Lecture 4

Integration & its Alternatives

Technical efficiency:
occurs if the firm is using least cost production techniques

Agency efficiency:
the extent to which the exchange of goods & services in the vertical chain has been organized to minimize coordination, agency, & transaction costs

Using the market improves *technical efficiency* [least cost production]

Vertical integration improves *agency efficiency* [coordination, agency & transaction costs]

$$\Delta \boldsymbol{T} = the\ difference\ in\ technical\ efficiency\ of\ market\ over\ vertical\ integration$$

I.e. minimum cost of production under vertical integration, **minus** the minimum cost of production under arm's length market exchange

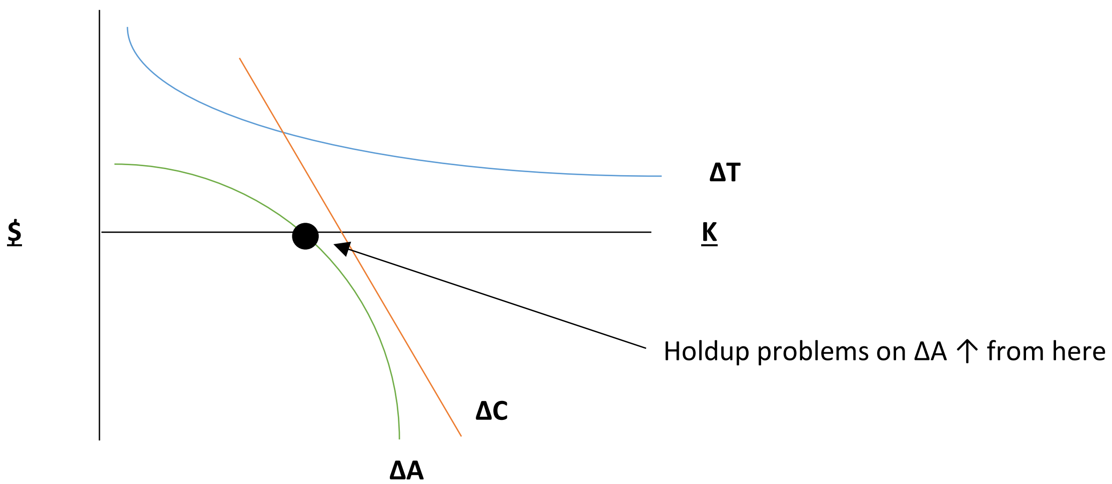
The technical efficiency differential is *dependent on the nature of assets involved*

$$\Delta \boldsymbol{A} = The\ difference\ in\ exchange\ costs\ when\ the\ item\ is\ produced\ internally\ compared\ to\ purchased\ from\ the\ market$$

The agency differential is equal to the transaction costs when production is vertically integrated, minus the transaction costs when it is organized through an arm's length market exchange

At low levels of asset specificity:
differential agency efficiency is likely to be positive

At high levels of asset specificity:
the costs from vertical integration are less than the costs from market exchange



K = degree of asset specificity
$ = cost differences
ΔT = technical efficiency differential

ΔA = agency efficiency differential
ΔC = efficiency differential = overall cost difference between vertical & market