The theory of the firm and the markets for strategic acquisitions*

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Abstract. Five problems are addressed: (1) the role of competent actors in the venture capital and exit markets supporting the industrialization of winning technologies in small innovative firms, (2) the competence of the large firm to integrate large-scale operational efficiency with small-scale innovative capability through distributed development work and integrated production and (3) the importance of viable markets for strategic acquisitions, both in making this possible and in allowing a flexible choice for the small firm between growing aggressively on its own through own acquisitions, or being acquired strategically itself. We (4) find that the less developed markets in continental Europe may be a disadvantage compared to the US in ushering in a future New Economy. We finally (5) discuss what becomes of the Coasian theory of the firm when production is constantly outsourced in, or insourced from the market as the relative efficiency of coordination through management and over the market changes. One logical consequence is that the costs of business mistakes will have to be included in transaction costs.

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1 The problems

The last couple of decades have seen an increase in the fragmentation over markets of firms as centrally coordinated hierarchies (Eliasson, 1986b, 1996b, 2001b,a). Products have been modularized and the production of components or entire systems outsourced in the market, only to be insourced again at some later stage. Coase (1937) outlined the principles behind such organizational change when explaining the rationale for the existence of the firm as a hierarchy in those instances in which management has a transaction cost advantage over production coordination. Holmstroem and Tirole (1989) extend that notion of a firm to a "contract between a multitude of parties" imposed over the market to "minimize transaction costs between specialized factors of production". Since this is an authoritative statement in the Handbook of Industrial Organization on the theory of the firm, we begin there. Empirically integrated development work and production distributed over markets are becoming an increasingly important productivity factor in the emerging industrial technology (Eliasson, 1996b; Jovanovic and Rosseau, 2002; Lerner and Merges, 1997) moved, notably, by modern computer and communications technology. Firms are reorganizing through acquisitions and divestments to gain competitive advantage. Both the notion of a firm and the structure of markets for control, hence, are experiencing radical change. To integrate the organizational problem of firms that have to rely on the external market for innovations with the theory of the firm, the notion of the reorganization of production structures over markets has to be endogenized. This means not only accepting complexity, ignorance and business failure, but also making *business mistakes part of transaction costs*. This disrupts the exogenous equilibrium properties of the neoclassical model. Transaction costs can no longer be minimized independently of the production organization. Further, the story to follow argues that it is empirically unacceptable to structure the theory of the firm such that this is possible.

We use competence bloc theory (Eliasson and Eliasson, 1996, 2002a) to (1) model the firm as an endogenously changing organization distributed over markets, the extended firm (Eliasson, 1996b), and (2) to demonstrate that an endogenous hierarchy makes it possible simultaneously to achieve both the narrow focus needed for operations efficiency and the broad exposure to a maximum of varied competence needed to be dynamically[1] efficient in the Austrian-Schumpeterian environment of the Experimentally Organized Economy (EOE, Eliasson, 1987, 1992). More precisely, we address the existence of a market for strategic acquisitions as a source of systemic productivity gains ("economies of scale") and a mover of industrial dynamics. The problem addressed is elucidated by the fact that the large firm, normally oriented towards large-scale operational efficiency (Eliasson, 1976, 1984, 1996a, 2001a; Acs and Audretsch, 1988), has problems with its innovative capabilities. Small firms, on the other hand, are less formally organized and more flexible and, therefore, thought to be more capable of innovative achievement. The small firms, oriented towards innovative performance and pursuing radically new innovations,

[1] The reader should observe already here that this notion of dynamics takes us far beyond the neoclassical notion of dynamics, that often uses the attribute as soon as a time variable figures in the equations