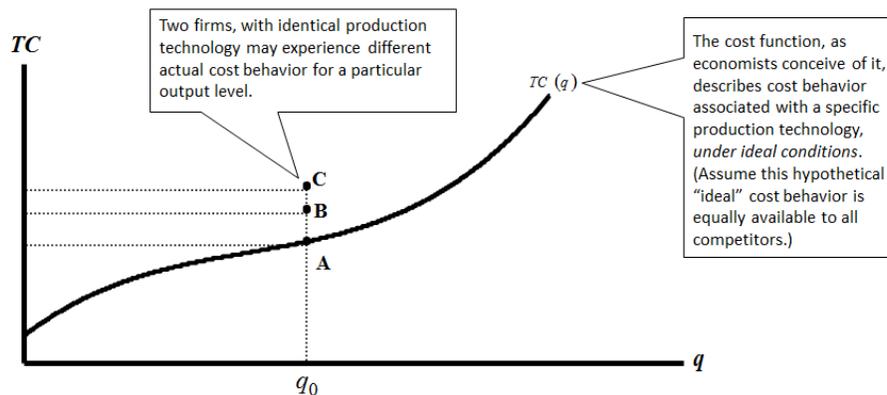


4.5: Corporate Governance: Agency and Transaction Costs

To prepare for this lecture, read Hirschey, chapter 18

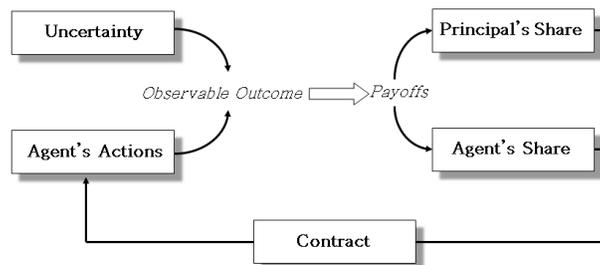
Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled. **Governance structure** refers to the mechanisms and decision making protocols that exist, either explicitly or implicitly, within a firm. As such, governance structure is a means for allocating what economists call **residual rights of control** within a business organization. Building on the concept of **organizational advantage** first addressed in lecture 1.3, governance structure differ among business firms and may be a source of competitive advantage.



In general, to explain such cross-company differences economists focus on two broad categories of governance costs: agency costs and transaction costs.

Agency Costs

This refers to those costs associated with inducing an agent to act in ways that support a firm's profit maximization objective. These may include supervisory costs, monitoring costs, and incentive payments. The underlying agency problem may be thought of within the context of this diagram:

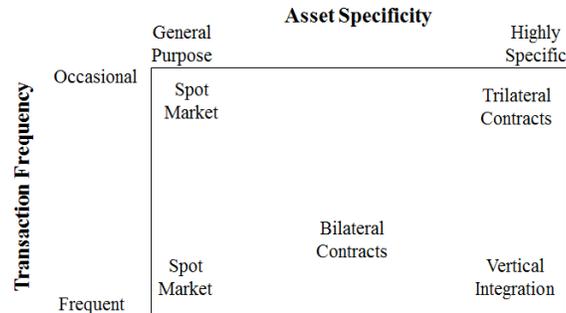


In any principal-agent relationship, the principal's challenge is structure contracts that specify division of payoffs in such a way that the agents' actions will maximize those payoffs, subject to the two complicating factors of uncertainty and an inability to observe true levels of effort.

Transaction Costs

This refers to those coordination costs associated with acquiring inputs, which are over and above amounts paid directly to input suppliers. These may include search costs, negotiation costs, contract enforcement costs, and other required investments or expenditures that are specific to a project. Nobel

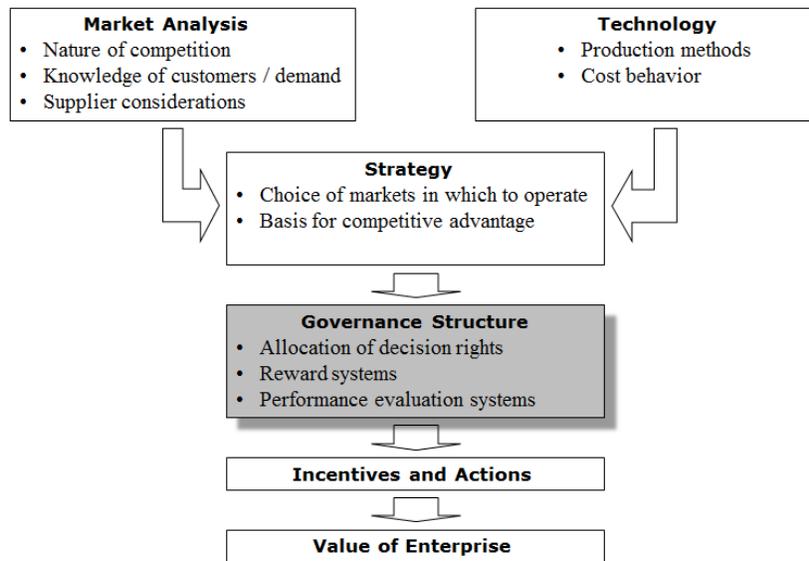
laureate Oliver Williamson hypothesized that transaction costs rise with asset specificity and transaction frequency.¹ Such thinking has led to managerial models regarding the optimal boundaries of the firm: firms should integrate processes within their governance structure when transaction costs are high and contract with other firms or individuals when transaction costs are low. Williamson’s “contracting schema” summarizes these ideas:



The general idea, originating with Ronald Coase (1937) and expanded upon by Williamson and many others since, is that successful firms are those that do the best job economizing on transaction costs. In other words, successful firms will be those that do the best job managing their supplier relationships and that make the most efficient vertical integration decisions.

Putting Corporate Governance in Perspective

To understand how issues of corporate governance fit within the overall value maximization framework first introduced in lecture 1.2, consider the following diagram:²



Relevant Textbook Problems: 18.1, 18.2, 18.8, 18.9

¹ Oliver Williamson, *The Economic Institutions of Capitalism*, 1975.

² Adapted from James A. Brickley, Clifford W. Smith, Jr., and Jerold L. Zimmerman, *Managerial Economics and Organizational Architecture*, 2004, p. 286.