

Lecture XIII: Williamson – Chapter 6: Limits to Integration

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Outline

Readings for next time
Introduction – A Chronic Puzzle
Integration of an Owner-Operator
Acquisition of Separated Firm
Cost of Bureaucracy
Examples

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Introduction – A Chronic Puzzle

Integration of an Owner-Operator

Unified Ownership

Asset Utilization Losses

Accounting Contrivances

Acquisition of Separated Firm

Cost of Bureaucracy

Examples

Readings for next time

- ▶ Williamson, O.E. 1985. *The Economic Institutions of Capitalism*, Free Press – Chapters 7, 8 and 11.

Introduction – A Chronic Puzzle

- ▶ Frank Knight – Diminished returns to management is a subject often referred to in economic literature, but in regard to which there is a dearth of scientific discussion.
- ▶ Tracy Lewis, large firms will always realize greater value from inputs than smaller potential entrants – The reason is that the leader can at least use the input *exactly* as the entrant would have used it, and earn the same profits as the entrant. But typically, the leader can *improve* on this by coordinating production from his new and existing inputs.

- ▶ Knight - The question of diminishing returns from entrepreneurship is really a matter of the amount of uncertainty present. To imagine that a man could adequately manage a business enterprise of indefinite size and complexity is to imagine a situation in which effective uncertainty is entirely absent. – **Bounded Rationality**

- ▶ Joining two firms does not increase aggregate uncertainty.
 - ▶ Game and rivalry moves have been removed.
 - ▶ Decisions not forced to the top can always be assigned to the lowest level possible – ideally the lowest level is in the best place to make the decision.
- ▶ There is the possibility of control loss through information transformation.

Integration of an Owner-Operator

- ▶ Types of Mergers – Accounting
- ▶ To date we have been a little "fast and loose" about the concept of merger.
- ▶ There are several types of merger.
 - ▶ I will start by assuming that two firms are organized as *closely held corporations* – There is one class of corporate stock that is owned by a single person. This person is also the manager of the firm.
 - ▶ One form of merger is for firm A to buy all the assets of firm B. Firm B then closes its books – the owner operator of firm B pays off the corporation's liabilities and retires the equity claims.

- ▶ Alternatively, firm A could buy all the stock of firm B.
- ▶ Firm A could buy enough of firm B's stock to exercise significant control (i.e., between 50 and 100 %).
- ▶ Finally, firm A and firm B can both be bought by another entity.

- ▶ Each of these transactions have implications for accounting principles.
- ▶ In addition each of these transactions imply different potential contracts for owner of firm B.

- ▶ Assume that this ownership change is accomplished as follows:
 - ▶ A price which the assets are transferred is agreed to.
 - ▶ The formula for determining the price at which product is to be transferred from the supply division to the buying division is stipulated.
 - ▶ So as to encourage cost economizing, high-powered incentives that characterize markets are carried over into the firm.
 - ▶ Selective intervention will obtain. Accordingly, the supply division is advised to control business as usual with the following exception: The supplier will accede to decisions by the buyer to adapt to new circumstances, thereby to realized collective gains, without resistance.

Unified Ownership

- ▶ Preserves high-powered incentives.
- ▶ Provides for selective intervention.
- ▶ Precludes costly haggling.

Asset Utilization Losses

- ▶ A critical feature is that the manager of firm B (the supplier of product) is no longer a residual claimant.
- ▶ Thus, this manager has no incentive to appropriately use fixed assets (i.e., additional wear and tear that effect the asset's value are recognized by the owner of the consolidated firm).
- ▶ Put another way, firm B's manager has already been paid for the asset.

Accounting Contrivances

- ▶ One of my constant grivances about how we teach Agribusiness both at the undergraduate and graduate level is the reduction in accounting training in our current programs.
- ▶ What is the goal of accounting? – King (2006) identifies four different users of accounting information:
 - a. creditors and investors who rely on financial accounting;
 - b. managers of the firm who are interested in the cost of production (hence, cost or managerial accounting);
 - c. the federal government as a taxing authority (the Internal Revenue Service's tax accounting requirements); and
 - d. government entities with regulatory authority (such as the Securities and Exchange Commission) – (Moss 2013, p.58).

