

# **How the Internet Redefines Organizational Boundaries: A transaction Cost Analysis**

# Introduction

- ▶ In the previous chapters, comprehensive evidence was presented to illustrate some changing in the business environment.
- ▶ The changing is leading to the emergence of all rules that are different from current tested rules of the industrial economy.
- ▶ If the rules of the game are changing, all players in the game include private and public sector organizations - need to re-evaluate and transformation of their strategies, business models, and organizational designs.

# Introduction

- ▶ The changing will lead to existing organization will not survive, while new and different ones will emerge.
- ▶ One question is raised which is they have been led to accept the changing in new business environment that required to develop organizations.
- ▶ Therefore, the organizations have to adopt strategic and organizational innovations by exploiting the new capabilities from ICTs.
- ▶ However, it remains unclear how the internet could or should, have such effects on business strategies and organizational designs.

# Transaction Cost Economics

- ▶ To answer this question, this chapter will present the **theory of the economics transaction cost** to illustrate the **relationships** between the Internet and changes in industrial structures and organizational boundaries.
- ▶ In economics and related disciplines, a transaction cost is the price should be paid as extra on the top of service such as the commission in stock market that is paid to the brokers.
- ▶ What is the transaction cost for purchase something online (**Share your information**)

# The Internet and Changing Organizational Boundaries: A Revolution in Interaction

- ▶ Minimizing costs is one important principle that most **(if not all)** organizations need to do it. It is useful to examine the appropriateness of organizational designs from the cost and efficiency perspective.
- ▶ To make clear boundary between the organization and their market, so the costs to an organization can be divided into two main categories:
  - ▶ Transaction costs of arranging and coordinating exchanges.
  - ▶ Transformation costs of production and delivery.

# A Revolution in Interaction

- ▶ Generally, transaction costs can be lower inside the organizations, **because** the organization could use administrative tool that use to minimize and eliminate some of their associated costs with the transaction.
- ▶ One of the main reasons is scale economy, where the suppliers can get more cheaply through **bulk** purchase and they have more expertise in specific field or service. For Example, car manufacturing and tiers

# A Revolution in Interaction

- ▶ Transaction cost can be calculated by comparing the total cost of transaction and transformation within its boundary for a component or service, with the total costs of the transaction and transformation by the same component or service from outside its boundary

# A Revolution in Interaction

- ▶ If the component or service can be managed internally, then the associated activities should be part of the organization's hierarchy and they should be managed within its boundary. And vice versa
- ▶ The structure of the organization and industry at a given time is designed to minimize the total costs of transformation and transaction, which sets the boundary between the organization and its market.



# Changing cost structure of industries

- ▶ According to Moore's and Gilder's laws, When the costs of computing and telecommunications decrease and the capacity increases. This development is leading to :
  - ▶ Revolution in our society and economy.
  - ▶ Deep implications for organizational designs and industrial structures, consumer behavior, an organization's strategies and business models.
- ▶ The methods that can be effected is communications channels such as phone calls, problem-solving sessions, reports, and memos. To make the enabling the exchange of goods, services and ideas.

# Changing cost structure of industries

- ▶ Interactions are not free, and in fact they are very expensive.
- ▶ At the economy level,
  - ▶ the McKinsey study found that in the USA. interactions represent 51% of all labor activities.
  - ▶ Even in developing countries, the figure is still as much as 36% of all labor activities.
- ▶ At an industry level,
  - ▶ interactions account for over 50% of all labor activities in services and over 30% in mining, agriculture and manufacturing.

# Changing cost structure of industries

- ▶ At the firm level,
  - ▶ interactions make up a large part of an individual firm's activities (58 per cent in the USA)
- ▶ at the individual level,
  - ▶ managers and supervisors spend over 80% of their time in interactions.
- ▶ Many of the associated with interactions can be classified under transaction costs, as opposed to transformation or production costs.

# Changing cost structure of industries

- ▶ Interaction costs are lower when production occurs within the boundary of the organization, while transformation costs are lower for specialist outside suppliers.
- ▶ The decision to make or to buy a particular component or service depends on the total cost of transformation and interaction associated to it.
- ▶ Moore's and Gilder's predicted that with the rapid development of the technologies, the capacity to interact would increase significantly, the cost associated with interactions will decrease dramatically.

# Changing cost structure of industries

- ▶ Reducing the transaction costs in many activities mean that the cost structures of industries and organizations are being refined, significantly which can be used this cost in **transformation costs**.
- ▶ This gives rise to emerge integrated business model, leading to the emergence of virtual organizations in a wide range of industry

