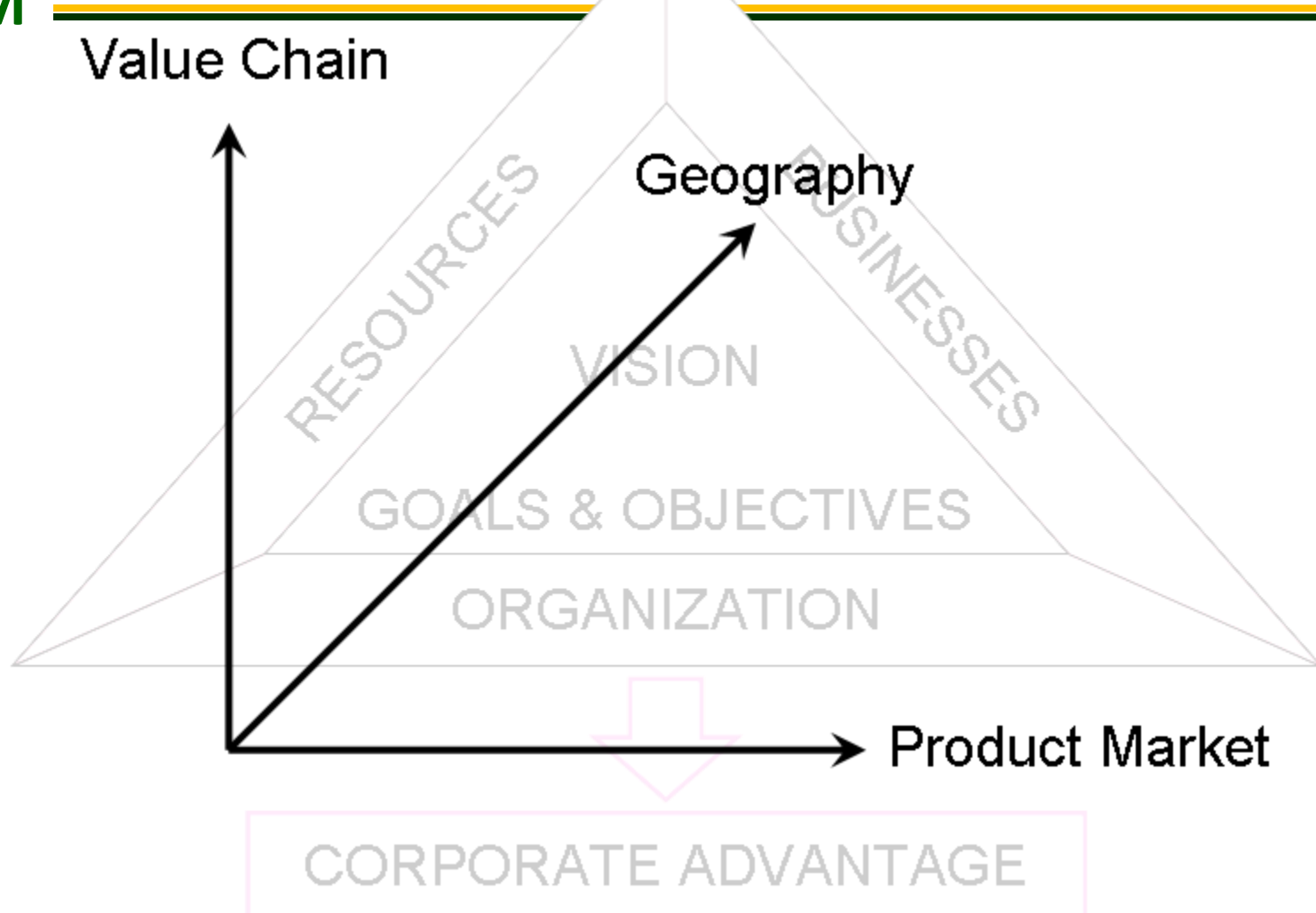


# Businesses Vertical Boundaries of The Firm

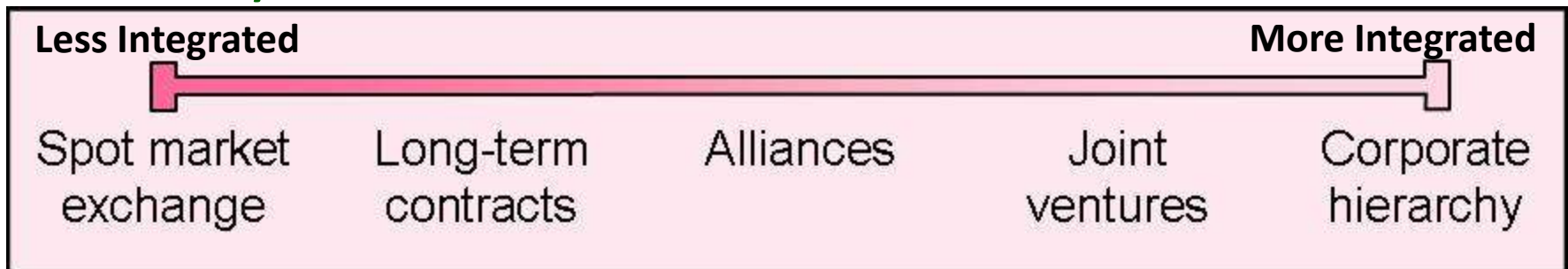


- The vertical chain
- Make Versus Buy
- Reasons to “Buy”
- Reasons to “Make”
- Alternatives to make-or-buy

- The value chain – primary & support activities
- Which steps of the vertical chain are to be performed inside the firm?
- Which steps of the vertical chain to be out-sourced?
- Choice between the “invisible hand” of the market and the “visible hand” of the organization (Make or Buy)
- Vertically integrated vs. vertically disintegrated
  - Eg., Vertical disintegration in the pharmaceutical industry

- Decision depends on the costs and benefits of using the market as opposed to performing the task in-house
- Outside specialists may perform a task better than the firm can
- Intermediate solutions are possible (Examples: Strategic alliances with suppliers, Joint ventures)

## Make or Buy Continuum



# Some Make-or-Buy Fallacies

1. Firm should make rather than buy assets that provide competitive advantages
2. Outsourcing an activity eliminates the cost of that activity
3. Backward integration captures the profit margin of the supplier
4. Backward integration insures against the risk of high input prices
5. It makes sense to tie up the distribution channel in order to deny access to the rivals

## Reasons to Buy rather than Make (Using the Market) $\Rightarrow$ Efficiency

- **Economies of scale & scope and learning curve**
  - Market firms (outside specialists) may have patents/proprietary information that makes low cost production possible
  - Aggregate need of many firms
  - Exploit experience – learning economies
- **Absence/ elimination of bureaucracy**
  - Agency & influence costs

