that, without a theoretical framework including transaction costs, we cannot address the question of why a firm exists, what their boundaries should be and more generally, all the questions related to governance structures' issues. This is the message of the Coase Theorem (Coase (1960)): in a world without transaction costs, you do not care about alternative governance structures, organizational choices and the way property rights are distributed. At the end of the day, scarce resources will be used the same way.

In my opinion, the selective intervention puzzle is another face of the same coin: without transaction costs you can negotiate and reach (at least) a situation where you integrate a transaction that is unchanged compared to before integration, suggesting that firms outperform markets in all situations. Of course, once transaction costs exist this is no longer true.

With this starting point, it becomes clear that if you want to handle organizational questions such as the make or buy issues and the boundaries of the firms, you must build on a theoretical framework that allows for the existence of such transaction costs. You must relax the assumptions of the neoclassical theory.¹ Several frameworks are possible candidates. All of them, of course, suggest that the Principal does not leave the stage once the contract is written and insist on the fact that, in a complex world, all agreements are usually incomplete and must evolve through time.

2 The “Selective Intervention” Puzzle

The standard incentive theory to which Jacques Crémer refers departs from the standard neoclassical theory by relaxing assumptions concerning the distribution of information. More precisely, making the assumption that information is asymmetric, the theory provides new insights into the consequences and how to deal with adverse selection and moral hazard problems. Nevertheless, this is not sufficient in order to bring transaction costs into the analysis and thus to resolve the selective intervention puzzle. As Malin and Martimort (2000) noted, “incentive theory has nothing to say about such things as the distribution of authority within an organization, the limits of the firm, the separation between

¹I would also like to point out to my students that in such a theoretical framework, many market failures vanished, such as natural monopolies, for example. Indeed, as soon as there are no transaction costs - as it is supposed in standard neoclassical textbooks - consumers might freely negotiate with the monopoly in order to set aside payments to convince the monopoly to behave such as if competition existed. And this would lead to a win-win game. Of course, as soon as you consider the existence of transaction costs, coordination is an issue for consumers, as well as enforcement of side payments.

the public and the private spheres of the economy, and more generally nothing to say about organizational forms and designs". Nevertheless, such an approach provides us with the second best solution. Third best optimizations that describe a world in which the Irrelevance Theorem no longer holds is possible when ad hoc transactional constraints are introduced.

As pointed out by Jacques Crémer, other theoretical frameworks go a step further, by relaxing other assumptions helping transaction costs to make their appearance. I will not give an extensive description of alternative theoretical frameworks (See (Garrouste and Saussier (2005) and Gibbons (2005)) for more on this topic). The incomplete contract theory (Grossman and Hart (1986)) is obviously one of the main candidates, making the assumption that contractual agreements are incomplete because of institutional imperfections making contractual provisions unverifiable and then leading contracting parties to renegotiate once unverifiable investments have been made. The relational contracting literature (Baker, Gibbons, and Murphy (1994), Baker, Gibbons, and Murphy (2002)) completes the picture by taking into account that the contracting parties might cooperate through promises instead of formal contractual agreements once the future business restrains opportunistic behavior. Furthermore, this approach argues that property rights are a bunch of revenue and decision rights, some of which are transferable through contracts, others are not explaining in part why integration changes things regardless of the willingness of the parties (Baker, Gibbons, and Murphy (2008)).

In all cases, because of existing transaction costs, contracting is no longer an ex ante issue, where the Principal must find incentive mechanisms in order to select and to give proper incentives to his agent. But it is also almost an ex post issue, in a transaction costs' world in which the contracting parties sign incomplete contracts that must be adapted to a changing environment.

3 Is the Puzzle Already Resolved?

Oliver E. Williamson proposed a solution to the "selective intervention" puzzle: The firm, with its distinctive capabilities, is able to govern transactions of particular kinds for which markets are not suitable, by controlling more strongly opportunistic behaviors and transaction costs that may arise as soon as economic actors are in a dependency relationship. However, such control is at the expense of high transaction costs coming from a loss of incentive intensity (e.g. bureaucratic costs). Thus there is no selective intervention puzzle since two things change automatically when one firm integrates another firm: the distribution of property rights and the incentive levels.

I see several problems with this solution. One of the main problems is that if there is an analysis of the limits of the markets (i.e. the sources of transaction costs), I do not see a counter part concerning the firms in the transaction cost economics framework. Where are the bureaucratic costs coming from? There is a need for a clearer understanding of the limits of the firms to properly solve the selective intervention puzzle. As noted by Williamson, transaction

cost economics mainly look at transaction costs on the market, making the assumption that "substantially the same factors that are ultimately responsible for market failures also explain failures of internal organization" (Williamson (1973), page 316; Williamson (1996)).

I agree with Jacques Crémer that I would feel more confident with a more "unified" theoretical framework. I follow Oliver Hart's path in stating that "It would be too easy to construct a theory of the firm with the assumption that incentives are decreasing in the firm compared to the market" (Hart (1995)). And I applaud the theoretical paths that try to solve the puzzle with more formal foundations, specifying the precise assumptions that are needed to build a theory of the firm. As far as I can see, they are giving rise to interesting stories that are clearly in competition with each other when considering make or buy issues (Whinston (2003)) or contracting choices (Masten and Saussier (2000)). At the end of the road, we can bet that such "competition" between existing theories of the firm will increase our understandings of those issues and will lead to a unified theory.

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