Toulouse School of Economics

Understanding Real World Organizations

TSE M1 – Semester 1

September 2023

Paul Seabright

Week 2: Ronald Coase and the Nature of the Firm (continued)

Economics for the Common Good

Summary of conclusions from Week 1

- The “information economy” has made the creation, processing and sharing of information massively less costly.
- Paradoxically this means that economic systems are no longer about allocating information but about the new scarce resource – ATTENTION.
- Tasks can be broken into components and reassembled to allocate this scarce resource more efficiently (we looked at the example of MOOCs in higher education).
- Organizations can be considered as allocating “entitlements to attention”.

Organizations as allocators of entitlements to attention

- Ronald Coase drew attention to a crucial distinction between transactions inside versus transactions outside the firm (“hierarchies” versus “markets”).

- In fact, attention entitlements are not an all-or-nothing matter: there can be more or less priority entitlements.

- An organization does not accord equal priority to everyone inside to the attention of everyone else: instead, it allocates attention according to a set of escalating entitlement priorities.

- Outside it (”in the market”) attention is allocated by bilateral negotiation constrained by communication technology.

So *how* do organizations allocate entitlements to attention?

- In practice organizations never allocate attention entitlements with perfect efficiency.

- Existing attention entitlements create veto power, which can prevent efficient reorganization when technology changes.

- An important reason organizations differ in their response to the availability of *information* technology is differences in the existing allocations of *attention*, which create different configurations of winners and losers from adopting the new technology.

- Reallocating information and reallocating attention may have quite different effects – and losers may not trust the outcome.

Can this help us understand why many “good” ICT practices are not adopted?

- A general answer: because the people with the power to adopt them fear them as substitutes, not as complements!

- Compare:
  - Yield management systems for airlines, IT in retailing – big productivity gains, rapid adoption.
  - Electronic medical records (EMRs) in health care – small gains, slow adoption.

- The lesson: good ICT practices need a champion within the organization!

Back to Coase: what shapes the boundaries of the firm?

- If markets have informational advantages over hierarchies, what advantages can hierarchies have over markets?

- A Fundamental Question: how big (and complex) should a firm become?

- The advantages of size:
  - Technical economies of scale or scope?
  - Resolving hold-up problems.

- The costs of size:
  - Slow diffusion of information.
  - Strategic behavior by those who have private information.
  - Coase called these “transactions costs”.

