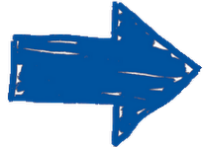


Beyond the neoclassical theory of the firm

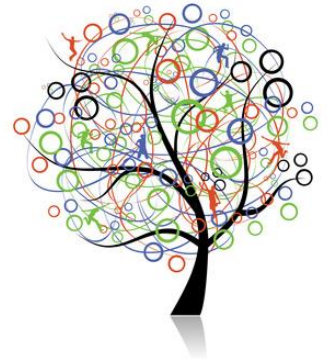
Managerial and behavioural theories
of the firm

Main critiques to the NT



NOT REALISTIC

1. Not all people in charge of deciding the strategy share the same goals. Managers might have their own goals, different from profit maximisation;
2. In most cases the reality is characterised by uncertainty and imperfect information;
3. Modern firms are complex and communication problems are possible and frequent;
4. The rule $MR=MC$ is not always followed because it requires knowledge both on demand and on costs. Sometimes firms follow simpler rules (such as cost plus pricing based on average cost).



WIDE DEBATE

Main alternatives to the NT



Schumpeter

Dynamic competition model with the entrepreneur playing a central role. The Schumpeterian entrepreneurs is the main driving force behind economic process. Innovation allows to replace old production methods with new and better ones. This allows abnormal or monopoly profits, that are only a **temporary** phenomenon.



The Austrian School



The entrepreneur facilitates the spread of information among consumers and resource owners. He identifies missed opportunities, also acquiring new information (disequilibrium results from the ignorance of buyers and sellers).



Managerial theories of the firm

They study the contribution of managers to decision-making within the firm. Ownership/management separation. Managers might maximise:

1. Sales (Baumol)
2. Present value of future sales
3. Growth
4. Managerial utility



Main alternatives to the NT (cont.)

4

Behavioural theory of the firm

1. Loose firm boundaries (everyone with interests in the organisation's activities): stakeholders.
2. Bounded rationality (Simon, 1959): uncertainty makes it impossible to identify a precise set of actions maximising profits. Everybody takes the best decision according to the information he owns (which are limited). This creates the potentiality for **conflicts** within the organization and the corporate goals are the result of **BARGAINING** within the organization and they are dependent from the past performance. Firms look for a **satisfactory profit**.
3. Side payments: Sometimes side payments are not monetary (ex participation in the board). In a successful firm, side payments are sufficient to prevent essential individuals to withdraw. SP happens when there is organizational slack, i.e. the organization is imperfect. If the organization is perfect, you don't need side payments because the owner is perfectly able to control the manager and to evaluate his decisions.

Given the complexity of organisation's decision making there is **NOT** one definitive behavioural theory of the firm.

The behavioural theory of the firm is particular effective in finding explanations for existing phenomena, but weak on prediction.



Starting point

- Unease towards the NT, considered to be unrealistic
- The reality is different: need for an explanation

New theories

- Schumpeter
- Austrian school
- Managerial Theory
- Behavioural Theory

Theory of the firm

- Transaction cost theory

Ideally, with a perfectly functioning market (no transaction costs), the price would always reflect **all (opportunity) costs** associated to a transaction. Given that this condition would be equally true for all firms, we expect that all firms organize their production in a similar way.

IF THIS IS TRUE, THEN:

Why are there firms that decide to internally produce all phases of production (MAKE), while others decide to buy most input/components/services on the market, from external suppliers (BUY)?



Theory of the Firm

The **theory of the firm** consists of a number of economic theories that describe the nature of the firm (existence, behavior, structure, and relationship to the market).

- Why are not all transactions in the economy mediated over the market?
- Why are firms structured in such a specific way, for example as to hierarchy or decentralization?
- What drives different actions and performances of firms?

Agency theory

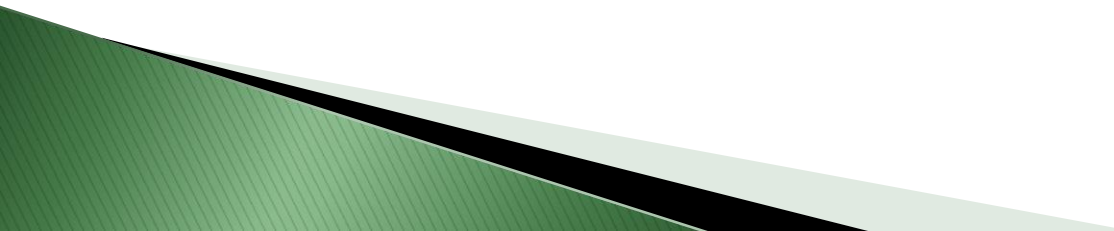
- ▶ Agency theory refers to those situations where there is a **contract** between one party, the principal, and the other, the agent.
- ▶ The agent contracts to carry out certain activities **for** the principal, and the principal agrees to **reward** the agent accordingly.

Three assumptions are at the core of agency theory:

1. Common to most economists: individuals maximize **their own self-interest**.
2. More specific to agency theory: social and economic life is a series of contracts, or exchanges, governed by competitive self-interest.
3. Applied to internal organizational analysis: monitoring contracts is costly and somewhat ineffective, especially in organizations, thus encouraging self-interested behavior, opportunism, or cheating.



Transaction Cost Theory

- ▶ **The TCT is part of the agency theory.**
 - ▶ **Transaction costs:** the costs of (1) negotiating, (2) monitoring, and (3) governing exchanges (=transactions) among people.
 - ▶ **Transaction cost theory:** the goal of an organization is to minimize the costs of exchanging resources in the environment on one side and the costs of managing exchanges inside the organization on the other. In other words, the transaction cost theory examines the conditions under which organizations chose to internalize some functions (hierarchy) or to purchase them on the market.
- 

Transaction costs: some specifications

- ▶ When studying idealized perfect competition, one of the assumptions is that there are no transactions costs (perfect information, no information asymmetries).
- ▶ The 1991 Nobel prize Ronald Coase argued that the market mechanism is not cost-free, but involves transaction costs: time & money to search for sellers & buyers, negotiate exchange terms, write contracts, inspect results, enforce deals. In other words, the market is a powerful co-ordinating device but there are a range of transactions costs associated with it.
- ▶ In the absence of transaction costs, markets and hierarchies (=firms) would be equivalent in terms of allocative efficiency (Coase, 1937). In a world of positive transaction costs, the choice of markets and hierarchies (and the choice of liability rules) matters for efficiency.
- ▶ Transaction costs ARE NOT the price that a firm pay to buy a product/service on the market.

Transaction Costs

Search & Information Costs



Costs incurred in identifying possibilities for mutual gains



Identification of funding source

Identification of relevant stakeholders

Cost of gathering information

Bargaining & Decision Costs



All costs that are associated with negotiating an agreement



Time spent at meetings



Time expended in written and verbal communications

Policing & Enforcement Costs



Costs involved in making sure all parties stick to the agreement



Employment of an external monitor

Time and effort spent monitoring others informally

Sources of Transaction Costs

Transaction parties can never write completely detailed agreements covering all possible future contingencies (“incomplete contracting”), because of:

- ▶ **Environmental uncertainty and bounded rationality**
 - *Bounded rationality*: refers to the limited ability to process the available information
- ▶ **Opportunism**
- ▶ **Risk and specific assets**
 - *Specific assets*: investments that create value in one particular exchange relationship but have no value in any other exchange relationship (quasi-rent and sunk costs)

Contract completeness (avoiding both ex ante and ex post transaction costs) would require:

- To identify all contingencies, the actions to be taken in each case and to agree on outcomes
- To agree on the forms of performance measurement
- To be enforceable: observable and subject to rule of law

Sources of transaction costs (cont.): Asymmetric information



- ▶ Parties to a contract are not equally well informed:
 - private information
 - temptation to misrepresent or exploit private information
- ▶ Two basic forms:
 - **hidden information:** *adverse selection*. The principal is unable to verify the agent's claims about his ability or productivity.
 - information about cost, quality, performance (e.g. used cars)
 - incentive to exclude reference to this from the contract
 - **hidden action:** *moral hazard*. The agent could act in his own private interests but against the principal's interests as stipulated in the contract.
 - actions that **cannot be monitored** but affect outcomes
 - quality **difficult to measure** and affected by agents' actions (ex. buyers have incentive to take less care if not observed)

CONSEQUENCE: Not possible to include in the contract unobservable information/actions.

Transaction Costs are low when :

1. Organizations are exchanging nonspecific goods and services.
2. Uncertainty is low.
3. There are many possible exchange partners.
4. There is a high level of trust among partners.

BUY

Transaction Costs are high when :

1. Organizations exchange very specific (or strategic) goods and services.
2. There are asset-specific investments (investments with no alternative uses except at loss of productive value)
3. Uncertainty increases (EX: Floods delay the just-in-time deliveries of a key supplier).
4. The number of possible exchange partners falls.
5. The firm does not know/trust its partner.

MAKE

Transaction costs can be avoided by the firm by producing the needed good/service internally:

- ▶ **Search costs:** inputs transferred internally from one department to the other do not require prices and do not imply high costs for searching the best partner;
- ▶ **Negotiation costs:** firms do not hire workers day by day, but on long-term contracts that only need to specify the obligations of the contracting parties;
- ▶ **Governmentally created costs:** for transactions taking place within the organization, it might be possible to avoid sale taxes and quota.

As a consequence the firm grows. Up to when?



Internal organisational costs

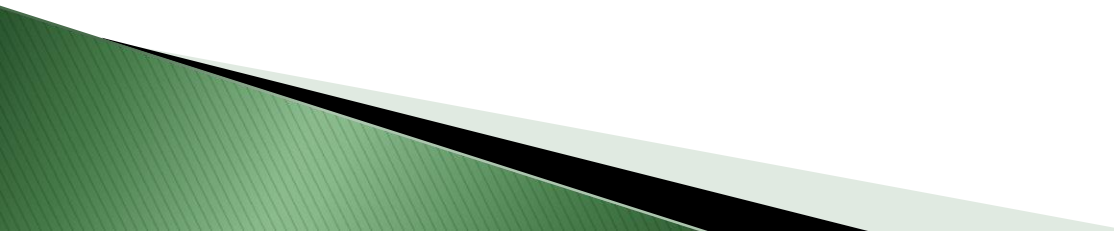
In general, making the firm larger will initially be advantageous, BUT the decreasing returns will eventually kick in, preventing the firm from growing indefinitely.

What is the best firm's structure?

