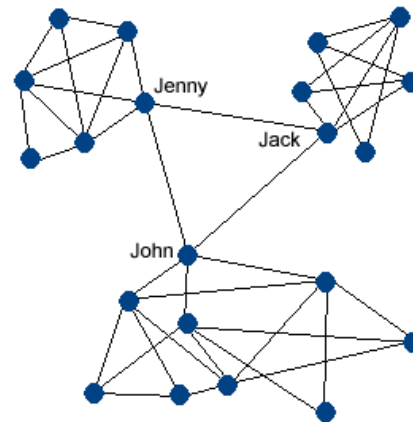


Role of firm structure and organization in achieving sustained competitive advantage

- ▶ Lowering costs, increasing productivity
 - Economies of scale and scope
 - Vertical integration
 - Incentive alignment
- ▶ Organizational form as a unique, proprietary resource
- ▶ Organizing for innovation
 - Incentives
 - Networks and alliances
 - Location (clustering)



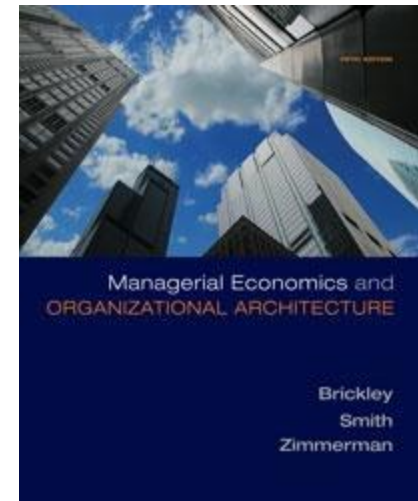
A framework for studying firm structure and organization

▶ Firm boundaries

- The make-or-buy decision: spot markets, contracts, or vertical integration?
- Product diversification versus specialization

▶ Brickley, Smith, and Zimmerman's "organizational architecture"

