



ORIGINAL RESEARCH PAPER

Economics

THE THEORY OF THE FIRM

KEY WORDS: The Theory of the Firm

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ABSTRACT

Before examining business objectives, it is necessary to address more fundamental issues. The main areas of economic theory that are involved in the examination of the nature of the firm.

We should not think of economic aspects and behavioral aspects as being two distinct areas of study. Any behavior has economic aspects if it involves the allocation of resources. As we shall see, the motivation and decision-making of individuals are more fundamental than that of the organizations which they form.

These are now described briefly before being examined in greater depth.

Transaction Cost Theory

This examines the costs of undertaking transactions in different ways. These include trading on spot markets, long-term contracts with external parties and internalizing transactions within the firm. Different methods are appropriate under different circumstances.

Information Theory

This examines the concept of bounded rationality, and the associated aspects of incomplete contracting, asymmetric and imperfect information. These give rise to opportunistic behavior, which in turn affects the behavior of other parties and can lead to inefficiencies.

Motivation Theory

This examines the underlying factors that cause people to behave in certain ways. In economic terms we are searching for general principles which can be used to explain and predict behavior.

Agency Theory

This examines the situation where one party, an agent, is involved in carrying out the wishes of another, a principal. This happens very frequently in all sorts of transactions; indeed it is the cornerstone of democracy, where people elect a government to govern on their behalf. The nature of the resulting problem is that principal and agent usually have goals that do not exactly coincide, and that the principal can only partially observe the behavior of the agent. Therefore principals have to engage in monitoring activities and design incentives in ways that optimize their own welfare.

Property Rights Theory

This examines the nature of ownership, and its relationship with incentives to invest and bargaining power. On this basis it predicts the allocation of property rights on the basis of efficiency.

Game Theory

This examines the strategic interaction of different agents. The key to understanding the strategic interaction is that the behavior of one party affects the behavior of other parties, and the first party must consider this in determining their own strategy. Furthermore the first party must also consider that the other party or parties will also consider the first party's considerations in determining their own strategy. This area of economics has expanded greatly in the last twenty years and, in view of its importance.

Motivation Theory

In order to understand the nature of the firm we must first appreciate that any firm consists of individuals. In order to understand the behavior of these individuals we must in turn

examine the nature of motivation. Economists tend to assume that people in general act in such a way as to maximize their individual utilities, where these utilities are subjective measures of value or satisfaction. Thus the fundamental pillar in the basic economic model of behavior is that people are motivated by self-interest. This has been a feature of the economic model of behavior since the days of Adam Smith, who famously stated: 'It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.' The neoclassical economist Edgeworth expressed the same attitude even more forcibly: 'The first principle of Economics is that every agent is actuated only by self-interest.

The resulting behavior is sometimes said to typify homo economics. However, it is not just economists who make use of this basic assumption. It has been applied in the fields of politics, for example by Downs, in law, by Posner, and in crime, by Becker, to mention just some of the more important areas and contributions. However, some of the most fundamental contributions have come in the fields of evolutionary biology and psychology, in connection with what has sometimes been referred to as 'selfish gene' theory. This term was originated by Dawkins, but there have been many other similar accounts, in particular by Hamilton, Maynard Smith, Pinker, Ridley, Trivers and Williams. It is not within the scope of this text to review the findings here in any details, but we will see shortly that many respects these contributions have helped to rescue the economic model from its critics.

The main criticisms are that the economic model is too narrow and ignores altruistic behavior and spiteful behavior.

Property Rights Theory

This is a relatively new area of economic theory, opened up in the 1980s, with a seminal paper by Grossman and Hart in 1986. The Focus is on the issue of ownership, the nature of ownership and its relationship with incentives to invest and bargaining power are the key features of this model.

The institution of private ownership and the associated property right is one of the most fundamental characteristics of any capitalist system. Its main advantage compared with the state ownership of the majority of assets. However, we must ask the question: what does it mean own an asset? This question turns out to be particularly difficult to answer for a complex asset like a firm.