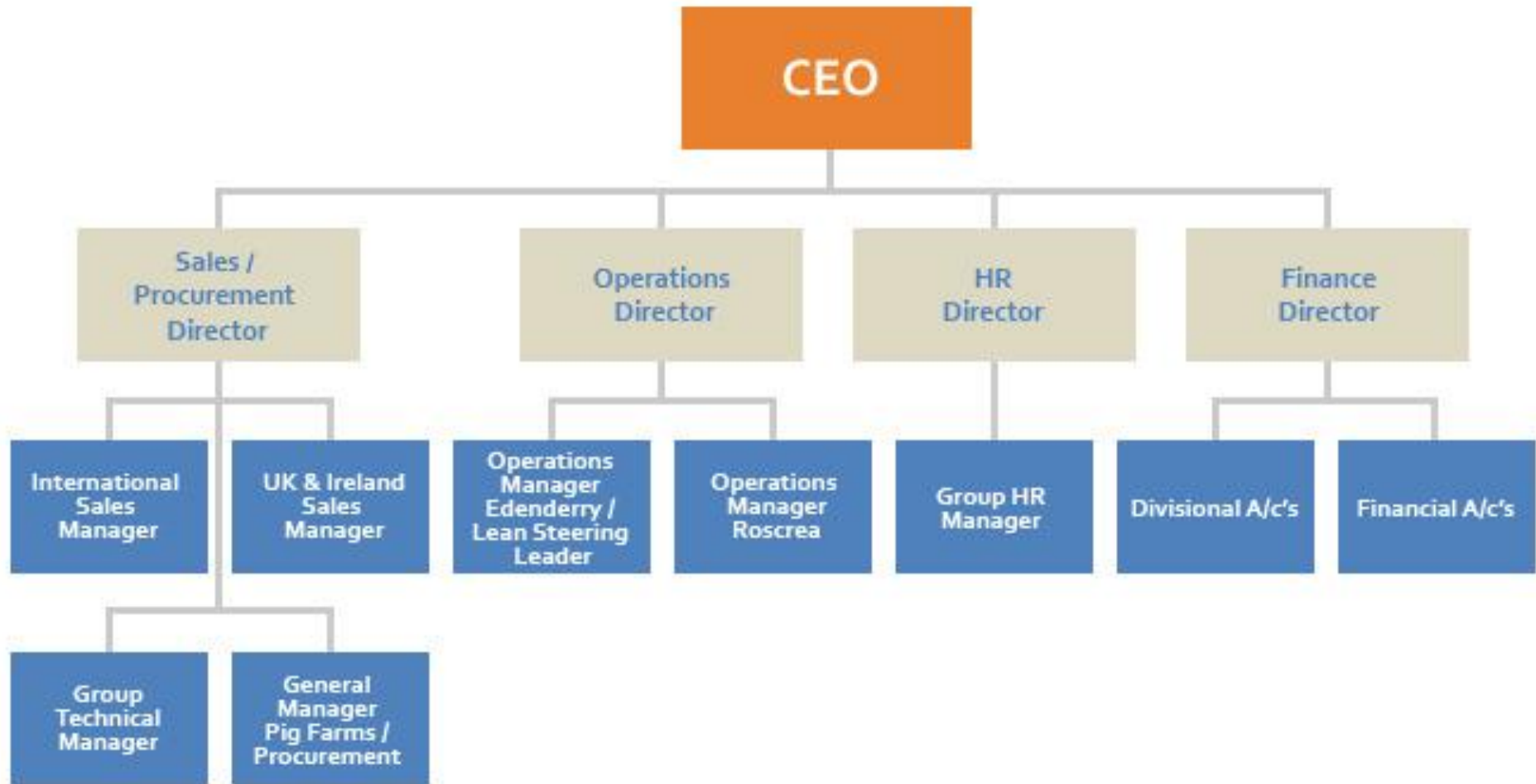
The principal-agent problem can be afforded also by means of a proper organization structure, facilitating the dialogue, the circulation of information, the control.

Furthermore, the structure should evolve with the firm, according to its internal changes and the evolution of the environment.

The main organisational structures are:

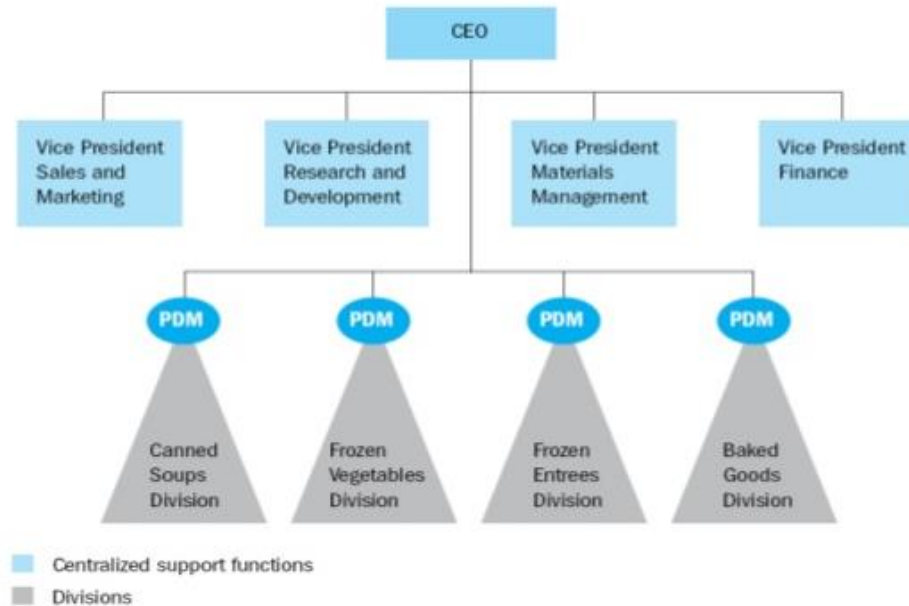
- Functional;
 - Multidivisional by product/ area;
 - Matrix;
 - Holding.
- 

(A) The functional organisation structure

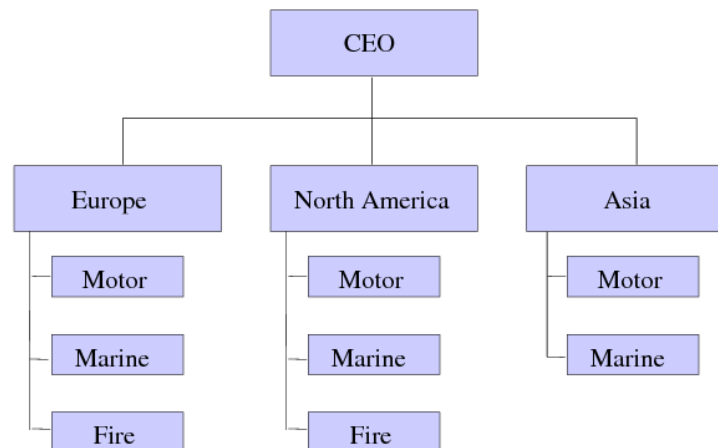


(B) The multidivisional organisation structure

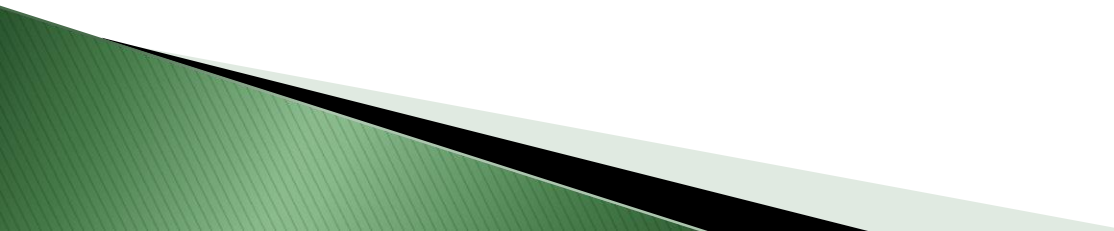
BY PRODUCT



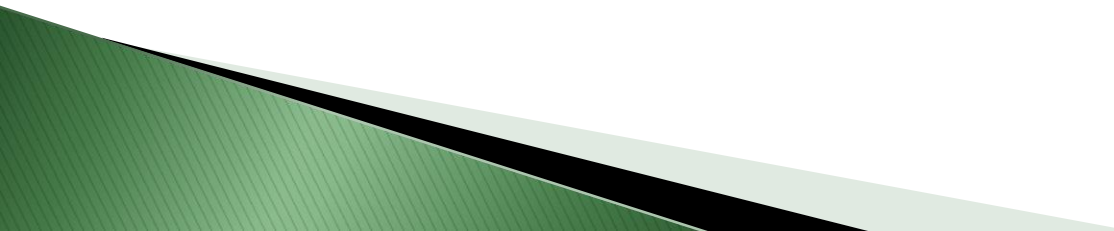
BY AREA

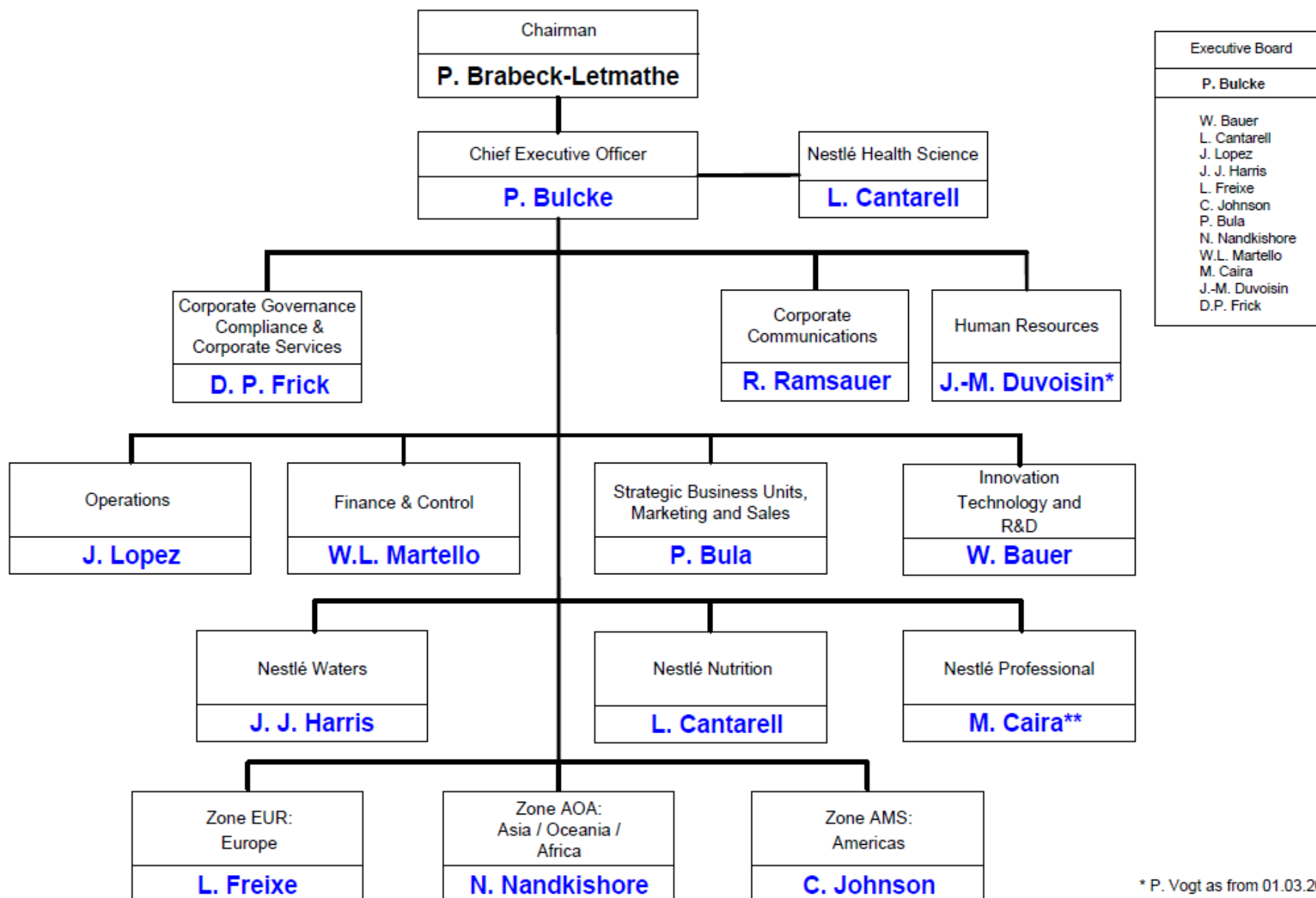


Advantages of the multidivisional form

1. **Simplified decision process:** the CEO only deals with the main problems arising in each division. In this way he can concentrate on strategic planning and coordination and control (to align the behaviour of every division to the overall firm strategy).
 2. Managers are in direct contact with the «critical» part (market, production or suppliers): they have the best information and can take decisions autonomously. They are responsible for the performance of their division and are evaluated and incentivised on the basis of such results.
 3. Improved capacity to control **different activities**.
- 