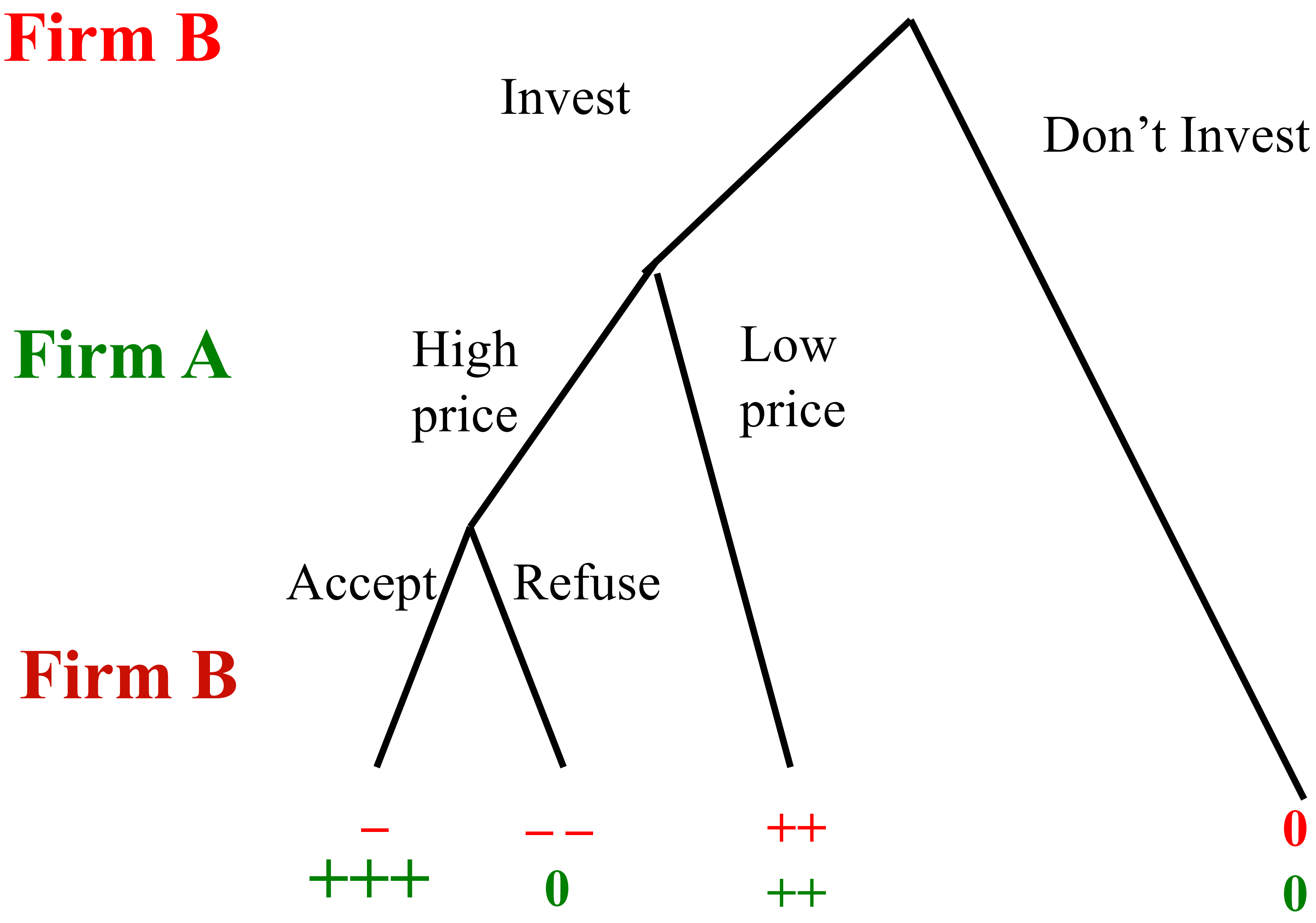
The advantages of size

- Economies of scale and scope predict common operation of activities – not common ownership.
- Markets allow coordination of activities without integrating them into one firm under common ownership.
- So when is integration necessary?
- Coase's answer: when it involves lower transaction costs.
- For example: when market relations would involve a "hold-up" problem.

