

# Do You Have an Efficient Organization?

Mikko Ketokivi, IE University

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If there are two alternative ways of doing something, why not choose the one that generates less waste?

Simple enough. Now try to apply it in a complex organization facing an uncertain future. Problems start with the fact that waste comes in many forms, some of which may be difficult to pinpoint. Delayed flights, expired Covid vaccines, and a high scrap rate in production are salient forms of waste, but how about the notion that communication, attention, and cognition can be wasted as well? Yes, sometimes the very act of having to think about something can be a form of waste.

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Economist Frank Knight famously equated avoidance of waste with *efficiency*. I am painfully aware of how dangerous the word is. When organizations seek efficiency, they downsize, they squeeze every penny out of their suppliers by aggressively renegotiating contracts, they make employees work more hours without additional pay, et cetera. This is efficiency, right?

Let me propose that these examples represent efficiency the same way undercooked poultry represents nutrition: hazardous. I will label ruthless cost-cutting *myopic efficiency*, which is not only distinct from but downright antithetical to *sustainable efficiency*, which is of interest here. Sustainable efficiency is about eliminating the excess, not the essential; nurturing cooperation, not jeopardizing it; mutual value creation, not unmitigated self-interest.

I am trying to think of examples of bullying providing a long-term solution to an efficiency problem but cannot come up with one. Can you?

Efficiency comes in many guises. In my collaboration with organization economist and strategy scholar Joe Mahoney (at the University of Illinois), we have cast a wide net to unearth and analyze different manifestations of efficiency in different organizational contexts.<sup>1</sup> The Table gives seven different examples of organizational efficiency and its drivers. In the following, I elaborate on two examples, one familiar and the other perhaps a little surprising: (1) vertical integration and (2) the legislature.

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About twenty years ago, I sat in an industry seminar with purchasing managers. One manager lamented the complexity of a problematic supplier relationship that kept him up at night. The contract with a parts supplier contained several hundred pages of legal and technical specifications that were beyond the ability of any one individual to comprehend in their entirety. I asked the manager whether the daily costs of enforcing the contract were considered jointly with the productivity benefits associated with outsourcing the parts instead of making them in-house, which is what the firm had done in the past.

The manager appeared puzzled, but really should not have been. Transaction costs are just as real and as relevant as production costs. The drafting and the daily

enforcement of a complex contract constitute a real cost that should be directly attributed to the transaction instead of being considered overhead. Also, not being able to sleep at night—what a waste!

This anecdote introduces my first example: vertical integration. Which components should the final assembler produce in-house, and which should it purchase from external suppliers? Should a firm have its own legal department to handle intellectual property issues, or should it contract with an external law firm? More generally, how should the organization approach the canonical “make-or-buy decision”?

How should the insomniac manager apply efficiency thinking in the make-or-buy decision of the component? The obvious part of the analysis is to compare the internal production costs to the price at which the external supplier would sell the part. This analysis should be comparatively straightforward. I have a creeping suspicion this was the criterion on which the outsourcing decision was originally made: The direct internal production cost was higher than the price the external vendor offered.

### Table: The Many Faces of Organizational Efficiency

(Adapted from Ketokivi and Mahoney.<sup>3</sup> Reprinted with permission from Oxford University Press)

Context	Efficiency criterion	Primary efficiency driver
(1) Vertical integration	Is the degree of vertical integration set such that the total cost of managing the buyer-supplier relationship (production costs + transaction costs) is minimized?	Productivity and coordination
(2) Franchising	Do the franchisor and the franchisee have the proper incentives to create value through the operations each manages and controls? Is free riding discouraged?	Incentive alignment within and across organizations
(3) Corporate diversification	Do the individual business units create collectively more value when they are divisions of the same corporation, as opposed to operating as separate businesses, or is there a <i>diversification discount</i> ?	Economies of scope within the organization
(4) Corporate governance	Does the composition of the corporation’s board of directors secure the long-term cooperation of the corporation’s most important stakeholders?	Cooperation among the organization’s stakeholders
(5) R&D collaboration	To manage uncertain inter-firm collaboration, is a joint-equity alliance (where a board of directors exercises oversight over collaboration) a more flexible governance mode than collaborative contracting?	The ability to address unanticipated developments in inter-firm cooperation
(6) Corporate finance	Is the mix of debt and equity financing set such that it minimizes the cost of capital?	Cost of capital
(7) Legislature	Do members of Congress, individually and collectively, serve the interests of their constituencies?	Alignment of legislative work with constituency interests

The more elusive part is the cost of contracting. If the parts are standardized and alternate suppliers are available, then purchasing the parts would amount to little more than “ordering them from a catalog.” For example, it should not come as a surprise that car manufacturers do not make tires. Tire sizes are standardized, and specialized tire companies such as Bridgestone and Continental produce tires for all automakers. Due to massive economies of scale and economies of specialization, they are far more efficient in developing and producing tires than individual automakers would be. Since contracting costs are negligible, the efficiency logic suggests buying tires from specialized manufacturers instead of making them in-house.