Limits of the multidivisional form

1. **Identification of divisions.** By area: it could be difficult to coordinate with clients or suppliers operating on more than one market. By technology: planning and R&D are better organised but there could be problems with clients. By product: there could be cost duplications when selling to the same clients or producing using the same plants. Possible solution: division grouping.
 2. What activities and responsibilities to **assign** to the different levels.
 3. **Moral hazard and incentives**: increase in the intra-managerial conflicts.
 4. Necessity to introduce **internal prices**.
 5. Choice of the **range of activities**.
 6. Possible increase in **coordination costs**.
- 

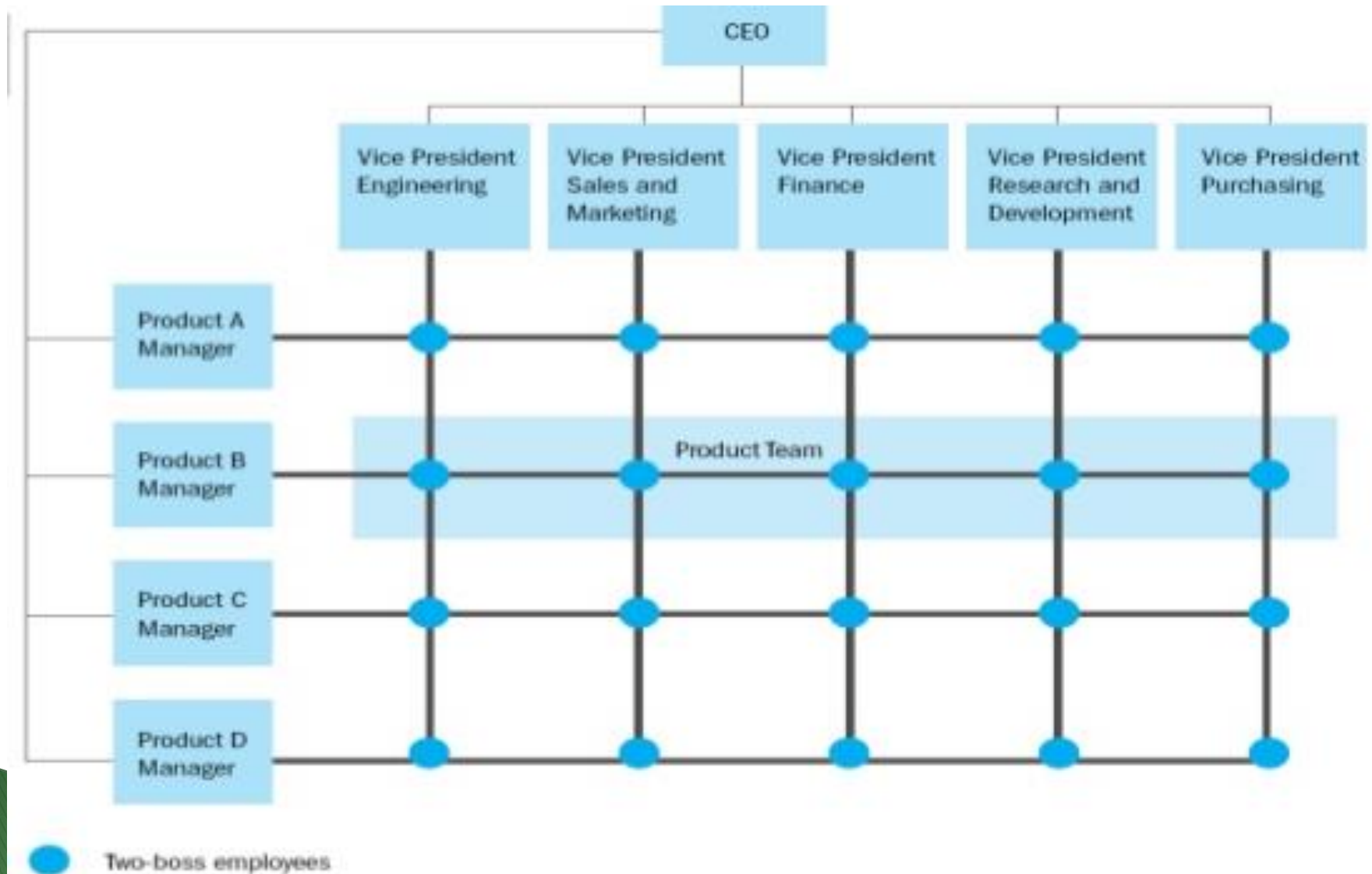

Executive Board
P. Bulcke

W. Bauer
L. Cantarell
J. Lopez
J. J. Harris
L. Freixe
C. Johnson
P. Bula
N. Nandkishore
W.L. Martello
M. Caira
J.-M. Duvoisin
D.P. Frick