# Changing cost structure of industries

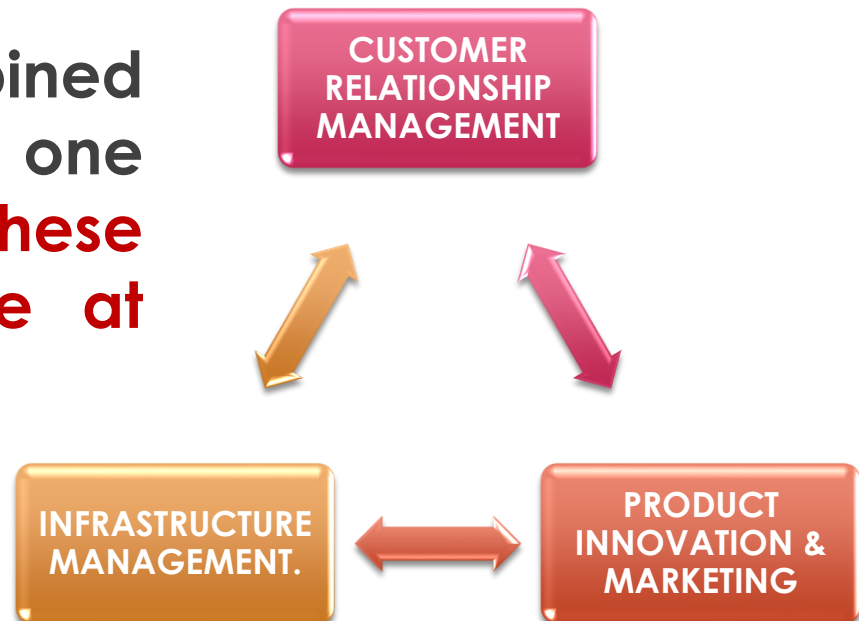
- ▶ The implication of the revolution in interaction goes far beyond organizational boundaries and industrial structures. Customers' behavior will also change
- ▶ The more they search the market the more likely they will be to locate a supplier that could provide the product of the same quality at lower costs

# Deconstruction of the Integrated Business Model

- ▶ The changing cost structure of organizations and industries has put pressure on organizations to focus on their core competences and outsource quality to stay in the market.
- ▶ This has resulted in the integrated business model in many industries
- ▶ For most organizations, their activities can be classified into the following three categories each illustrating the nature of activities they actually do:
  - ▶ Customer relationship management
  - ▶ Product innovation and marketing
  - ▶ Infrastructure management.

# Deconstruction of the Integrated Business Model

- ▶ These activities have very different features and require different styles of organization and management.
- ▶ When they are combined together in one organization, **none of these activities can operate at the optimum level.**





# Deconstruction of the Integrated Business Model

- ▶ **The customer relation management** is scope - i.e. each customer should be treated as an individual and the offering the organization provides should match the requirements of the customer as far as possible.
- ▶ **The product innovation and marketing** is focused on innovate fast and get the innovations to market as quickly as possible.
- ▶ **Infrastructure management**, the key word is scale - full utilization of capacity and increase throughout as far as possible.

# Deconstruction of the Integrated Business Model

- ▶ With the rapid development of computing and telecommunications interaction costs have been reduced significantly both within and between organizations. Organizations are increasingly to:
  - ▶ Reassessing the situation to determine if this still the most efficient business model
  - ▶ Many organizations are increasingly outsourcing strategic activities from specialist suppliers, such as the whole or part of the IT, accounting, or human resource functions. known as strategic outsourcing.

# Virtual Vs Vertically Integrated Organization

- ▶ Several unrelated things are named as virtual organizations. Virtual organization share its resources to achieve a common goal.
- ▶ In vertically integrated organizations, all partners produce different products/services and products can be combined to produce common need.

# When is Virtual Virtuous?

- ▶ **Cost, is only one of the factors that organizations consider when making strategic decisions on organizational boundaries and strategic focuses**
- ▶ **The success of virtual organizations requires all partners to work towards a common goal, but it is not uncommon for each party to act in own self-interest at the expense of others.**

# When is Virtual Virtuous? Vertically integrated design vs. virtual organization

- ▶ It is very important to be clear about the circumstances under which the virtual organization is more suitable than vertical integration, and vice versa
- ▶ one important factor to consider is the nature of the activities. **There are two kinds of innovation.**
  - ▶ For independent innovations that can be pursued independently and supplied to multiple buyers.
  - ▶ For systemic innovations where benefits depend on related innovations in different areas.

# General Implications ... Summary

- ▶ In this chapter, the links between the development of Internet and related technologies and changes in organizational boundaries and industrial structures were examined
- ▶ From the perspective of transaction cost economics, this chapter illustrated the changing cost structure in many industries as a result of the ongoing revolution in interactions associated with the rapid development of the Internet.

# General Implications ... Summary

- ▶ The implications are very profound. All organizations need to
  - ▶ Consider alternative configurations of their structures and boundaries, explore new business models, new organizational designs and new inter-organizational relations.
  - ▶ They should also take into account changes in customer behaviors with the collapsing of interaction and information searching costs and the growing transparency of the market.
- ▶ The transaction cost analysis revealed the cost pressure on all organizations to contact with outsource an increasing range of activities, and to unbundle their core activities.

# General Implications ... Summary

- ▶ However, it should also be noted that cost is only one of many factors an organization should consider when making strategic decisions, and there are circumstances when:
- ▶ Outsourcing is exactly the **wrong option** even though such new business models and organizational designs could lead to reduced costs in many organizations and industries,
- ▶ The changing business environment (rapid development and proliferation of ICTs in general and internet and related technologies in particular) requires all organizations to re-evaluate their strategies, business models and organizational designs, amongst many other issues.