- Decision rights
- Compensation and motivation
- Performance evaluation



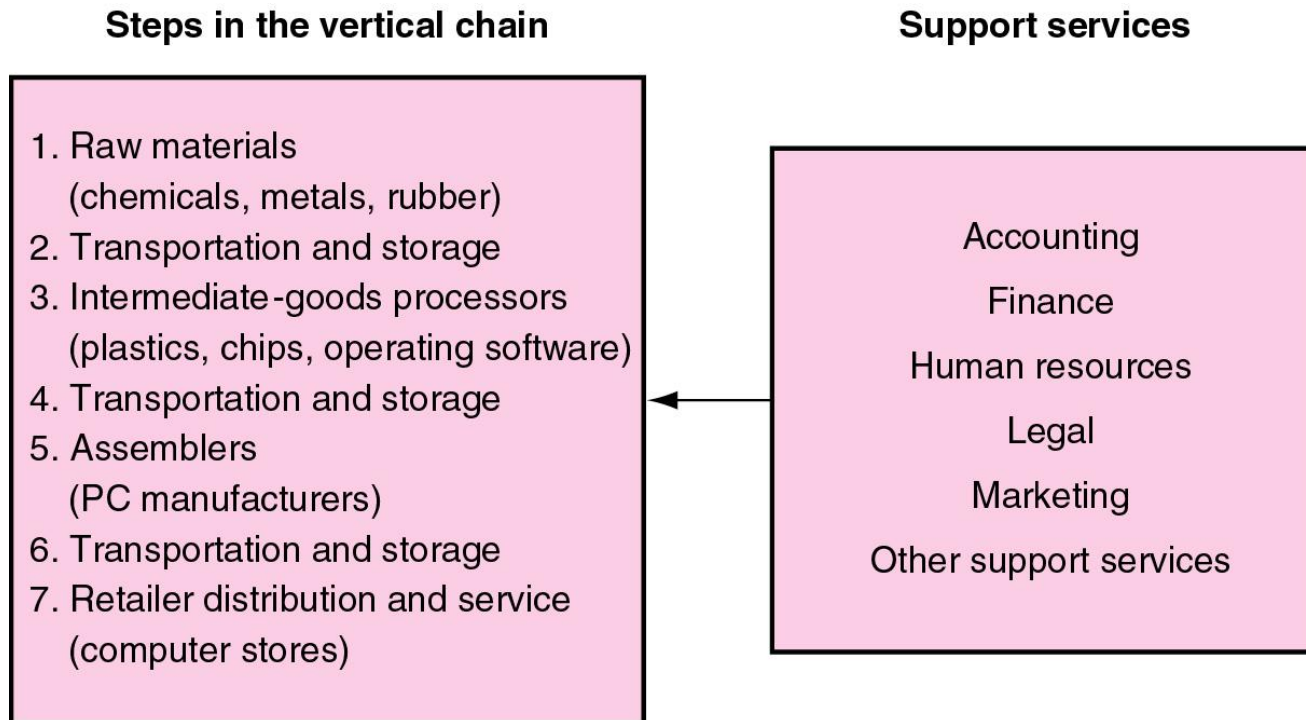
The theory of “optimal” boundaries

▶ Horizontal

- Economies of scale
- Transaction or coordination costs

▶ Vertical

- The stages of production



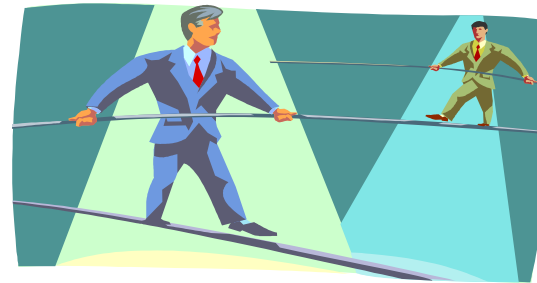
The theory of “optimal” boundaries

▶ The transaction-cost approach to the firm

- Coase: optimal boundary of the firm comes from balancing, at the margin, the transaction costs of external and internal exchange.

▶ Horizontal boundaries

- Economies of scale
- Transaction costs

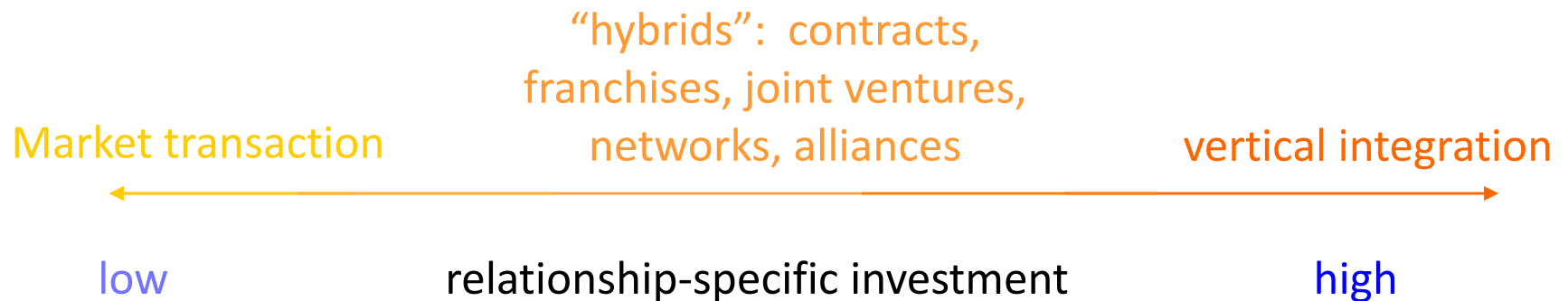


▶ Vertical boundaries

- The stages of production
- Advantages of vertical dis-integration: comparative advantage, specialization, trade, and the division of labor
- Tax and regulatory rationales for vertical integration
- Transaction costs: the role of relationship-specific investments

The transaction-cost approach to vertical integration

- ▶ Investments can be relationship-specific.
- ▶ Relationship-specific investment encourages “holdup.”
- ▶ Holdup can’t be completely eliminated by contract.
- ▶ Organizational form: market transactions, intermediate forms (long-term contracts, joint ventures, franchises), full ownership
- ▶ How should individual transactions be organized and governed?



Organizing transactions to reduce costs: two variables

		Uncertainty		
		Low	Medium	High
Asset Specificity	Low	Market transaction	Market transaction	Market transaction
	Medium	Contract	Contract or vertical integration	Contract or vertical integration
	High	Contract	Contract or vertical integration	Vertical integration

The effects of information technology on firm size and vertical integration

▶ Reducing external transaction costs

- B2B exchanges, ASPs facilitate outsourcing (e.g., call centers in India)
- Sharing of point-of-sale data (e.g., from scanners) and integration with ECR systems promotes tighter “hybrid” relationships
- Results: increased outsourcing in some sectors; more strategic vertical alliances

▶ Reducing internal transaction costs

- Enterprise Resource Planning systems (PeopleSoft, Oracle, SAP) reduce the costs of internal organization
- IT systems can reduce monitoring costs

▶ Net effect varies widely!

Organizational design

► Background

- Production approach: firm as a **single actor**
- Organizational approach: firm as a **team or organization**
- A central problem of economic organization: align the incentives of the individuals to coordinate their actions.