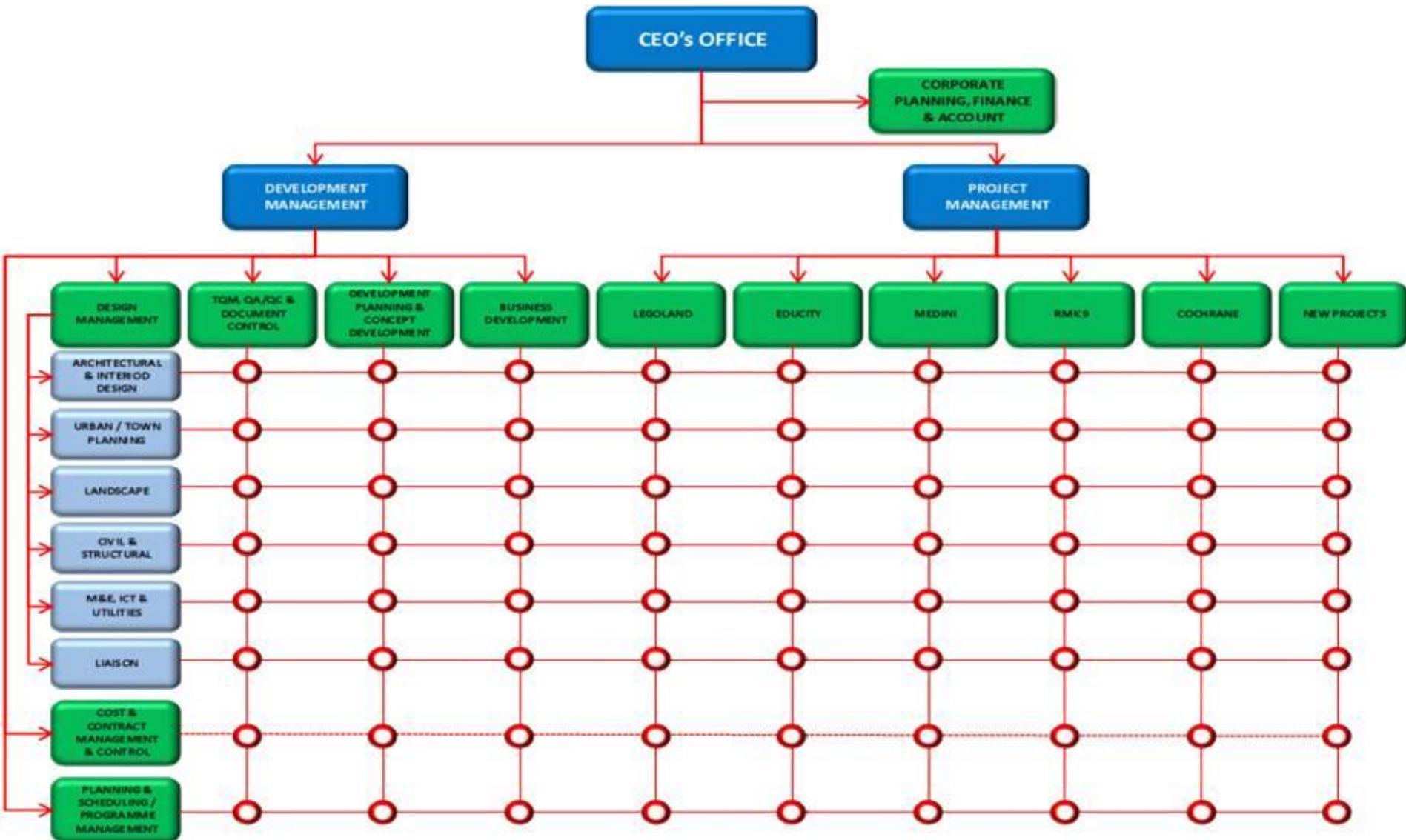
* P. Vogt as from 01.03.2013

** M. Rolland as from 01.05.2013

(C) The matrix structure



Ex. Iskandar investments

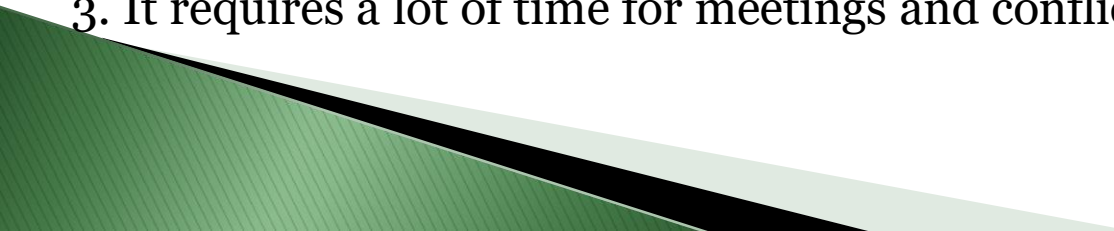


Matrix structure

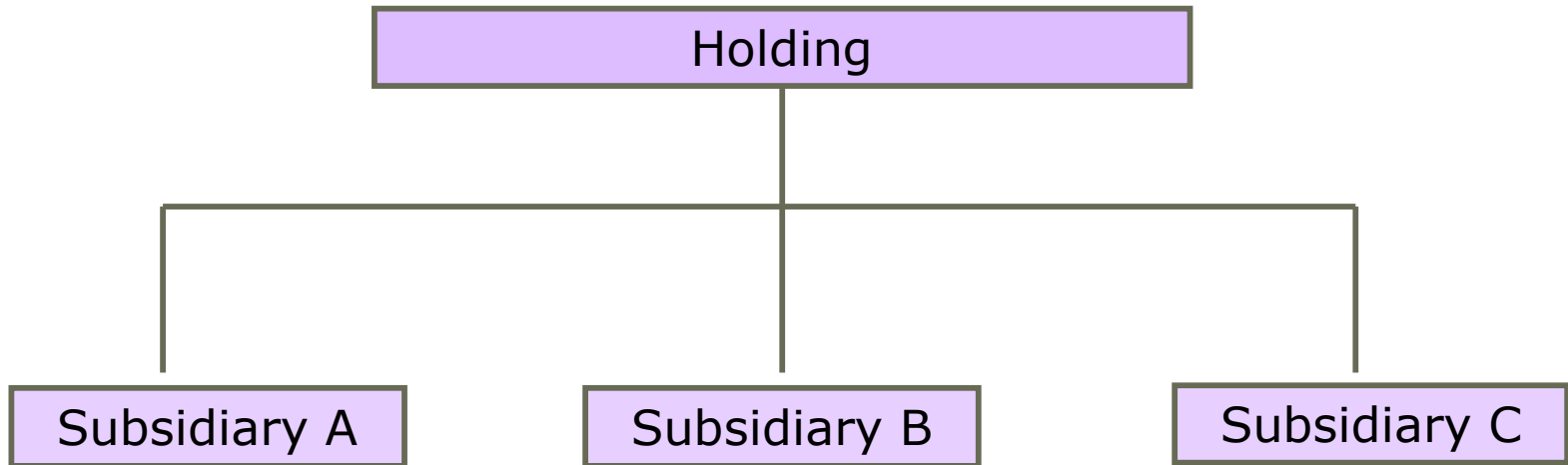
Advantages

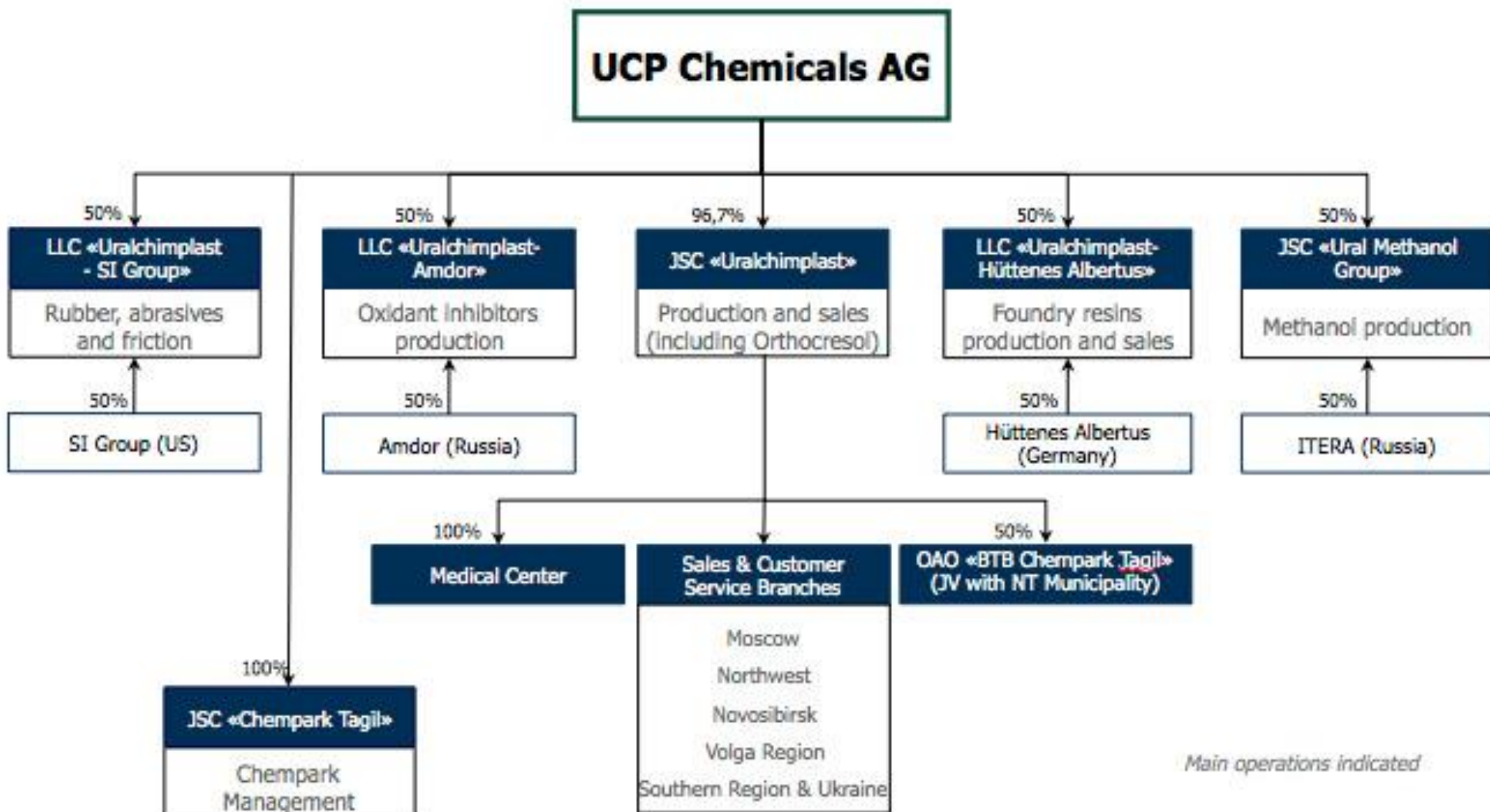
1. It allows coordination for complex requests of customers
2. It ensures flexible sharing of human resources among projects
3. It can adapt to complex decisions and frequent changes in unstable environments
4. It offers opportunities to develop both functional and project competences
5. It is suitable for medium-sized firms with a wide range of products.

Disadvantages

1. Double authority: it can be confusing and frustrating and it requires big efforts in maintaining a power balance
 2. Employees need to have good interpersonal capacities and specific training: the structure works only if employees understand it and avoid vertical relations
 3. It requires a lot of time for meetings and conflict resolutions
- 

