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Subir Gokarn: The value of organisation

Oliver Williamson's work has great relevance for many contemporary Indian issues

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Adam Smith is best known for his characterisation of the market economy as an “invisible hand”. Buyers and sellers, each acting in their own interest, lead to a collectively superior outcome in terms of the efficiency of resource utilisation. The efficiency gains that the invisible hand generated were a primary contributor to the “wealth of nations”. But, a very important complement to his description of the market is his famous description of the pin factory, in which he highlights the role of combining specialised resources within a single establishment in enhancing productivity. Putting the two together gives us the perspective that aggregate productivity is highest when the economy finds the right balance between activities that are carried out within specific organisational boundaries and those that are transacted through markets.

The distinct characteristics of these two alternative modes of resource allocation and their relative superiority in different contexts was the topic of Oliver Williamson’s 1975 book Markets and Hierarchies, one of the highlights of a body of work that won him the Nobel Prize for Economics in 2009. Smith’s insights into the working of markets became by far his dominant legacy; for two centuries, the theoretical evolution of economics was far more driven by understanding what went on between firms rather than within them. There were exceptions, of course, Ronald Coase (Nobel 1991), being a prominent one. But, Prof. Williamson was the first to characterise markets and hierarchies/organisations as distinct mechanisms of resource allocation and identify specific conditions under which one worked better than the other.

These conditions were broadly related to the nature of the assets involved. Simply put, if a buyer/user of a particular good or service was able to procure it with reasonable quality, price and convenience from any of several suppliers, this would be an ideal situation for a market transaction. There would be little benefit to the buyer from internalising the capacity to produce that good. For example, if you live in a neighbourhood with lots of decent restaurants who deliver, there is little incentive to hire anybody to cook for you.

By contrast, complicated requirements both reduce the number of potential suppliers and entail specific investments by them. Therefore the incentive changes. For example, suppose you have unusual dietary requirements, which the typical neighbourhood restaurant doesn't provide for. You would be better off hiring someone who can procure the ingredients and cook for you. In Prof. Williamson’s framework, the concept of “asset specificity” was critical to determining the relative efficiency of markets vs. hierarchies. The more specific the requirements and the assets needed to satisfy them, the more benefits there were from internalising the transaction within the boundaries of an organisation.

Of course, while such internalisation had the potential to enhance efficiency, there was no guarantee that company managements knew exactly where to draw the line. In fact, using this approach to analyse the performance and survival of companies provides insights into appropriate strategies for both organic and inorganic growth. Growth should focus on the creation or acquisition of resources and capacities that are “specific” in the way described above.

Further, Prof. Williamson also emphasised that the motivations of senior management would also be critical in determining the benefits of internalising transactions. The authority to allocate and monitor resources that managers were given by shareholders could be used in ways that were detrimental to their interests. This concern links up directly to the issue of effective corporate governance. In fact, the prize citation for both Prof.

Williamson and the other laureate, Elinor Ostrom, mentions their contributions to our understanding of governance.

Three issues in the current Indian context can be fruitfully viewed from a Williamsonian perspective. First, the whole outsourcing model represents a re-drawing of organisational boundaries to externalise certain transactions as the capacity to provide these services became more easily available and relatively simple contracts could ensure their provision. The development of this activity in its current form suggests that companies around the world are always looking for opportunities to re-structure their organisations to find the right balance between internal and external transactions — in fact, their performance, even survival depends on this.

From the Indian perspective, this has both macro and micro implications. At the national level, the creation of generic capacities — from software development to English language skills — shifted the balance from hierarchies to markets as far as global clients were concerned. But, from the perspective of individual service providers, the generic nature of the skills required is a threat. Faced with inadequate delivery, a client will lose no time in shifting his business to another provider, because switching costs are negligible. Survival and growth are going to depend on the ability of the provider to make the right investments in "specific" assets, which tangibly enhance the value proposition to the client and increase his switching costs.

The second is the ongoing debate on CEO compensation. In ideal circumstances, the value of a CEO lies in his ability to get the best of the firm's resources — by constantly striving for the right balance between internal and external transactions. In this sense, the CEO is also a "specific" asset, in the sense that he has been selected for his ability to achieve that objective. The shareholders who selected him for the job are, therefore, best placed to assess his value to the firm. Of course, they also have the incentive and the power to axe him if he doesn't deliver and they shouldn't shy away from using it.

The third one is the even more contentious issue of organising the 2010 Commonwealth Games. These involve a series of mutual explicit and implicit contractual obligations between four major stakeholders — the Organising Committee, the Commonwealth Games Federation, the Government of Delhi and the Government of India. Many of these are apparently proving difficult to fulfill. This is a situation in which at least some of those obligations need to be internalised within a single organisation, the head of which has the explicit authority to resolve conflicts. The stakeholder with the largest stake is the one that should define the boundaries of that organisation.

An ongoing internet survey being conducted on the Nobel Prize website, less than 50 per cent of respondents said they were aware of "governance" as a field of study in Economics. This year's awards should help to give it the prominence it deserves.

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