# How Can Integration Reduce Inefficiencies Due to *Ex Post* Adaptation?

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**Abstract**

How can integrated firms immediately settle *ex post* adaptations to unanticipated disturbances? While this question is crucial to the argument of transaction cost economics (TCE), TCE has not provided any formal answer. This paper develops a model that explores the question by employing three behavioral assumptions: reference-dependent preference, self-serving bias, and shading. We present two reasons why integration can avoid costly renegotiations and realize immediate adaptations, and they stem from the fact that while non-integrated parties have to engage in negotiations for the adaptations, integrated firms can implement these by fiat. First, punishments for rejection of an order under integration are severer than those for rejection of an offer under non-integration. Second, under integration, the utility improvement from rejecting an order is not enough for a subordinate to offset the loss from the severe punishment. Furthermore, we point out a trade-off between immediate agreement and the aggregate sense of loss.

**Keywords**: Reference-dependent preference; self-serving bias; contracts as reference points; transaction cost; *ex post* adaptation

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