(D) The holding company







Viaggi e Trasporti

TRENITALIA

100%

FS LOGISTICA

100%

BUSITALIA Sita Nord

100%

Infrastrutture

RFI

100%

ITALFERR

100%

Urbanizzazione

GRANDISTAZIONI

59,9%

NETINERA

51%

CENTOSTAZIONI

59,9%

Servizi

FERCREDIT

100%

FERSERVIZI

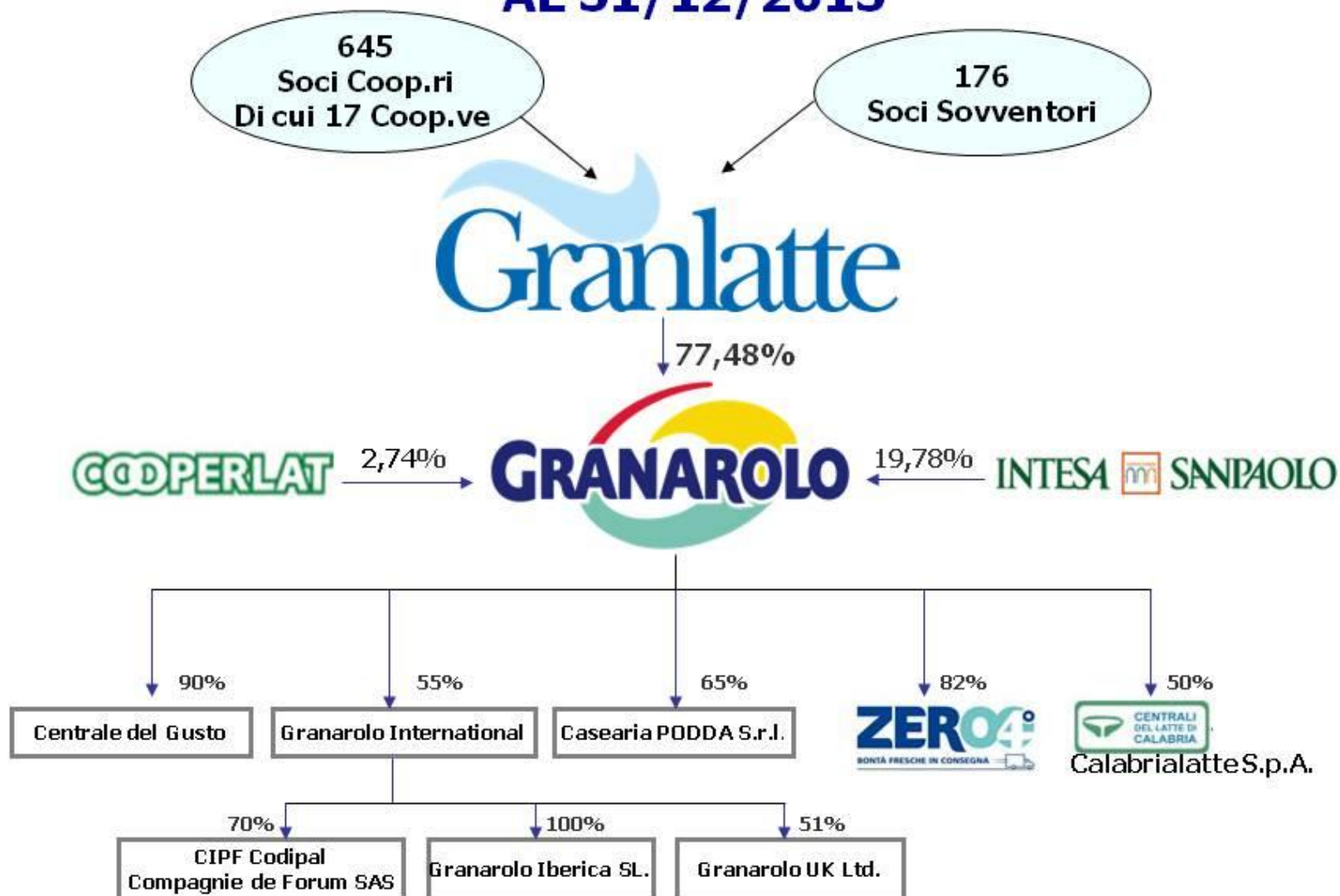
100%

FS SISTEMI URBANI

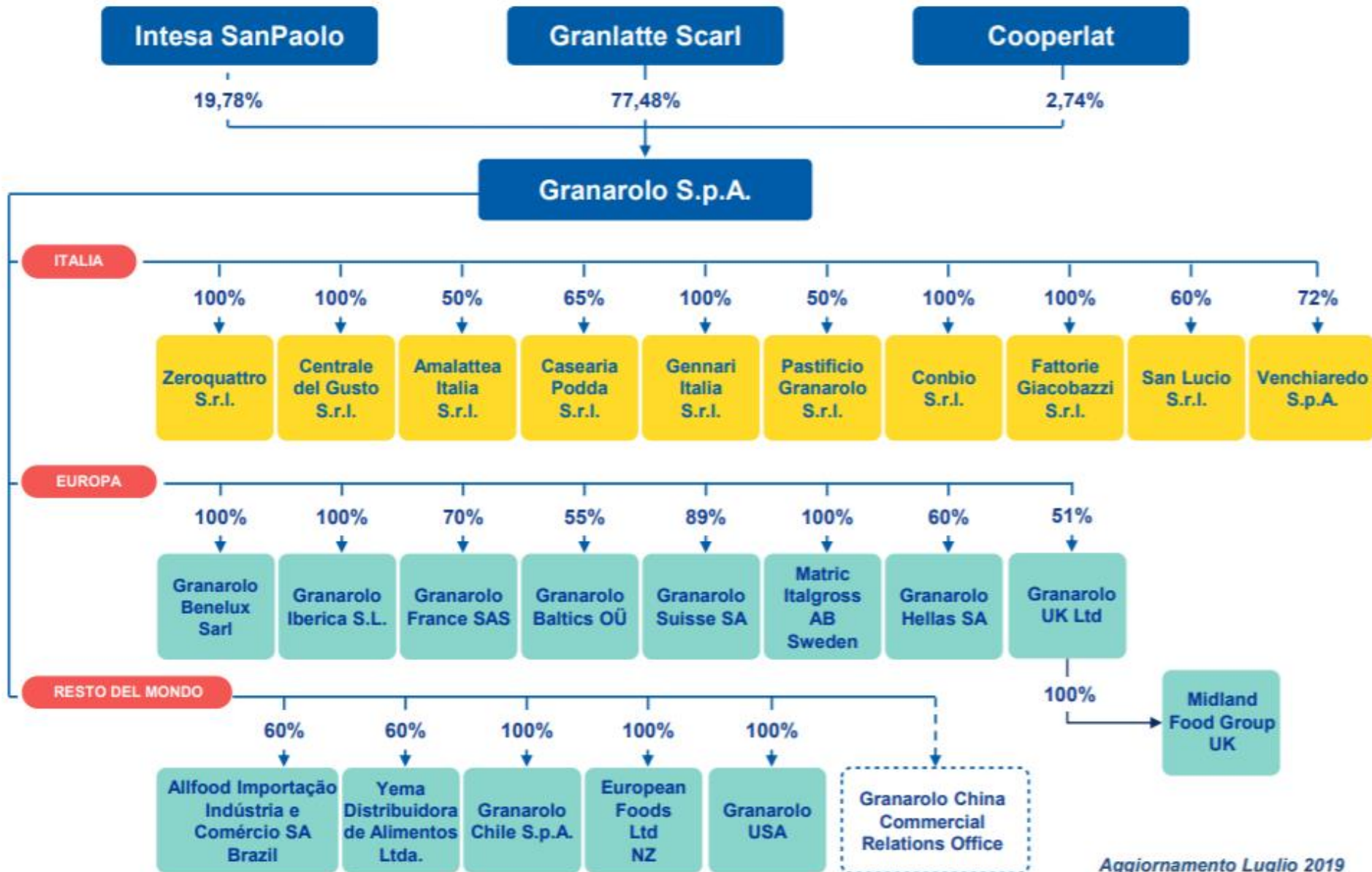
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LA STRUTTURA DEL GRUPPO GRANLATTE

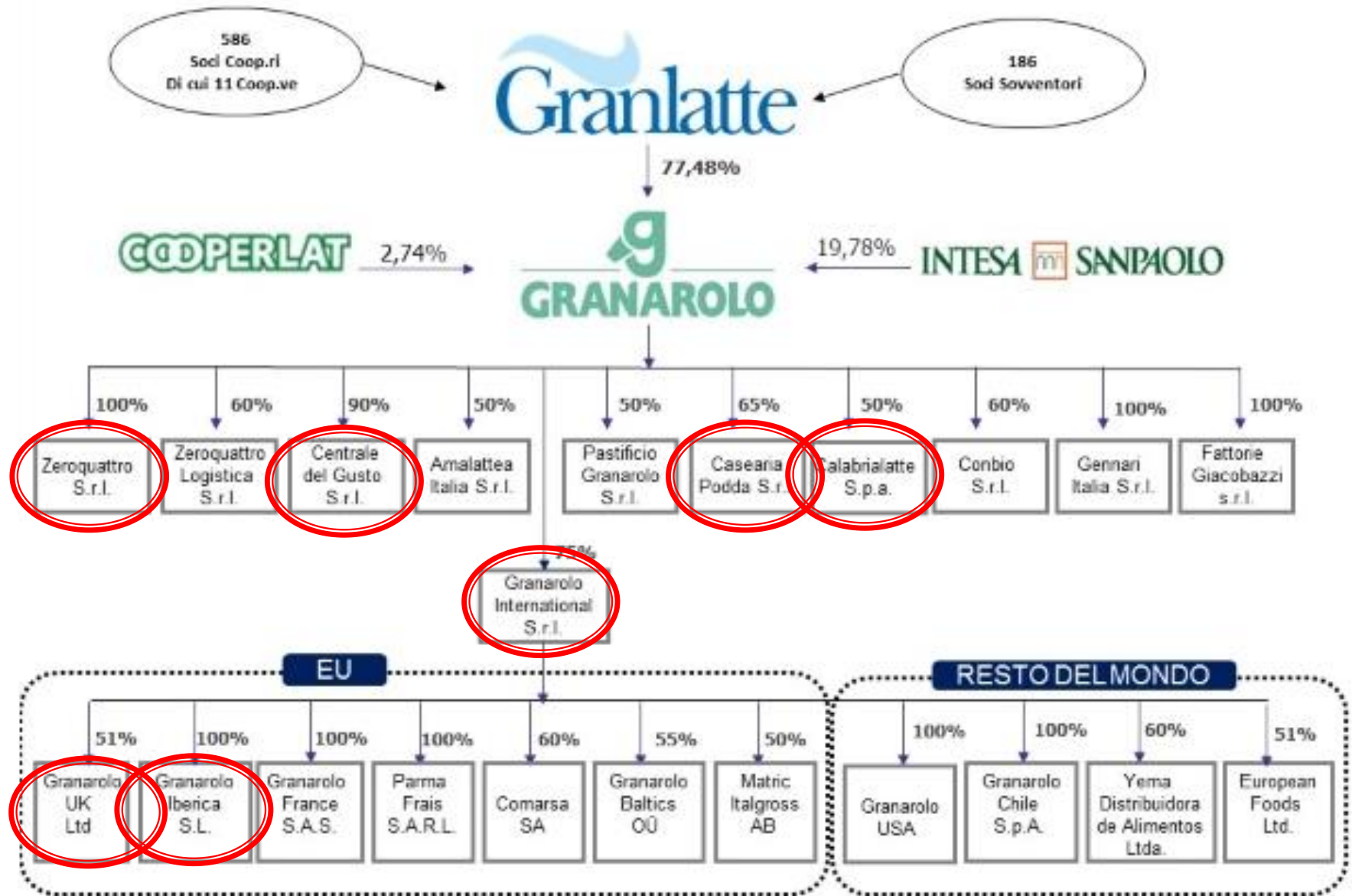
AL 31/12/2013



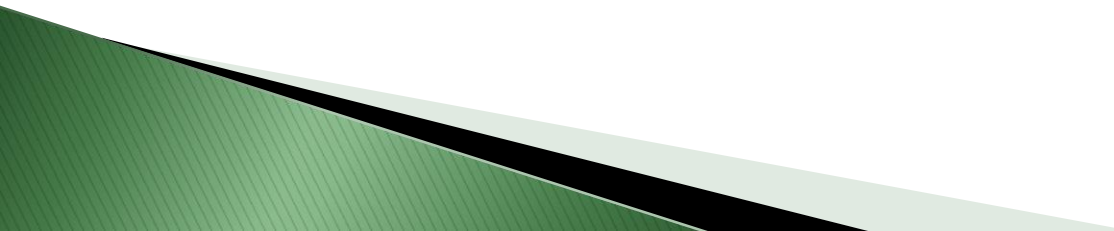
LA STRUTTURA DEL GRUPPO GRANLATTE (LUGLIO 2019)



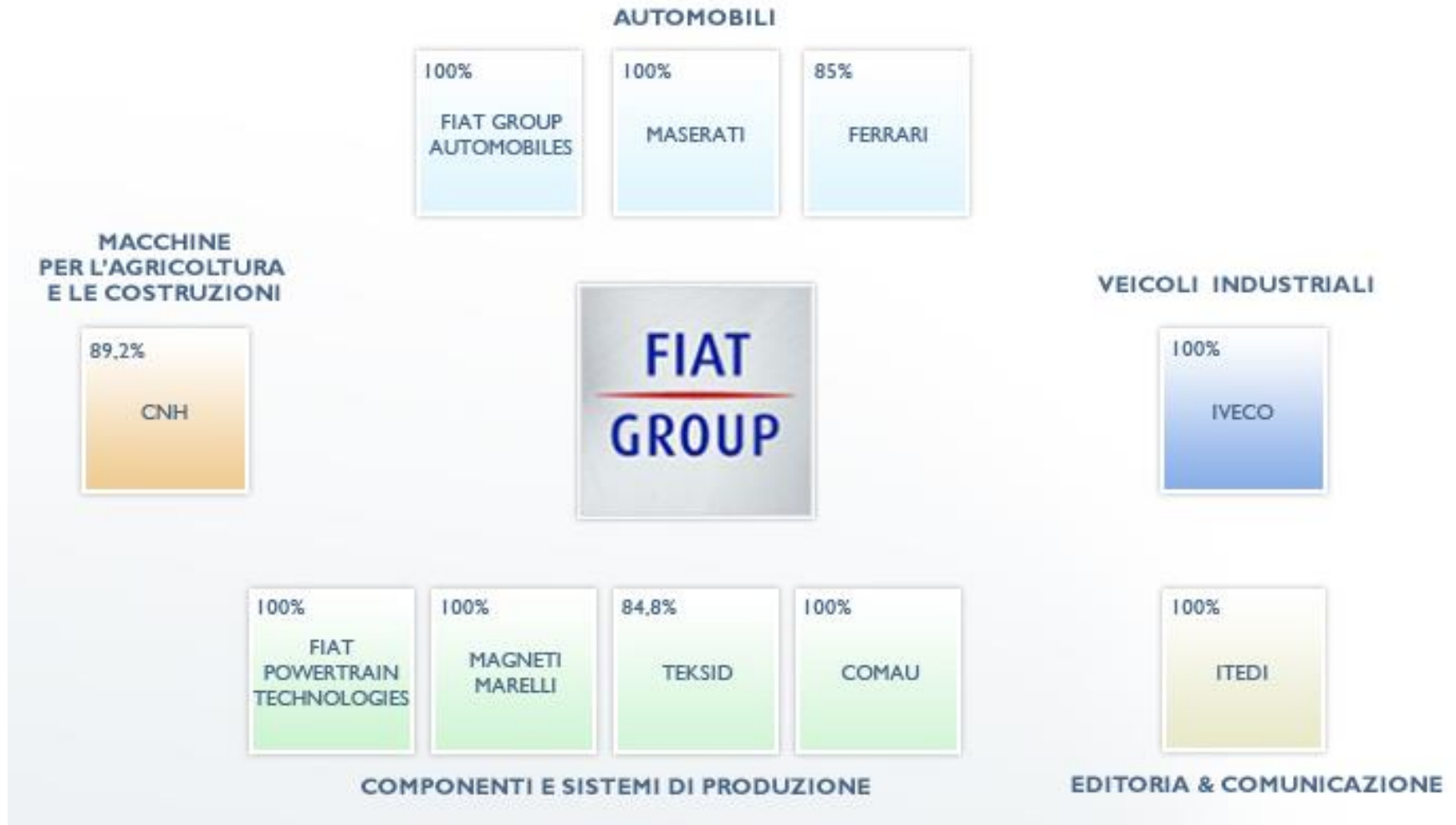
LA STRUTTURA DEL GRUPPO GRANLATTE al 31/12/2016



