The Coase Theorem and New Implications of Strategic Management

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Abstract: - This The rationale of this research goes into the origins of the nature of firm theorem developed by Ronald Coase but is willing to underpin new ideas about strategic management along with the understanding of transactional cost analysis. A familiar account about success and failures of firms underlines the importance of transactional costs but profit is to be made rather by added value than by keeping the policy of cutting costs. Nor were these problems of recent origin; they were rooted in deep structural changes in the economy that date back many years, but strategic management and microeconomics might claim responsibility for new solutions for preventing the economic crises. Financial innovations overheated the world economy and made market participants to focus on macroeconomics indicators whereas transactional costs and microeconomics realities were ignored because of an irrational exuberance. Considering the evidence analyzed in this paper work, this approach of Coase theorem and strategic management puts forward new highlights of economic thought.

Key-Words: - business development, economic value, nature of the firm, strategic management, social value.

1 Methodology. Current stage of knowledge over Coase theory of firm

As The methodology of economic doctrines and of the present paper are supported by a scientific apparatus of genesis of the doctrine, the filiations of ideas, perpetuity and genuinely. We have analyzed the Coase article from 1937 and ones of the most important articles from the ’30s and from the present days, especially those articles which preceded and sustained the ideas from The Nature of the
The main two approaches our methodology is based on are:

- Retrospection: economic doctrines are a theoretical output of spontaneous perfection of economic ideas but could be as well a result of a natural selection of founding theories. The surviving theories make the prove of their value adapting best to the theoretical challenges.

- Prospection: economic doctrines are analyzed after the manner they improved economic theoretical background, according to their perpetuity and especially owing the power of changing reality and mentalities through ideas.

The methodology guiding this paper is comparative and qualitative.

The nature of the firm was a scientifically approach developed in a crisis of defining economic theory assumptions. Coase were interested in discovering the foundations of economic acts, in a microeconomic perspective, in an era where mainstream meant mostly market and prices and less human action analysis. The importance of studying foundations lies on the controversy between sets of assumptions when a theory is about to be set, and Ronald Coase developed his theorem inspired probably by a remark of professor Joan Robinson among other sources. A crude example underpinning this idea is the fact that “firm” has particular meanings and uses for ordinary average people, or plain men, and other meanings for economists (Robinson: 1932, 12). In the mid-thirties the world had been hit by the Great Recession and the macroeconomic theories were about to become mainstream along with the Keynesian economics. But recovery had been doing little progress and naturally there were attempts for rebirth of microeconomics along with Austrian economists. Therefore market participants and economists faced a dilemma in finding the most appropriate methodology regarding assumptions for developing theories. Related on this issue Joan Robinson has said that “the two questions to be asked of a set of assumptions in economics are: Are they tractable ? and: Do they correspond with the real world ?” (Robinson: 1934, 6). Coase explained the answer of these questions as the possibility that assumptions for theories might be both manageable and realistic, even Joan Robinson initially went for manageable or realistic. The double character of assumption was then associated with institution on microeconomic level, therefore the basis of firm theorem.

First it is important to establish the perspective of the following approach of the firm. Apparently, according to Coase, strategic analysis of the firm begins from two major domains, internal and external environments. Components underpinning these domains are commonly encountered in the well-known SWOT analysis. This characteristic of the firm is supported in the internal environment by set of resources, strengths and weaknesses, all of them susceptible of generating distinctive competences (Coase:1937, 393 ), and in the external environment by trends, threats and opportunities. The economic background of efficiency is strategic management, but gaining strategic management means a perfect match between internal resources and external conditions (Coase:1992, 716 ).

Coase pointed out that firm’s analysis has to be made in an amoral and non-economic context, in order to understand the real issues related on one of the most important institution of the market. During time, economic thinkers used to call most important and powerful economic theories as mainstreams. Whether by the free market allocation of resources through price system or the centralized closed economies, it was accustomed to understand that an institution of market was the one who guided economic flows. The most interesting fact is that Coase questioned this very idea of allocation through prices and market. This does not mean that Coase was socialist or was against the free market but that he founded a different institutional approach. Therefore, if a
market participant switch product A for product B through free market system, he probably would not do the same thing whether he would has worked into a firm. An employee would probably change job A for job B, presuming for additional wage, but not especially because of the money, but because of an assignment set on top management of the firm. Worse, he could entirely challenge the whole market system, choosing lower paid job A instead for better job B, only because a direct order from top management (Coase:1988, 102 ). Therefore there is the interest of Coase for nature of firm as a particular institution which proves that in real life things happen in a different manner. This economic issue is clear enough. In other words Coase has asked himself why firm exists whereas there is already a complex economic system and coordination is done by price mechanism. To this issue D.H. Robertson has written about “islands of conscious power in an ocean of unconscious cooperating like lumps of butter coagulating in a pail of buttermilk”(Coase:1937, 390) in a very interesting way to identify the clusters of power and heterogeneity in the common known ocean of power, or atomicity of the market as an important condition of perfect competition. Just as balls of butter tend to separate from the rest of the buttermilk and to rule their own formation aside from the others, firm could be interpreted as an island, a microeconomic entity of self-consciousness and power. As a preliminary conclusion firm is analyzed from a new approach, as an island of conscious power (Robertson: 1932, 87).

