

# No Firm Is An Island: The Price Mechanism and the Institutional Structure of Production

Robert Gibbons, Richard Holden and Michael Powell\*

March 12, 2009

## **Abstract**

We analyze a rational-expectations model of price formation in goods markets in which there is a continuum of dyads of upstream and downstream parties. Both parties can make specific investments at private cost. Different dyads may operate under different governance structures and hence participate differently in the market. In this model, the informativeness of the price mechanism affects the returns to specific investments and hence the optimal governance structure for individual dyads. Also, the governance-structure choices by individual dyads affect the informativeness of the price mechanism. Thus, dyads' choices of governance structure are interdependent (JEL D20, D23).

---

\*Gibbons: Massachusetts Institute of Technology and NBER, rgibbons@mit.edu. Holden: Massachusetts Institute of Technology and NBER, rholden@mit.edu. Powell: Massachusetts Institute of Technology, mlp@mit.edu. We thank Daron Acemoglu, Glenn Ellison, Oliver Hart, Bengt Holmström and Oliver Williamson for helpful comments and discussions. We acknowledge support from MIT Sloan's Program on Innovation in Markets and Organizations.