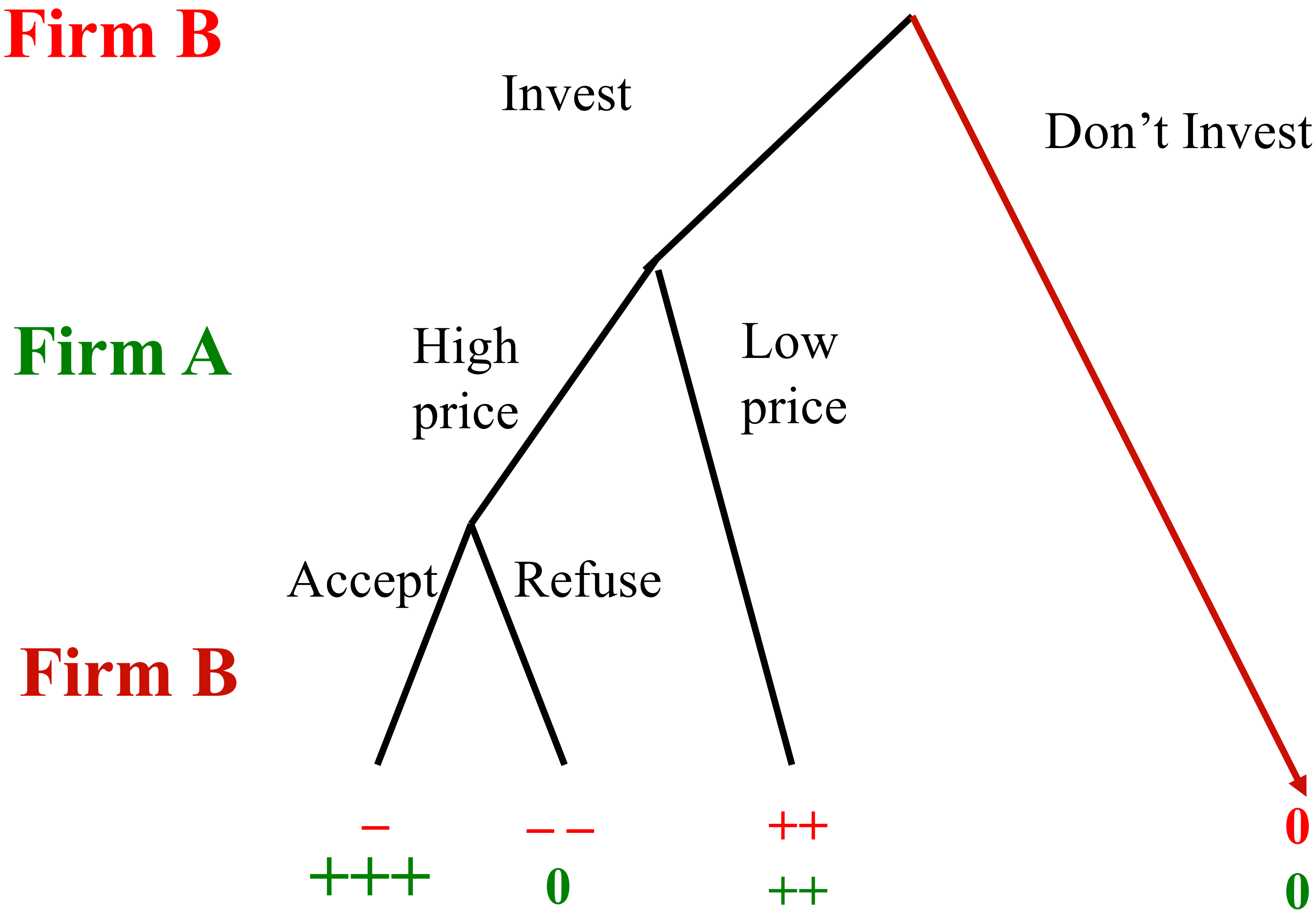
What is a “hold-up” problem?

- Suppose firm A has invented a new technology for mobile telephony.
- Firm B would like to use it in its handsets, but first has to invest (infrastructure, production facilities etc.).
- These investments are specific to the technology and would be useless for any other: how can firm B be sure of the price it will have to pay?
- After it has invested, firm A will be tempted to demand a high price, knowing firm B cannot easily walk away from the deal.
- Two solutions:
  - A contract in advance – but sometimes such contracts are hard to write since they depend on factors that are hard to foresee.
  - Vertical integration – then firm A and firm B have the same interests.