2 Firm as island of conscious power

Outside the firm market participants are guided in their decisions by price system which drives exchanges of resources and help the process of decision making. But within a firm things are set in a totally different manner, because exchanges are not driven anymore by the price system, but by the manager himself, or the entrepreneur-coordinator who manages to apply alternative coordinate methods (Coase:1937, 400). Yet, Coase maintained his dilemma: why allocation of resources and production regulated through market need an institution like firm in order to do the same thing. This issue is the rationale of Coase’s theory of firm, to bridge the gap between price mechanism’s role and entrepreneur-coordinator’s role (Williamson&Winter:1991, 24 ).

First, a firm is an institution emerged in a particular field, supported by specialized exchange relations between market participants. The firm is born like a core of manager’s actions, to who is added then several other external actions, letting the core becoming an island, precisely that island of conscious power. A first issue related on the purpose of creating the firm is the neglected cost of using the price mechanism. This idea of Coase is an answer to Nikolas Kaldor who argued in his article “A Classificatory Note of the Determinateness of Equilibrium” from couple years earlier that “All the relevant prices are known to all individuals”, which is almost impossible in the real world (Kaldor, 1934a: 8). There is a hidden cost for each individual to know to some extent how important are prices for those goods he is interested for his own future actions. Of course that cost can be reduced through mass-media and new items of communications discovered in a tremendous world of technological progress. Nevertheless, the cost cannot be eliminated, but only reduced. Discovering how relevant prices are is what later Coase named transactional cost. There is of course a huge interest to lower these costs, but what is certain is the fact that these costs can never be zero (Kaldor, 1934b: 8). One of the most important transactional costs along with the relevance of prices are:

- Cost of negotiations concluding on separate contracts for each exchange act
- Length of a contract, which will analyzed in detail in the following lines

Firm also cannot eliminate transactional costs, but can reduce them. Let us analyze for example two original factors of production within a firm, labor and capital. Between these two factors there is no need to engage several contracts as long as operations supported by them are developed under the same jurisdiction. All contracts are substituted by a single one as a
general case of setting the terms of transactions, using then particular data to make several particular cases from different combinations between labor and capital. Nevertheless, contracts can be set for the price mechanism too. Instead of numerous short-term contracts, market participants can express option for a single long-term contract, more expensive than a single short-term contract, but much cheaper than all the short-term contracts. Certain costs of making each contract will be avoided. But a long-term contract guided through price system implies a major disadvantage for market participants: the difficulty of forecasting the future events and the result controlled by the other side of the contract. The longer the term would be, the lower will be also the certitude that the other contracting party will act according to content of the contract. Owing to the risk attitude of the people concerned, long-term contracts are advantageous, but owing to the difficulty of forecasting of the same people concerned, the long-term contracts present a disadvantage. Contracts have not the same significance for the supplier of a service/good and for the purchaser. The contract depend mainly on supplier on the market, because the supplier provides a good, for example, in general terms, letting the details for further steps into the contract and making details different for each purchaser. Now there is a crucial moment: “When the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, the relationship which I term a firm may be obtained” (Coase:1937, 394). Therefore, firm is more important for understanding the dependence over the buyer in case of services which are impossible to stock, whereas commodities can be paid in advance, and stocked, letting the transaction to depend on supplier and making the firm less important. As a preliminary conclusion, the firm exists in a specialized economy in which market participants tend to assume that distribution of resources is guided by price mechanism and all transactional costs are zero. As Coase defined firm, “a firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur” (Coase:1937, 395).

3 Transactional costs and the management of sizing the firm

In the light of the hypothesis that firm tend to reduce transactional costs, one might ask why there are still transactions guided by market and not only by firms. Or, to extend this algorithm, the main question could be why market participants wouldn’t let all their transactions to be led by one single big firm, in order to minimize transactional costs (Demsetz, 1988: 8). There would be a lot of advantages whether production would be carried out by one single firm, but only owing to transactional costs, whereas side effects regarded the entrepreneur and his management decisions could arise:

- A larger firm will lose returns to the entrepreneur function. The greater becomes the firm; the many will be the assignments entrepreneur would have to delegate to other members of top management and so on. One single person, no matter how able to face management task, will eventually collapse in front of to many tasks which need to be accomplished at once. Therefore the firm will grow just as additional factors of production are added to gain a final product or service: when marginal cost of adding factors exceed marginal profit, the process of expanding will stop. When costs rise until market level, the firm will stop to increase.