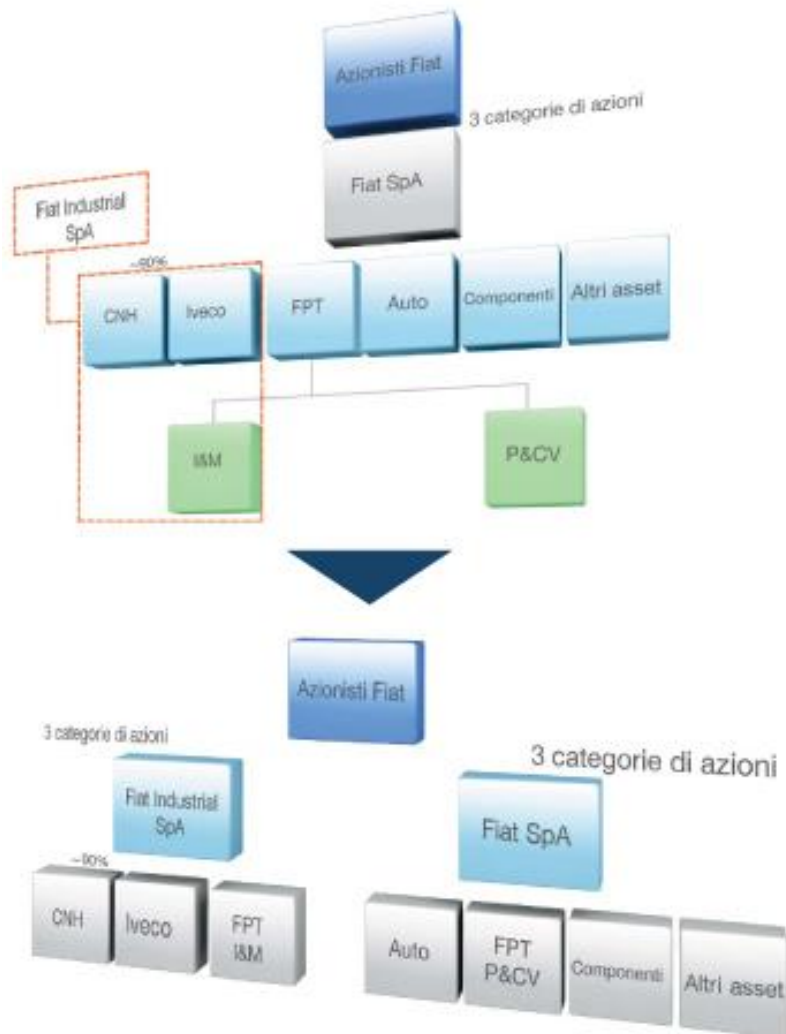
Holding company: advantages

1. Results are easy to **control**: every subsidiary has its own independent accounting.
 2. Different **risk** allocation.
 3. **Cooperation** among firms with different competences of different financial capacity.
 4. **Easy removal** of non satisfactory components.
- 

Ex. The Fiat group (2009)



Ex. The Fiat group. 2010 – 2014 demerger plan



“Questa scelta risponde a una logica di crescita, autonomia ed efficienza. Con la nuova struttura, i due gruppi avranno la libertà di perseguire le migliori scelte strategiche, incluse potenziali alleanze. Avranno completa autonomia di movimento e un profilo operativo ben definito, che consentirà loro di creare valore e perseguire al meglio il proprio sviluppo.

In particolare, Fiat, il business delle automobili, avrà la necessaria flessibilità per perseguire ulteriori opportunità di crescita. La partecipazione in Chrysler acquisirà un’ulteriore visibilità e farà scaturire sinergie con il Gruppo Auto. Fiat Industrial, invece, avrà la possibilità e il pieno diritto di meritare un ruolo come competitor globale nel business delle macchine industriali, potendo contare su una presenza stabile e su base mondiale.

(fonte: sito FIAT, novembre 2010).

Ex. The Fiat group (Jan. 2012)



Ex. The Fiat group (Dec. 2012)



Ex. The Fiat group (Sep. 2014)

Marchi Generalisti

100%

Fiat Group
Automobiles¹

Chrysler
Group LLC

100%



Marchi di lusso e sportivi

100%

Maserati

Ferrari

90%



CHRYSLER

Componenti e sistemi di produzione

100%

Magneti
Marelli

100%

Comau

Teksid

84,8%

Altri²

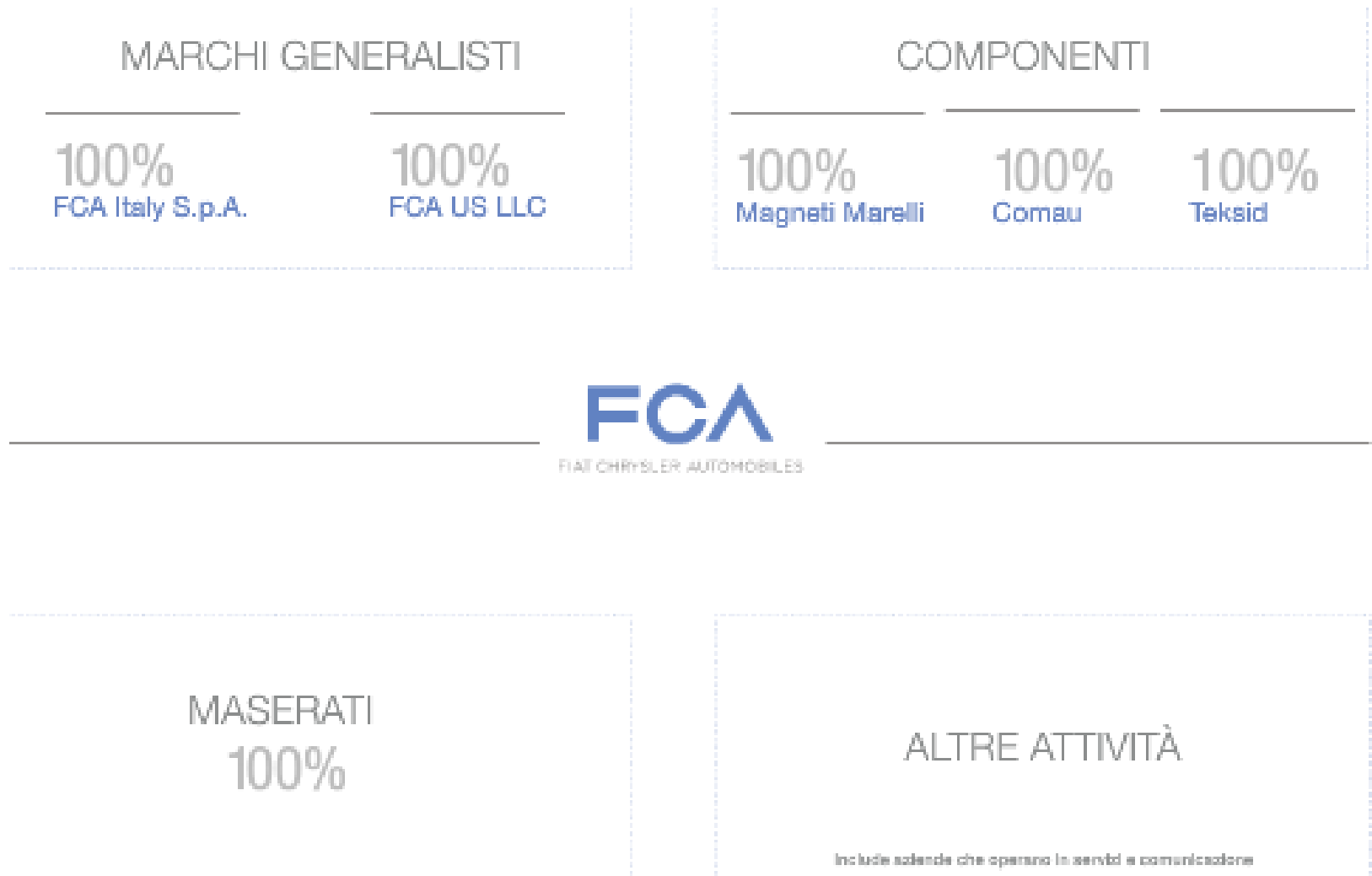
¹ Da gennaio 2013 Fiat Powertrain è stata inclusa in FGA

² Include aziende che operano in pubblicità, comunicazione e servizi

Ex. The Fiat group (Jan. 2015)



Ex. The Fiat group (Nov. 2016)