The hold-up problem



The hold-up problem

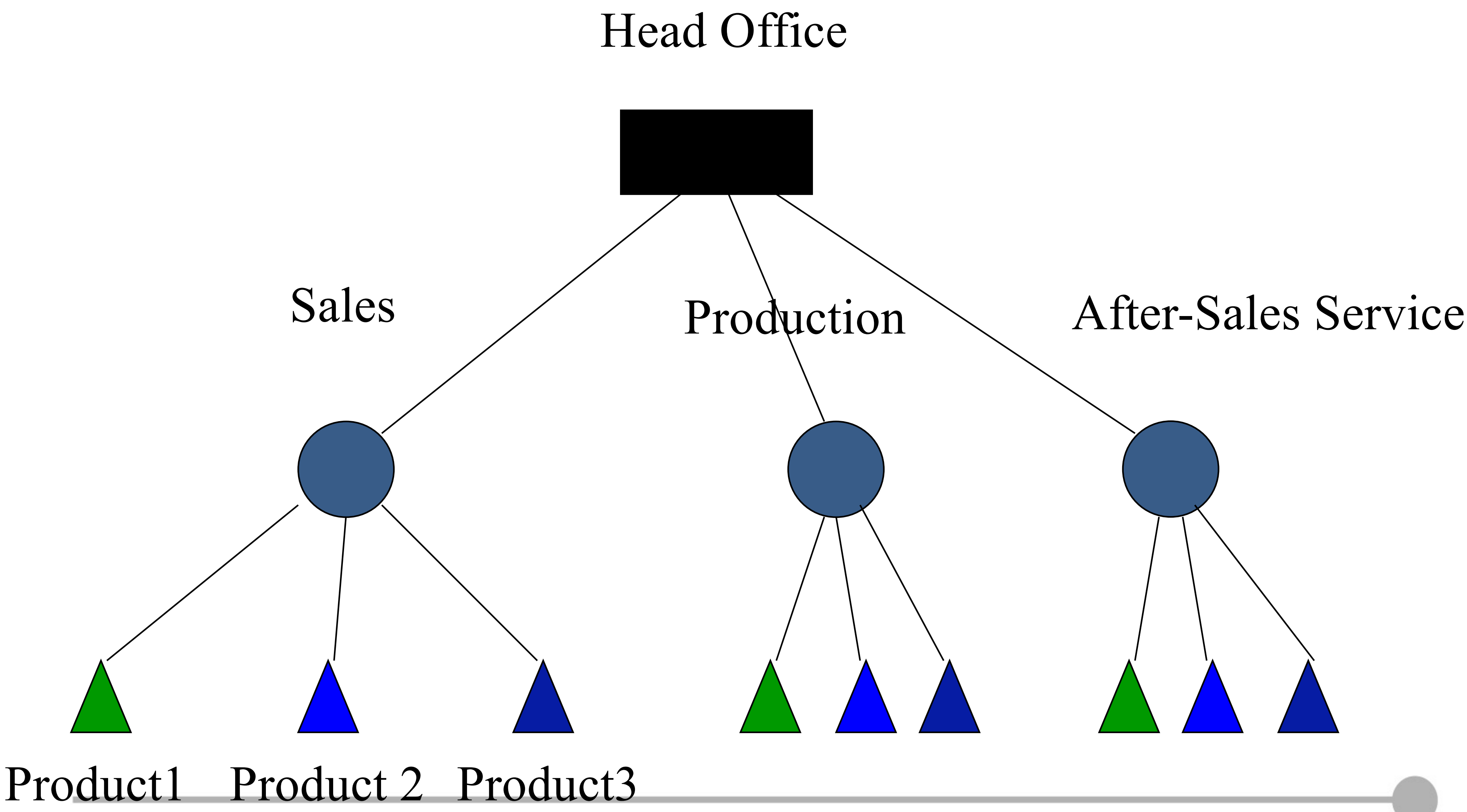


Firm B's only rational strategy is not to invest!