- A larger firm supposes to control large amount of factors of production for many economic actions. For the same principle described above, the coordinator-entrepreneur might fail to place
all factors of production in the optimum combination in order to extract the best from them. New factors of production will be added until the waste of resources will equalize the marketing cost along with several other transactional costs in the open market.

- The supply price of organizing ability will increase along with the firm. Larger firms and larger institutions generally speaking will reduce transactional costs to some extent, but the coordinator-entrepreneur usually prefers to stays that way instead of being only entrepreneur transformed in a manager of a department. He will coordinate less from that position; even the amount of activity will be greater. The problem is that he will be no longer his own master, and that his decision-making independence will shrink along with the perspectives of futures gains. Therefore men prefer to be heads of small independent business rather than the heads of departments in a large business (Coase:1937, 399), (Holmstrom&Tirole: 1988, 112). It is a matter of individualistic spirit of entrepreneurship. This cannot be converted in money.

Whether by dimension of transactions or the limit of entrepreneur’s personal availability to answer the tasks, the firm has a different purpose for the economy. A firm is a factor of homogeneity up to a point. Market participants usually treat transactions of the same type as homogenous, which might not be true. If a great amount of transactions will get under control of coordinator-entrepreneur, then there are all the premises for transactions to be both different in kind or in different places. Coase has expressed the view of transactions to be either different in kind or in different places. But one might ask whether a change in place would not usually lead to a change in common features, like climate, utilities, communication lines, map orientation, or in extraordinary features like history, culture, habits, tradition, expectations, ideas and mentalities. A growing firm will probably encounter this challenge from some point, therefore we have taken into account that changes will be in kind and in place as well. Changes provide an important reason why efficiency will tend to decrease as the firm gets larger. All what entrepreneur can do from now on is to adapt managerial techniques.

The theory of firm bring into light additional questions against perfect competition. Under perfect competition there is no need for any other product to be produced, because all products are homogenous. But this argument ignores the fact that beginning to some point, it might prove more expensive to develop further the same product or service whereas developing a new product could provide cheaper alternative. Coase imagined an example with concentric industries which has been improved in current analysis given the following picture:

![Figure 1. Transactional costs and the size of the firm](image-url)
The four circles represent the town center and three fields of industry, A, B and C. The three industrial facilities are placed in suburbia, encircling the center, just as it is in reality in many industrial cities. Now let us imagine an coordinator-entrepreneur x who controls B industry. He will extend the business following a normal path up to the point when B ring will be full completed. Another coordinator-entrepreneur controls industry from A ring, but according to the structure of the town, he finds difficult to complete the A ring, and makes an option for the nearest product/service B, and so on for C instead going on with A. The transactional cost derived from the extension of the longer line of communication force y to switch the combination of factors of production of same kind in favor of a combined formula of A, B and C, hence the argument of developing new products instead of exceeding the old ones. This situation is set on the ground of the following equilibrium: \( y = A + B + C = B + B + B = x \). Discovering transactional costs in the case of three circles industries is a management techniques issues. Determining the size of the firm means to use management in order to monitor transactional costs of marketing and the costs of organizing the business to determine how many products/services will be produced by firms and, more important, to what extent.

4 Conclusion

Management and theory of firm are strongly related because of the question of the cost-curve of the firm. Under presumption of perfect competition coordinator-entrepreneur will only manage to keep the cost-curve not to increase. Under imperfect competition the principal task of coordinator-entrepreneur is to receive signals from the market until the profit will reach the point when marginal cost is equal to marginal revenue. Whether in the case of sloping upward the cost-curve or the equilibrium point between marginal cost and marginal revenue, the management of the firm faces the impossibility of avoiding these combinations because of the heterogeneity of the products on a market. Even the perfect competition accept more products on market, despite of their homogeneity. Perfect competition is supported by concept of homogeneity, but homogeneity itself cannot be perfect, therefore this might question the whole concept of perfect competition. It was therefore important to investigate the case with more than one single product.

The theory of firm was a milestone for microeconomics and a pillar of liberalism. One of the followers, great Austrian economist Fritz Machlup wrote about firm as a major institution of market which has been given constitutes as follows(Conell:2007,45):

- The firm as a production unit;
- The firm as a decision-making process;
- The firm as a contracting solution;
- The firm as a collection of resources.

A theory of the firm should address the fundamental questions about what a firm is and its role in society. Besides the issues analyzed above, given the importance of management for theory of firm, there is still a concern regarding a theory of the firm for strategy. It would address coordinator-entrepreneur in order to make him understand what drives firm overall performance, why some firms have better performance than others, using strategic management and its sustainability through time versus competitors in order to provide recommendations for better returns.

Acknowledgements

This article is a result of the project POSDRU/88/1.5/S/55287 „Doctoral Program and PhD Students in the education research and innovation triangle”. This project is co funded by European Social Fund through The Sectorial Operational Programme for Human Resources Development 2007-2013, coordinated by The Bucharest Academy of Economic Studies.
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