- Cost of slack efforts & administrative controls to deter the same
- Get unnoticed & undeterred owing to common overhead & being cost centers -> lack of measures & market test
- It is difficult to internally replicate the incentives faced by market firms

- “Internal Capital or Labour Markets” allocates scarce capital/ resources.
- Allocations can be favorably affected by influence activities
- Resources consumed by influence activities represent “influence costs” – direct & indirect
- Eg., GM: Highest production & highest cost, Getting connected at Sony

1. Costs imposed by poor coordination
2. Reluctance of partners to develop and share valuable private information
3. Transactions cost that can be avoided by performing the task in-house

Each problem can be traced to difficulties in contracting

- Firms often use contracts when certain tasks are performed outside the firm
- Contracts list
  - the set of tasks that need to be performed
  - the remedies if one party fails to fulfill its obligation
- Contracts protect each party to a transaction from opportunistic behavior of other(s)
- Contracts' ability to provide this protection depends on
  - the “completeness” of contracts
  - the body of contract law

- Stipulates what each party should do for every possible contingency
- No party can exploit others' weaknesses
- Be able to contemplate all possible contingencies
- Be able to “map” each possible contingency to a set of actions
- Be able to define and measure performances
- Be able to enforce the contract
- To enforce a contract, an outside party (judge, arbitrator) should be able to
  - observe the contingency
  - observe the actions by the parties
  - impose the stated penalties for non-performance
- Real life contracts are usually incomplete contracts