The issue becomes more complicated for customer-specific parts that require make-and-model-specific engineering. Parts are no longer simply picked from a catalog, but instead, designed, redesigned, and exchanged in collaborative long-term relationships. Car seats, and entire car interiors, are a good example. These relationships include all kinds of sunk costs and relation-specific investments, which are usually comparatively easier to manage if the buyer and the supplier are divisions of the same firm. Internal disputes are always alleviated by the fact that they are subject to corporate intervention. But if the transacting parties are separate firms, such intervention is not possible. Further, in the case of internal transactions, there is also a strong incentive to address problems through internal organization, because litigation is not an option—courts do not hear or settle internal disputes.

A comparative analysis that incorporates transaction costs may, or may not, change the conclusion one would draw based on a comparison of production costs only. But we will not know until we do the math. At any rate, I do not find it surprising that many outsourcing decisions do not lead to the kinds of cost savings envisioned. Not incorporating transaction costs may have something to do with it.

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Let me now turn to a more elusive example. In their insightful economic analysis of the legislature, Barry Weingast and William Marshall<sup>2</sup> noted that the United States Congress was organized in a seemingly efficient way.

What does efficiency mean in the context of the legislature? It is useful to start by observing that lawmakers indeed have considerable incentives to exchange support with one another. Indeed, legislators often actively seek “trading partners” to further the interests of their own constituencies.

Note that the question is not whether the legislature makes smart decisions and passes high-quality laws, but rather, whether legislators, individually and collectively, succeed in introducing legislation that serves their constituencies. The question is not one of the quality of the decisions, but rather, the alignment of legislative work with the interests of the electorate.

The exchange of votes runs into severe problems in daily legislative practice. The issues of interest of two “trading partners” do not come up for a vote simultaneously, and therefore, packaging bills into a single “market exchange” is infeasible: When trading is non-simultaneous, how can the legislator who is to deliver first trust that the other will deliver later? Opportunism aside, what if an unforeseen circumstance (e.g., failure to get re-elected) led to a situation where the other party was simply unable to fulfill its side of the bargain? The simple market form of exchange becomes inefficient due to problems with enforceability.

A better alternative? The ubiquitous committee system found in legislatures around the world. The committee system provides protection against the uncertainties associated with market exchange. In many ways, the legislature functions more like a firm than a market. Just like the R&D department of an industrial firm focuses on product and service development tasks and the sales and marketing departments on revenue creation, U.S. House Committee on Energy & Commerce controls the agendas within its jurisdiction as it decides which bills to bring to the House floor for a vote.

The non-obvious function of the committee system is to introduce stability that enables comparatively more efficient legislative bargaining. While by no means perfect (no governance alternative is), it can be argued to be more efficient than simple market exchange, because the non-simultaneity problem is addressed.

I bet you never thought of the legislature in this way. Yet, from an efficient-bargaining point of view, perhaps automobile supply chains and legislatures are not all that different.

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What ultimately drives efficiency in organizations? As the Table suggests, it depends. There are likely multiple drivers in all situations, but one driver may dominate. For example, in the vertical integration case, efficiency is a function of productivity (e.g., economies of scale and economies of specialization) and coordination costs. In contexts such as franchising, the main driver may be the alignment of incentives, and in the case of corporate finance, the cost of capital. Just like efficiency comes in many guises, so do its drivers. The common denominator of all drivers is that they work toward eliminating waste in all its forms.

Obviously, coordination and negotiation are always necessary. The problem is that if you find yourself spending disproportionate amounts of time on coordination (at the expense of getting the work done), or if you find that no amount of negotiation aligns stakeholder interests in a way that secures cooperation, you have an inefficient organization.

This is all about matters of degree: Identifying the excessive and the disproportionate is central. To this end, organization economist and Nobel Laureate Oliver Williamson consistently encouraged organization designers to consider issues in their entirety. This analysis calls for incorporating all aspects of efficiency—not just the familiar, readily measurable parts—into the decision. This fosters sustainable efficiency, which should stand at the foundation of all organizations seeking long-term viability. Efficiency remains elusive and challenging, but smart minds always find ways to improve.

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<sup>1</sup> Mikko Ketokivi and Joseph Mahoney's forthcoming book *Efficient Organization: A Governance Approach* (Oxford University Press) dives deeper into the topics, ideas, and practical implications of this essay.

<https://global.oup.com/academic/product/efficient-organization-9780197610299>

<sup>2</sup> Barry Weingast and William Marshall, 1988. The industrial organization of Congress; or, why legislatures, like firms, are not organized as markets. *Journal of Political Economy*, vol. 96, pp. 132-163.

<https://doi.org/10.1086/261528>

<sup>3</sup> Mikko Ketokivi and Joseph T. Mahoney, 2017. Transaction cost economics as a theory of the firm, management, and governance. In R.J. Aldag (Ed.), *Oxford Research Encyclopedia of Business and Management*. Oxford: Oxford University Press.

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