- ▶ Each of these goals/types of accounting are driven or regulated by a different set of rules.
 - ▶ Most students have been exposed to the rules implicitly in the **Generally Accepted Accounting Principles (GAAP)**.
 - ▶ GAAP is typically intended to control the quality of the information provided by "arm's length" users (creditors and investors).
 - ▶ As such they are intended to provide information about the financial viability and profitability of the firm – Balance Sheets, Income Statements, Changes in Financial position. (See Moss 2013, pp. 73).

- ▶ Information uses inside the firm are not technically limited by GAAP.
 - ▶ The firm is free to establish accounting reporting decisions necessary to manage its assets.
 - ▶ The interaction between the use of accounting techniques as a basis of high-powered incentives, therefore, may be limited by the form of vertical integration chosen.
 - ▶ Acquiring a firm by stock purchase may lead to the use of financial accounting statements as the basis for high-powered incentives.
 - ▶ The other mechanisms lead to the use of cost or managerial accounting as a bases for high-powered incentives.

- ▶ Some of these difficulties are found in Williamson's discussion
 - ▶ In striking the bargain for the original firm's assets (i.e., acquiring firm B by purchasing its assets), the manager could be promised a "high income stream" (higher prices for the transferred product) to compensate for lower asset values.
 - ▶ The old owner is compensated by a share of the profit to the division from these higher transfer prices.
 - ▶ "Such guarantees accomplish little, however, if the net receipts of the supply division can be altered substantially through the exercise of accounting discretion."
 - ▶ The transfer price could be lowered.
 - ▶ The cost allocation for services provided by the home office could be increased.

► Effect of Integration on Innovation

- One of the dominant problems with vertical integration is the loss of incentives to innovate.
- The simple way to express this problem is following the Jensen and Meckling agent formulation – the incentive to innovate becomes

$$V_I = (1 - \alpha) \sum_{t=1}^N \tau^t \left([p(z)' y - C(w, y)] - [p(\tilde{z})' \tilde{y} - \tilde{C}(w, \tilde{y})] \right) \quad (1)$$

where α is the share of the payoff transferred to the integrator, $p(z)$ denotes the price or value of the input created, $C(\cdot)$ is cost function, w is a vector of input prices, and y is the level of output produced by the upstream firm.

- ▶ First, following Jensen and Meckling the former owner of firm B has less to gain by the innovation.
- ▶ However, unless the innovation is simply a reduction in the cost of the good required by downstream firm, it is not clear that the innovation will benefit the integrator – what if the upstream firm innovates to create a new product that is not useful to the integrator.

Acquisition of Supply Stage in Which Ownership and Management are Separated

- ▶ In this case we assume that the assets of the firm are not previously owned by the owner-operator. Hence, there is no loss of residual claim.
- ▶ Most of the losses here deal with the incentives offered to the managers – how do they change after an integration?
 - ▶ Salary – the assumption is that under a less integrated ownership structure that performance setting in the salary structure was more efficient. For example, as will be seen in the Tenneco example, the desire to construct a "one-size-fits all" management structure reduced the rewards for skilled individuals.
 - ▶ Promotions – this is a little more mixed bag.

- ▶ Like the salary mechanism, vertical integration may establish a bureaucracy making promotions less efficient.
- ▶ However, integration may provide for promotion opportunities outside the old firm.

The Cost of Bureaucracy

- ▶ The cost of bureaucracy is a little less established.
- ▶ Propensity to Manage
 - ▶ A propensity to manage seems to characterize all forms of bureaucratic organization.
 - ▶ To be sure, the public sector is widely thought to be especially culpable in this respect – and probably is. Charles Morris captures the spirit in his reference to "the cost of good intentions."
 - ▶ What he characterizes as "the new rationalist style of government" was based on "confident optimism that the most intractable problems would give way before the resolute assault of intelligent, committed people."

- ▶ There is propensity to organize in a way to pursue subgoals.
- ▶ Forgiveness – the concept is that we tend to "forgive" or make allowances for individuals in our family while the market tends to be quite ruthless. This concept extends forgiveness to overlooking failures within bureaucratic structures.
- ▶ Logrolling – in political circles I will vote for your bill for farm program support if you vote for my bill for increased nutritional subsidies.

Examples

- ▶ Car Sales Franchises
 - ▶ The car industry could have sold cars in several ways – They could own the local sales offices outright.
 - ▶ However, they choose to use a franchise situation – Why?
 - ▶ Trade-in values are a large part of the car trade.

► Tenneco's Oil Firm

- The story here was the purchase of a profitable oil company with specialized labor.
- The failure of the company to design individualist high-powered contracts led to labor flight.