- **Incomplete contracts**
  - Involve some ambiguities
  - Need not anticipate all possible contingencies
  - Do not spell out rights and responsibilities of parties completely
- **Factors that Prevent Complete Contracting**
  - Bounded rationality
  - Difficulties in specifying/measuring performance
  - Asymmetric information

- Contract law facilitates transactions with incomplete contracts
- Parties need not specify provisions that are common to a wide class of transactions
- Limitations of Contract Law
  - Doctrines of contract law are in broad language that could be interpreted in different ways
  - Litigation can be a costly way to deal with breach of contract
    - Litigation can be time consuming
    - Litigation weakens the business relationship

# 1. Coordination of Production Flows

- For successful coordination one party needs to make decisions that depend on the decision made by others
- A good fit should be accomplished in several dimensions. Some examples are:
  - Timing
  - Size
  - Color
  - Sequence

- Without good coordination, bottlenecks arise in the vertical chain
- Coordination is especially important when “design attributes” are present
  - Design attributes are attributes that need to relate to each other precisely; else significant loss in economic value results
- To ensure coordination, firms rely on contracts that specify delivery dates, design tolerances and other performance targets
- If coordination is critical, administration control may replace the market mechanism
- Design attributes may be moved in-house

## 2. Leakage of Private Information and Outsourcing

- Firms would not want to compromise the source of their competitive advantage
- Well- defined patents can help but may not provide full protection
- Contracts with non compete clauses can be used to protect against leakage of information
- In practice non-compete clauses can be hard to enforce

## 3. Transactions Costs

- If the market mechanism improves efficiency, why do so many of the activities take place outside the price system? (Ronald Coase)
- Costs of using the market that are saved by centralized direction – transactions costs

- Outsourcing entail costs of negotiating, writing and enforcing contracts
- Costs are incurred due to opportunistic behavior of parties to the contract and efforts to prevent such behavior
- Transactions costs explain why economic activities occur outside the price system

- Sources of transactions costs
  - Investments that need to be made in relationship specific assets
  - Possible opportunistic behavior after the investment is made (hold up problem)
  - Quasi-rents (magnitude of hold up problems)

# Relationship-Specific Assets

- Relation-specific assets are essential for a given transaction
- These assets cannot be redeployed for another transaction costlessly
- Once the asset is in place, the other party to the contract cannot be replaced costlessly, because the parties are locked into the relationship to some degree

- Relation-specific assets may exhibit different forms of specificity
  - Site specificity
  - Physical asset specificity
  - Dedicated assets
  - Human asset specificity
- Fundamental transformation
  - Eg., The fundamental transformation in the U.S. Automobile Industry

- Relation specific investment
- The term ‘rent’ denotes economic profits – profits after all the economic costs, including the cost of capital, are deducted
- Quasi-rent is the excess economic profit from a transaction compared with economic profits available from an alternate transaction

- The holdup problem raises the cost of transacting exchanges
  - Contract negotiations become more difficult
  - Investments may have to be made to improve the ex-post bargaining position
  - Potential holdup can cause distrust
  - There could be underinvestment in relation specific assets

- Relation-specific assets support a particular transaction
- Redeploying to other uses is costly
- Quasi rents become available to one party and there is incentive for a holdup
- Potential for holdups lead to
  - Underinvestment in these assets
  - Investment in safeguards
  - Reduced trust



Are there existing suppliers that can attain economies of scale that an in-house unit couldn't attain? Do they possess execution capabilities that an in-house unit would not?

YES

Are there significant relation-specific assets?  
Are there significant coordination problems?  
Are there significant problems involved in leakage of private information

YES

Is detailed contracting infeasible or too costly

YES

Is common ownership needed to mitigate contracting problems?

YES

Vertical Integration

NO

Would intermediate arrangement (alliances, close-knit supply arrangements) suffice

YES

Alliances joint ventures or other close-knit non-ownership arrangements

NO

Use the Market

NO

NO

NO

NO

Vertical Integration