LECTURE 12.1

THE FIRM AS A VERTICAL CHAIN

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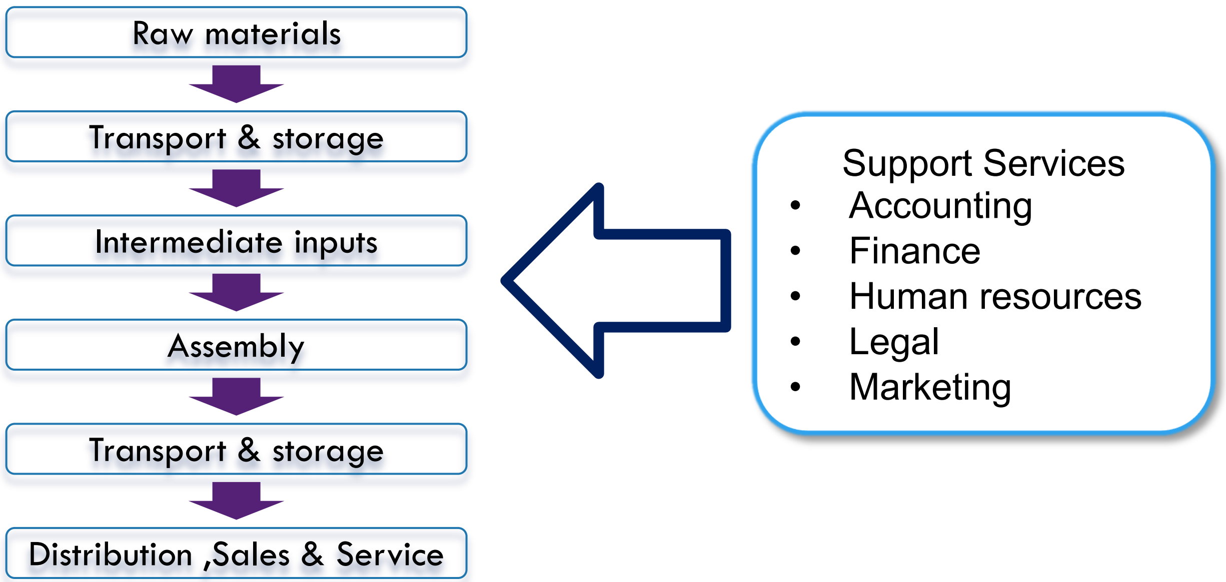
You can think about a firm as a ‘vertical chain’. A vertically integrated firm performs more than one successive stage of production.

Note that the example used in the textbook refers to computers, but approach obviously applies more generally.. For e.g., furniture manufacturers that could own the forests and retail stores…



THE FIRM AS A VERTICAL CHAIN

Terminology:

- upstream: occurs earlier in the production chain
- downstream: occurs later in the production chain
- vertical integration: combining successive steps in the production chain within the firm
- downstream integration: the firm performs additional downstream tasks in house
- upstream integration: the firm performs additional upstream tasks in house

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A key question for the firm is: What to do in house versus what to outsource?

The vertical boundaries of the firm define the activities that the firm itself performs as opposed to what it purchases from independent firms in the marketplace.

There is a trade-off between technical efficiency (cost minimisation) and agency efficiency (minimisation of coordination costs etc)

- Perhaps technical efficiency is best achieved by buying on the market. Alternatively, can agency costs be minimised when activities are done in house?

Optimal vertical organization requires that the sum of technical inefficiencies and agency inefficiencies are minimized.

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Apple and many others are examples of firms that do much outsourcing. Nike and Reebok do little or no production itself. The typical US manufacturer outsources 70-80 percent of its finished product.

Why might this be important?

- Decision rights: outsourcing reassigns decisions rights concerning assets and employees across firms.
- Compensation and performance evaluation: Compensation levels are one reason much outsourcing occurs.

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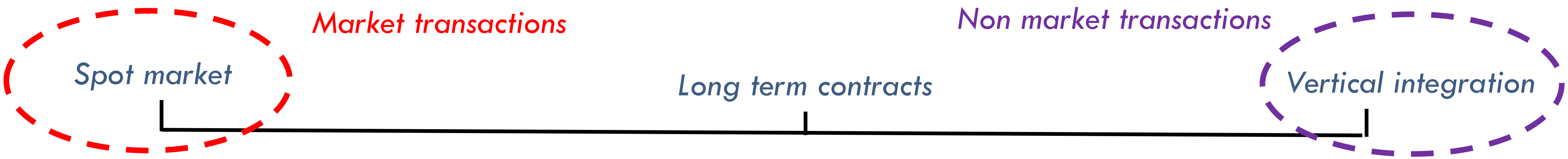
The choice of whether to do something in-house versus outsourcing is not a binary choice. There is a spectrum of choices available to firm:



Long term contracts themselves can take on a variety of forms:

- Standard supply and distribution contracts.
- Joint ventures.
- Lease contracts.
- Franchise agreements
- Strategic alliances.