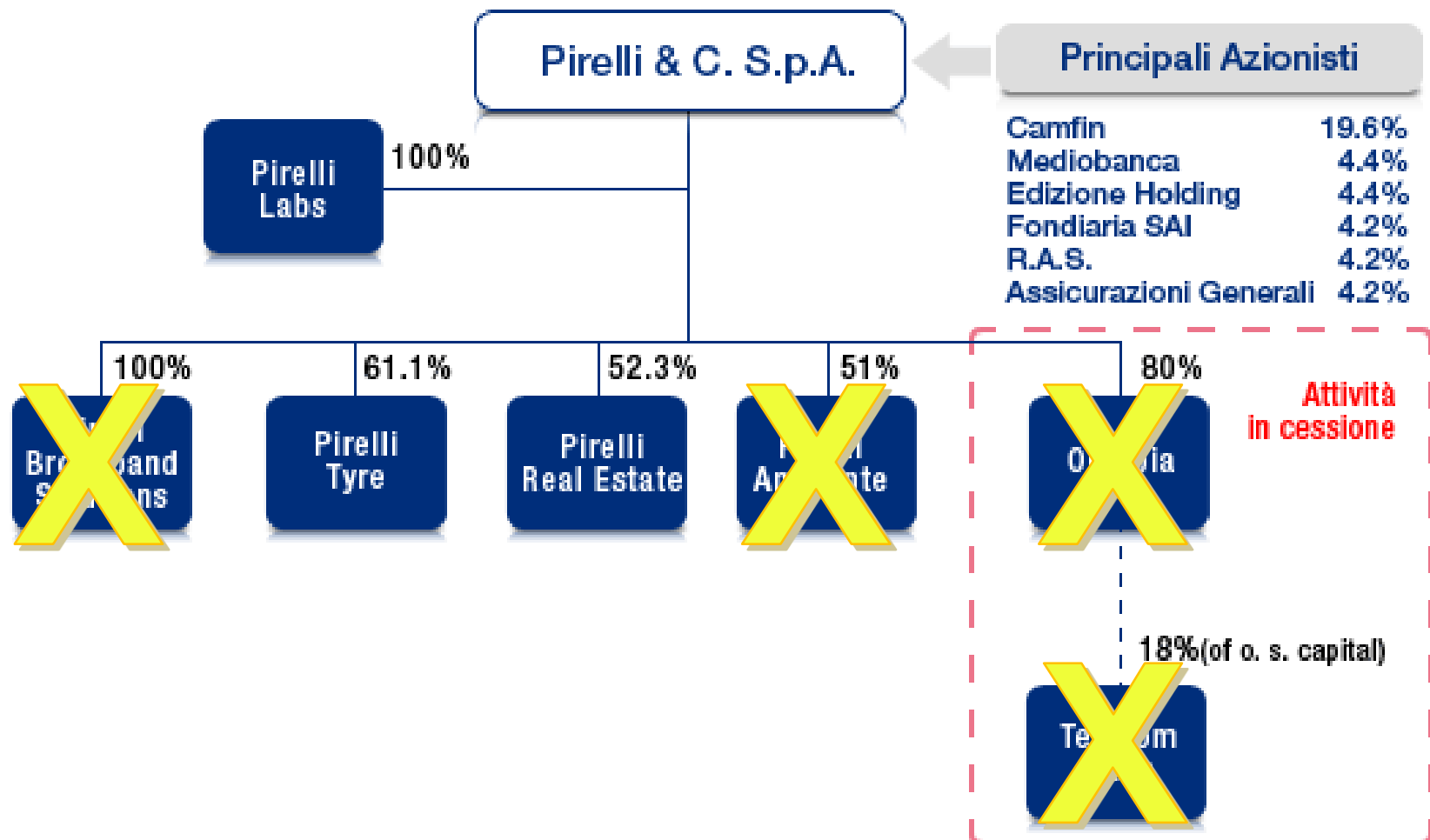
Ex. The Fiat group: Fiat industrial



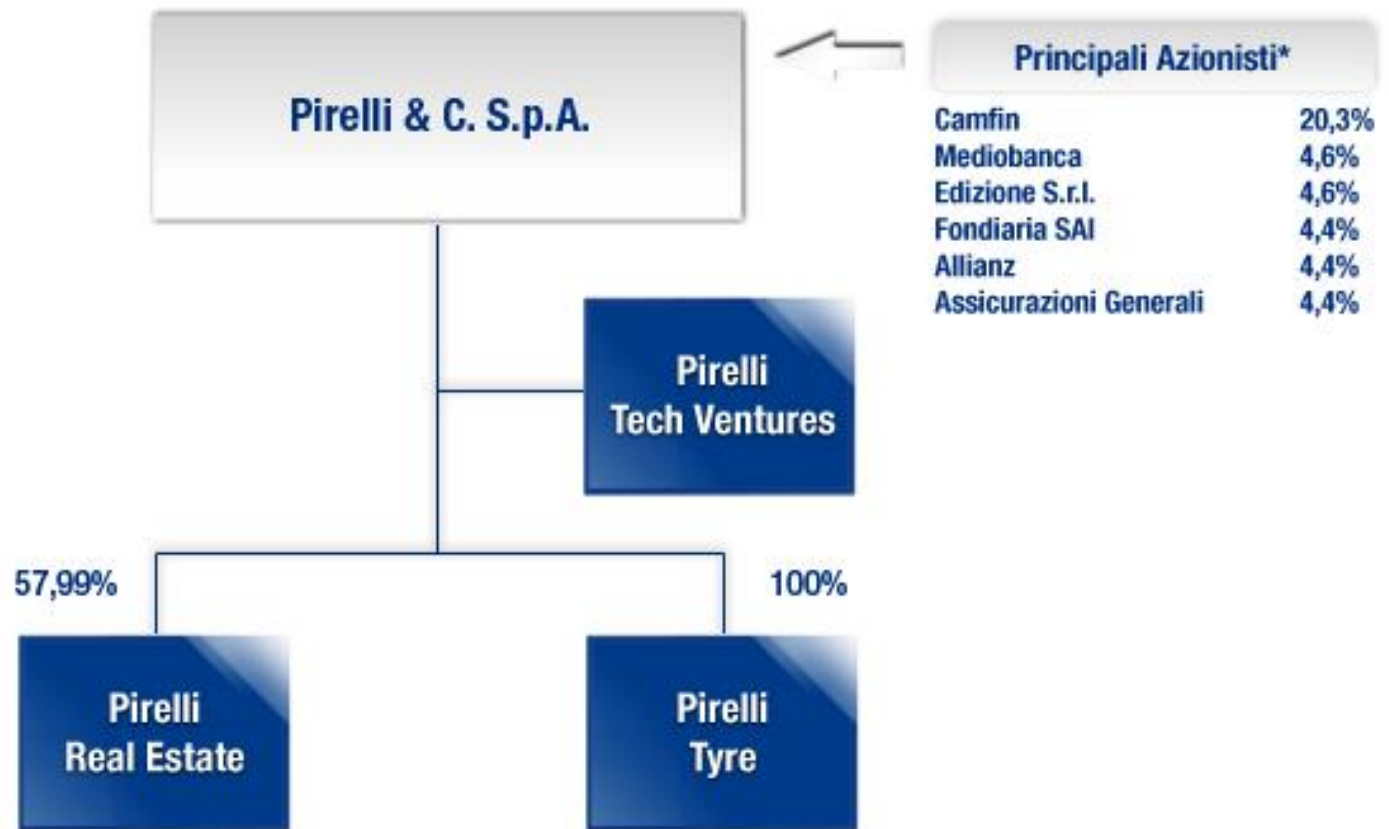
December 2012

In 2013 merger with CNH global (New Holland)

Ex. Pirelli group (2008)

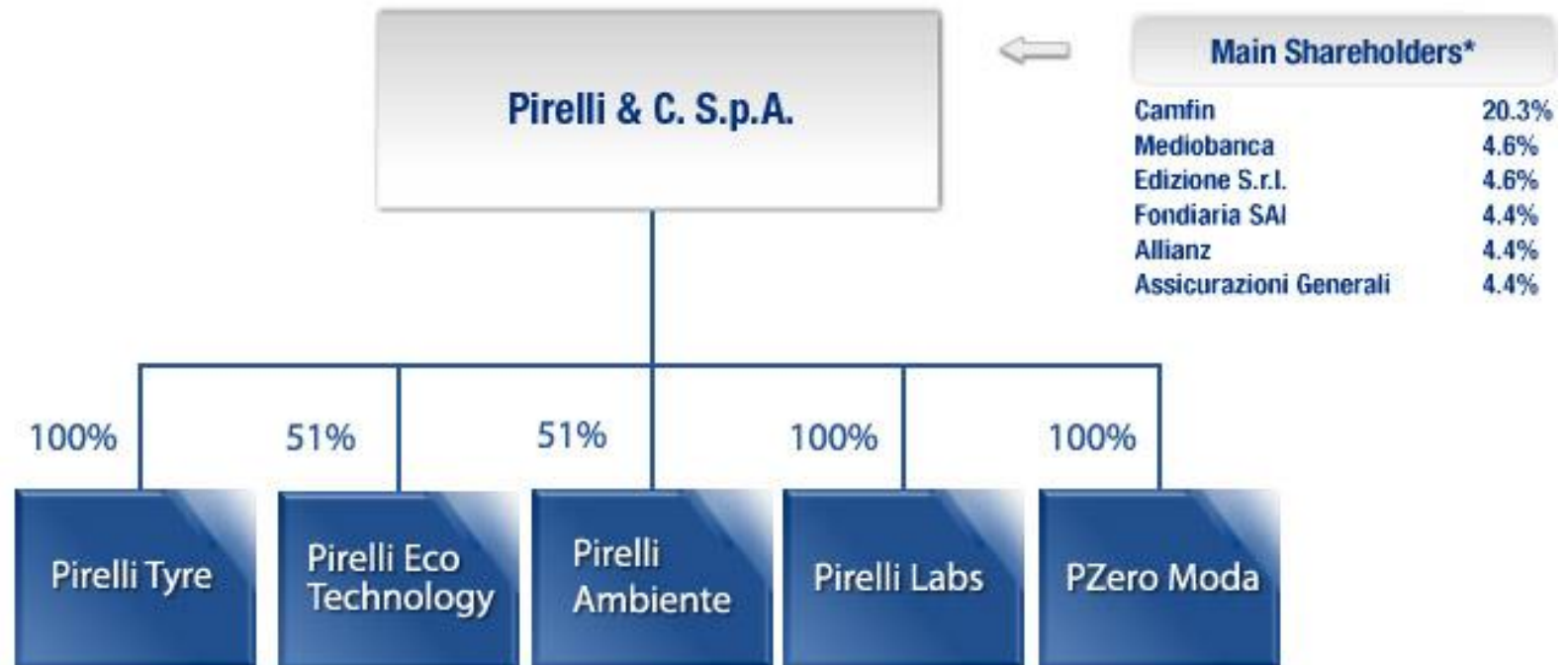


Ex. Pirelli group (July 2009)