► Organizational problems

- Worker effort
- Collective action costs
- Other coordination problems

$$y = f(x_1, x_2, x_3)$$



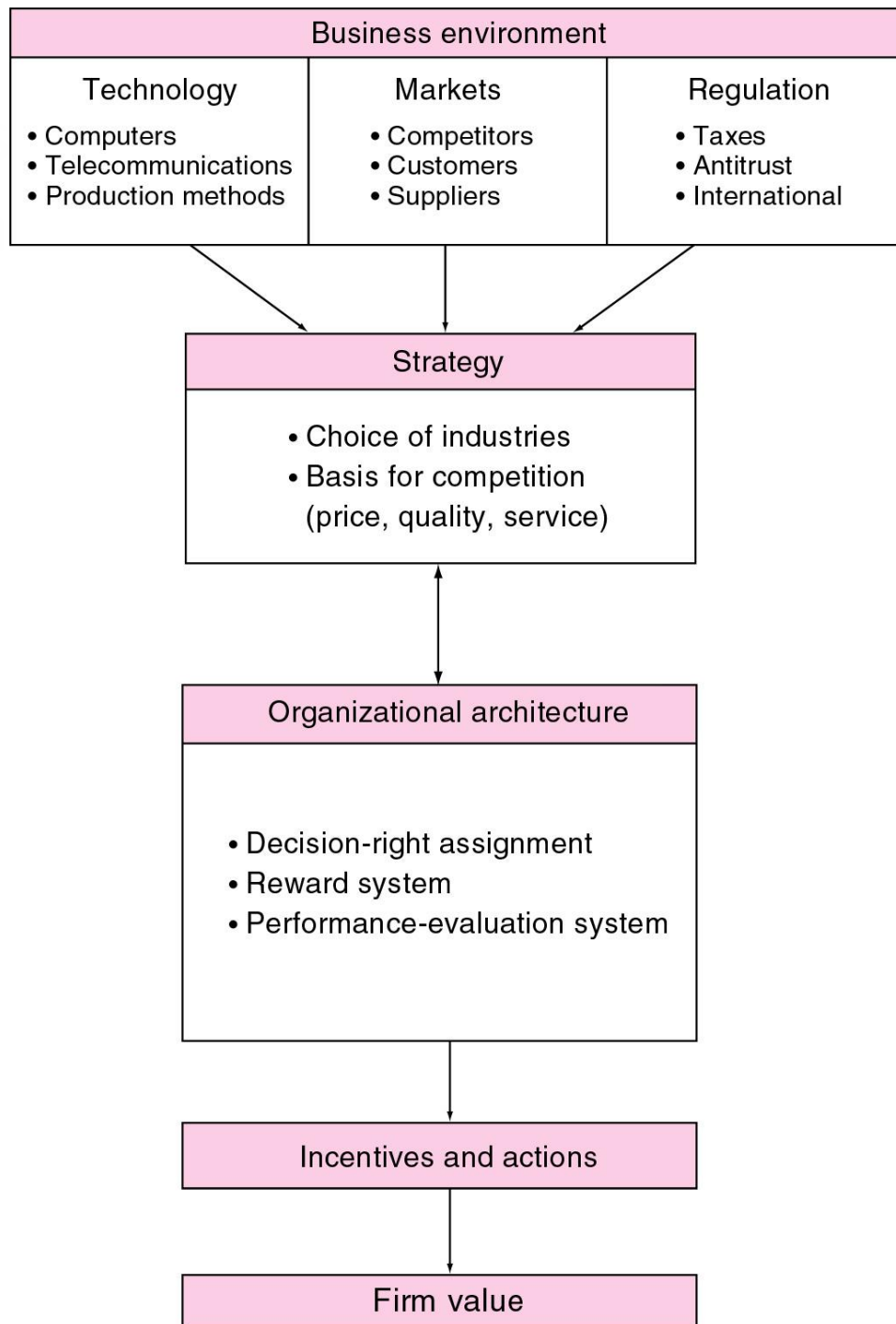
Organizations and markets

▶ Firms and markets

- “[T]he principal challenge in designing firms (and entire economic systems) is to maximize the likelihood that decision makers have both (1) the relevant information to make good decisions and (2) the incentives to use the information productively” (Brickley, Smith, and Zimmerman).
- Markets do this through (1) decentralized decision making and market prices and (2) property rights

▶ Elements of organizational architecture

- Assignment of decision rights
- Reward system
- Monitoring/performance evaluation



Decision rights

- ▶ Benefits of decentralized decision making
 - More effective use of local knowledge
 - Conservation of senior managers' time
 - Training for local managers
- ▶ Costs of decentralized decision making
 - Agency costs
 - Coordination problems
 - Less effective use of central information
- ▶ The role of alienability
 - Decision rights as property rights
 - The limits of delegation

Compensation and evaluation

- ▶ Piece rates versus time rates
 - Quantity versus quality
 - Measurement costs
- ▶ Elements of the compensation package
 - Compensating differentials (examples)
 - The mix of salary and benefits
- ▶ Base versus bonus pay
 - The basic incentive problem
 - Changes in base pay and bonus rates
 - Multi-task problems
 - Subjective versus objective performance evaluation
- ▶ Application: the debate over executive compensation