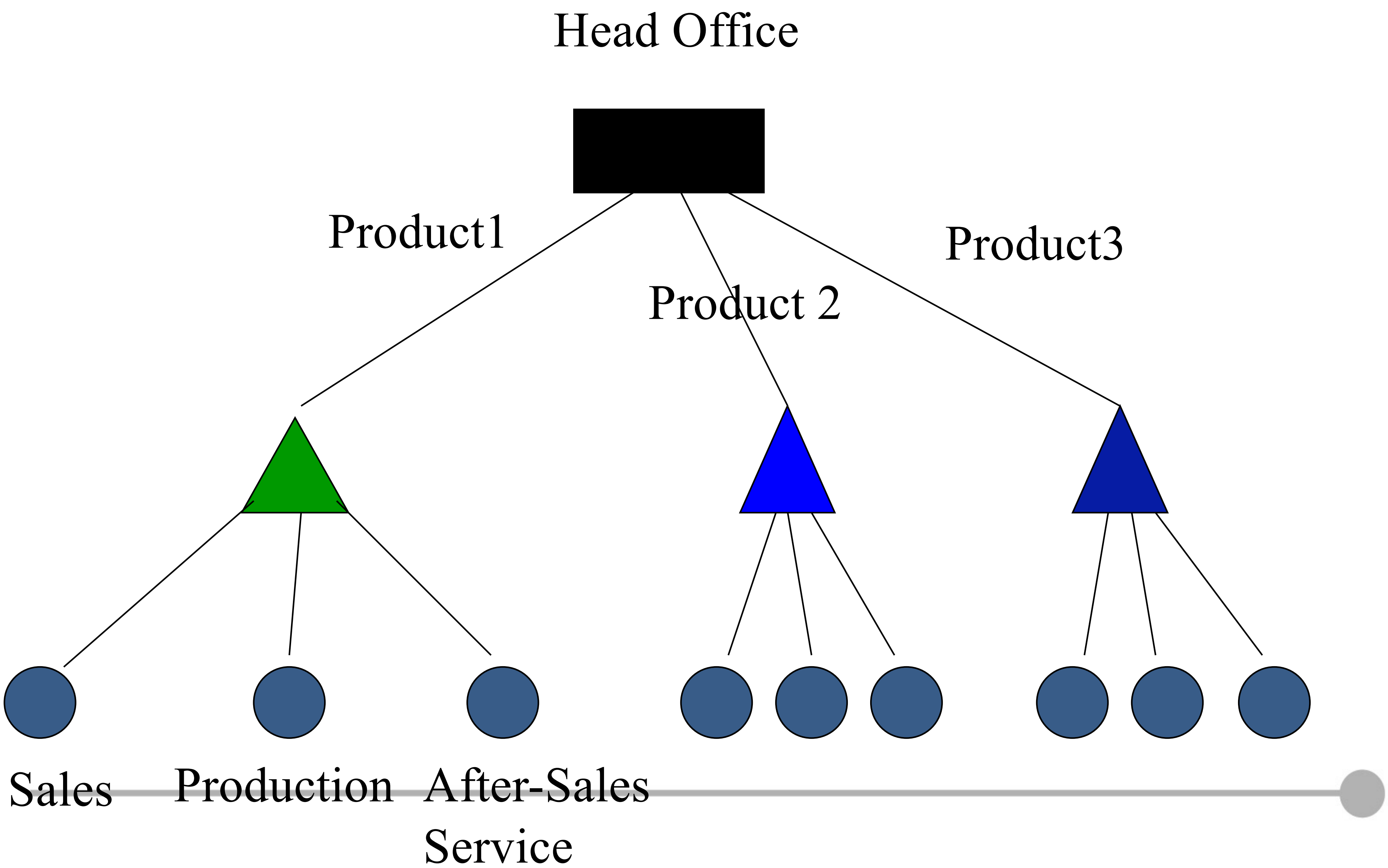
The costs of size

- Information transmitted within hierarchies is sometimes slow to diffuse.
- Organizational design can reduce these costs by grouping together the activities whose information sharing is most urgent for the firm.
- An example: Du Pont and the move from the U-form to the M-form company in the early 20th century.
- M-form was also key to combining scale with product differentiation (compare Ford & General Motors in 1920s).
- Sometimes information is used within hierarchies to exploit strategic advantages (eg to work less hard).
- Just-in-time production methods are designed to make this more difficult – what gave Toyota its advantage over GM.

The Unitary (U-form) firm



The Multidivisional (M-form) firm



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