

Lecture XVI: Williamson – Chapter 8 & 11: Modern Corporations

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Readings

Bilateral Applications

The Modern Corporation

M-Form

Readings

- ▶ Allen, Douglas W. and Dean Lueck. 1998. The Nature of the Farm. *Journal of Law and Economics* 41(2), 343-386.

Bilateral Applications

- ▶ In our last treatment of credible commitments we considered a "unilateral" product flow.
 - ▶ Producer A makes an output used as an input by Producer B.
 - ▶ Assuming that this relationship required a relationship specific investment (k) we could derive a price (if the investment was made by the buyer) or a hostage (h) (if the investment was made by the seller).

- ▶ In this case, we conceptualize the case of "bilateral" product flow where in some markets firm A is the buyer while in other markets firm B is the buyer.
 - ▶ The most frequently cited scenario is the case of oil companies. In case presented in the text, in some markets Shell oil bought oil from Imperial while in other markets Imperial bought oil from Shell.
 - ▶ The question is whether this scenario always implied market collaboration.

- ▶ **Original (1968) Merger Guidelines:**
 - ▶ Since reciprocal buying (i.e., favoring one's customer when making purchases of a product which is sold by the customer) is an economically unjustified business practice which confers a competitive advantage on the favored firm unrelated to the merits of the product, the Department will ordinarily challenge any merger which creates a significant danger of reciprocal buying....
 - ▶ Unless there are exceptional circumstances, the Department will not accept as a justification for a merger creating a significant danger of reciprocal buying the claim that the merger will produce economies, because, among other reasons, the Department believes that in general equivalent economies can be achieved by the firms involved through mergers.

- ▶ So here is the scenario – Firms A and B both produce oil.
 - ▶ One has a major presence in the Canadian Maritimes, while the other has a major presence around Quebec.
 - ▶ These firms have a standing agreement to sell fuel (rack gasoline) to the other in there area of dominance at at prenegotiated (preferred) price.
 - ▶ Does this agreement imply a restraint of trade or can it be justified throught the hostage model.

- ▶ "Assume that the two firms are engaged in tied bilateral trade and that both have made specific asset investments k in support of each other." – I can produce your gasoline and you can produce my gasoline.
 - ▶ As in the last model – each firm incurs variable cost v_2 (redeployable costs) given the fixed investment (compared to a variable cost of v_1 without the specific investment).
 - ▶ Assume that the price of the traded good within the relationship is $\hat{p}$.
 - ▶ We assume that the gain from buying the good is b_B

$$b_B = p - \hat{p} \quad (1)$$

while the return from selling the good is b_S

$$b_S = \hat{p} - v_2. \quad (2)$$

- ▶ The combined gain from reciprocity is then $b_R = b_B + b_S$.
- ▶ The net benefits from noncancellation—that is, of continuing reciprocal trade (given that your counterpart does not renege)—are then

$$b_R = (p - \hat{p}) + (\hat{p} - v_2) = p - v_2 \quad (3)$$

- ▶ As in the preceding example, k does not appear in the solution but it determines the values – for the trade to exist

$$\frac{(1 - v_2)^2}{2} - k > 0. \quad (4)$$

- ▶ In this solution, we are interested in a comparison between the selling price and the price of general purpose asset

$$b_S = \hat{p} - v_2 \quad (5)$$

- ▶ This price must be compared with the value under the non-differentiated input

$$b'_S = \hat{p} - v_1. \quad (6)$$

In fact, we are interested in whether the gain from the undifferentiated values is greater than the value from the investment-specific transaction

$$b'_R = p - v_1 \quad (7)$$

The Modern Corporation

The study of the modern corporation should extend beyond vertical integration to concern itself with and provide consistent explanations for the following features of the organization of economic activity:

- ▶ What economic purposes are served by the widespread adoption of divisionalization?
- ▶ What ramifications, if any, does internal organization have for the long-standing dilemma posed by the separation of ownership from control?
- ▶ Can the "puzzle" of the conglomerate be unraveled?
- ▶ Do similar considerations apply in assessing multinational enterprise?

- ▶ Key legal features of the corporation – limited liability and the transferability of ownership – are taken as a given.
- ▶ Railroad Organization
 - ▶ "According to Stuart Bruchey, the fifteenth-century merchant of Venice would have understood the form of organization and method of managing men, records, and investments used by Baltimore merchants in 1790."
 - ▶ "The two most significant developments were the appearance of the railroads and, in response, forward integration by manufacturers into distribution."

- ▶ The economic success of the railroads entailed more, however, than the substitution of one technology (rails) for another (canals). Rather, organizational aspects also required attention. As Chandler puts it: ... It meant the employment of a set of managers to supervise these functional activities over an extensive geographic area; and the appointment of an administrative command of middle and top executives to monitor, evaluate, and coordinate work of managers responsible for the day-to-day operations.
- ▶ The "natural" railroad units, as they first evolved, were lines of about fifty miles in length.... That was adequate as long as traffic flows were uncomplicated and short hauls prevailed.
- ▶ In principle, successive end-to-end systems could be joined by contract. The resulting contracts would be tightly bilateral, however, since investments in site-specific assets by each party were considerable.

- ▶ The result – from a transaction cost perspective – was some form of vertical integration.
- ▶ "As a consequence a new organizational form was fashioned whereby the first 'formal administrative structure manned by full-time salaried managers' in the United States appeared."
- ▶ The division superintendents were on the 'direct line of authority from the president through the general superintendent,' and the functional managers within the geographic divisions—who dealt with transportation, motive power, maintenance of way, passenger, freight, and accounting—reported to them rather than to their functional superiors at the central office.

The M-Form Innovation

- ▶ "The most significant organizational innovation of the twentieth century was the development in the 1920s of the multidivisional structure."
- ▶ "The leading figures in the creation of the multidivisional (or M-form) structure were Pierre S. du Pont and Alfred P. Sloan; the period was the early 1930s; the firms were du Pont and General Motors; and the organizational strain of trying to cope with economic diversity under the old structure was the occasion to innovate in both."
 - ▶ Du Pont was operating under the centralized, functionally departmentalized or unitary (U-form) structure."
 - ▶ General Motors, by contrast, had been operated more like a holding company (H-form)...

- ▶ "The M-form structure fashioned by du Pont and Sloan involved the creation of semiautonomous operating divisions (mainly profit centers) organized along product, brand, or geographic lines.
- ▶ "The basic reason for its success was simply that it clearly removed the executives responsible for the destiny of the entire enterprise from the more routine operational activities, and so gave them time, information, and even psychological commitment for long-term planning and appraisal...