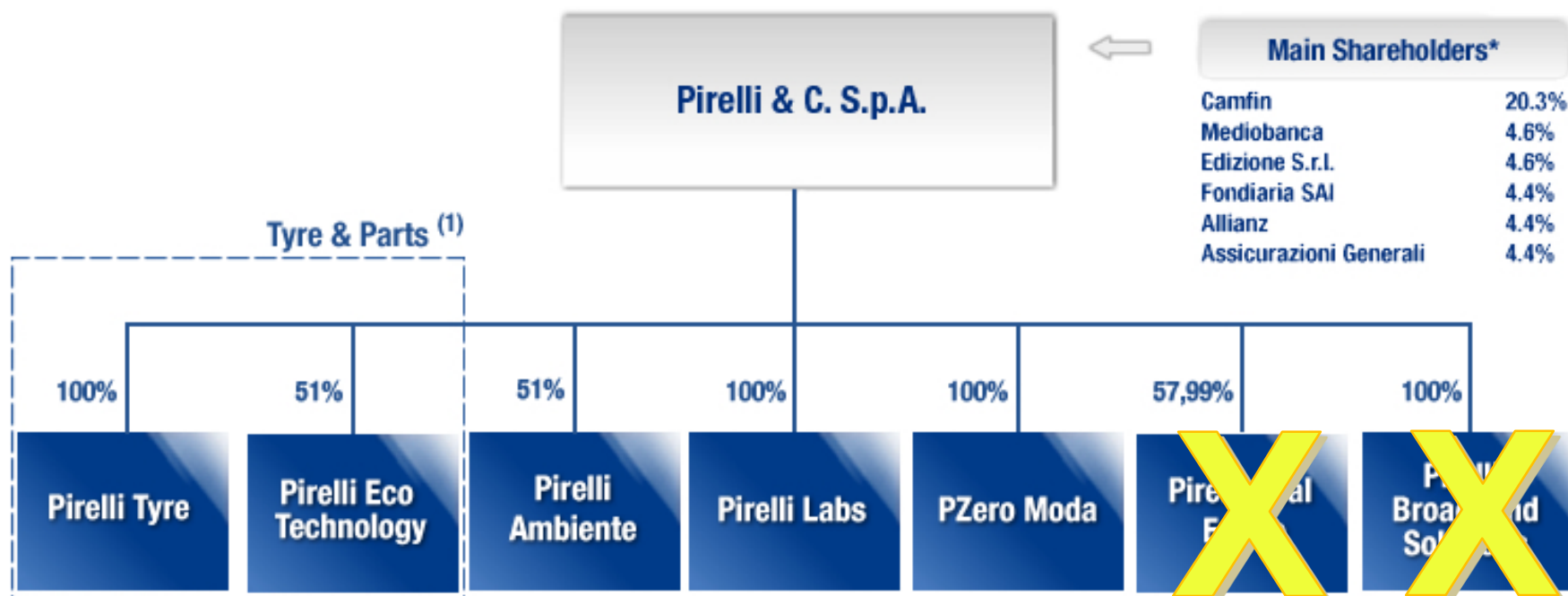


Al 22 luglio 2009

Ex. Pirelli group (March 2011)



Ex. Pirelli group (Nov. 2010)

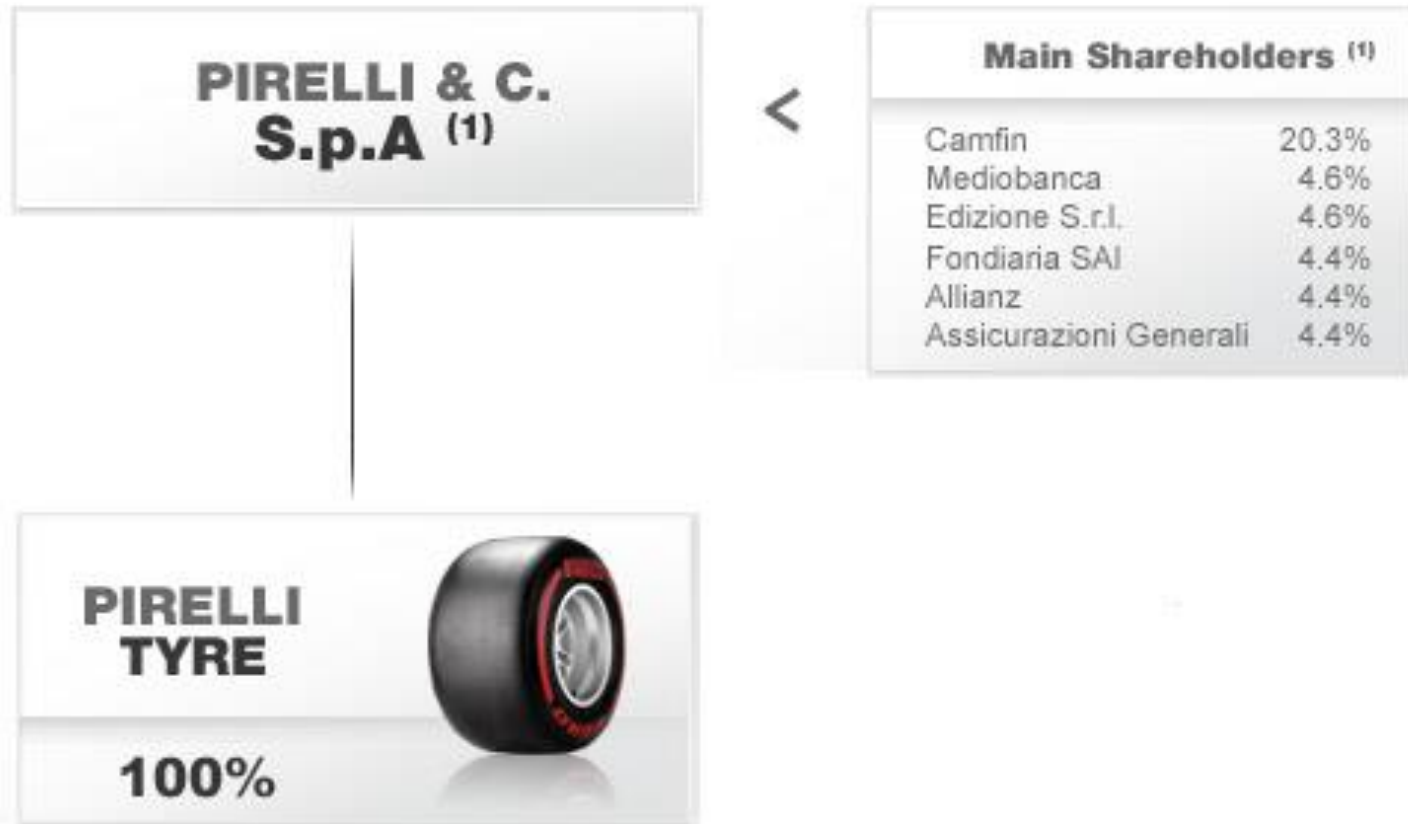


(1) Pirelli Tyre e Pirelli Eco Technology, a seguito della nuova organizzazione annunciata il 16 settembre 2009, sono raggruppate nella nuova Direzione Generale "Tyre & Parts"

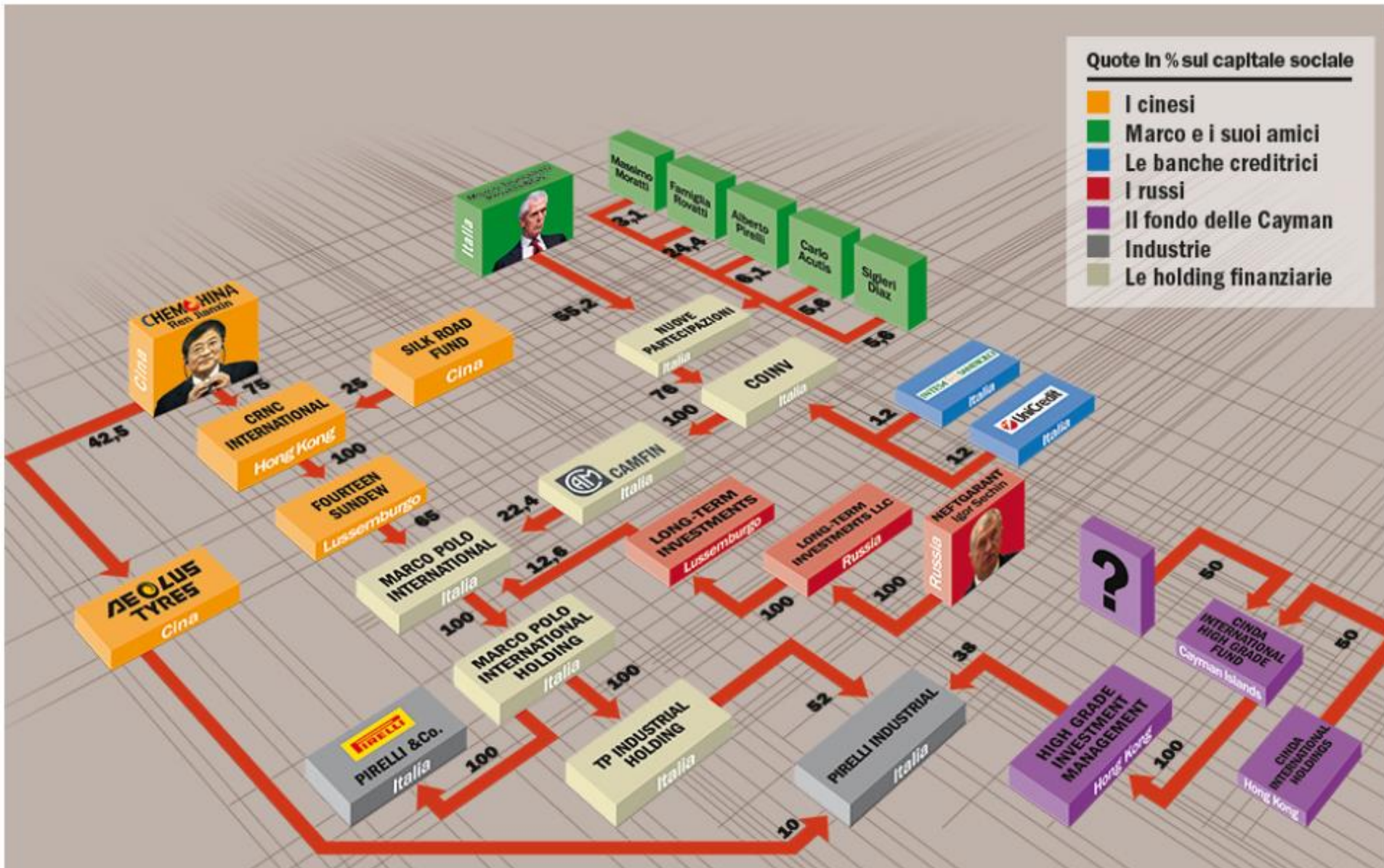
Ex. Pirelli group (January 2012)



Ex. Pirelli group (December 2012)



Ex. Pirelli group (2017)



Source: L'Espresso, 17th April 2017

Ex. Virgin group

Viaggi



Lifestyle



Media & Mobile



Servizi finanziari



Gente e pianeta



Musica



Virgin group and failures





Kukident



PANTENE
PRO-V

*Masini
Lindo*



Gillette



CAMAY



IAMS
Una vita di benessere



Eukanuba



BRAUN



Oral-B



TAMPAX

AZ



Pampers

P&G: Organisation structure 2014



We have made P&G's organization structure an important part of our capability to grow. It combines global scale benefits with a local focus to win with consumers and retail customers in each country where P&G products are sold.

P&G: 2019 organization structure

Le GBU sono responsabili per lo sviluppo della strategia generale della marca, dei nuovi aggiornamenti e innovazioni prodotto, e dei piani di marketing. Le nostre 10 categorie comprendono la Cura del bambino, la Cura dei tessuti, la Cura della donna, Rasatura, la Cura dei capelli, la Cura della casa, la Cura della salute personale e la Cura della pelle.



Summary

- ▶ Critiques to NT
- ▶ Alternatives to NT:
 - Schumpeter
 - Austrian School
 - Managerial theories
 - Behavioural theories
- Transaction costs and agent theory
- Firm's structure (functional, multidivisional, matrix, holding)

Reading list

- Chapter 4–5, Lipczynski et al., 2013