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HYBRID ORGANIZATIONS

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Hybrid organisations

Claude Ménard

There are many ways to organise transactions in a modern market economy. Beside the polar cases of spot markets on the one hand, in which trading activities are coordinated through the price mechanism, and integrated firms on the other hand, in which the allocation of resources and the coordination of decisions depend in last resort on a hierarchical structure, many different types of arrangements have developed, from long term bilateral contracts to franchise systems and networks of tightly interwoven firms. These non-standard forms likely represent the usual way of doing business, although they deviate from the usual representation of microeconomic textbooks in which there are firms, i.e., 'producers' processing goods and services through a production function, and 'markets', i.e., places in which producers and consumers proceed to exchanges.

In what follows I concentrate on forms that involve multiple partners pooling some strategic decision rights and even some property rights while keeping distinct ownership over key assets, so that they require specific governance to monitor and discipline their interactions. I identify these arrangements as 'hybrid organisations', in line with the terminology proposed by Oliver Williamson (1996).[1] In the second section I go farther in identifying and delineating these arrangements. The third section discusses the forces at work that may explain why parties accept to share strategic rights. The fourth section exhibits different mechanisms of coordination that may play distinctly or in combination. The fifth section suggests a typology of hybrid organisations based on the prevalence of each different mechanism. The final section concludes by emphasising problems raised by the very existence of hybrids, particularly with respect to competition policies.

halshs-00556728, version 1 - 17 Jan 2011

What are hybrids?

Although there is an abundant empirical literature describing the many different forms that the organisation of transactions can take, from strategic alliances involving several partners to network of firms tightly coordinated to franchise systems, the terminology fluctuates, making it difficult to capture exactly what is at stake. These variations in the vocabulary reflect the richness of arrangements to be considered as well as the lack of a unifying theory that could properly identify the nature of these arrangements and the logic underlying their diversity.

To fix ideas about what can be assembled under the term ‘hybrid organisations’, let me start with a stylised fact.[2] In the late 1970s, French millers were confronted by a sharp decline in the consumption of bread, particularly the famous ‘baguette’, and this decline exacerbated competition among them. A group of millers decided to react by establishing a niche of high quality products. To do so, they created a brand name to signal these products, with a strict list of requirements regarding the quality of flour to be used, the conditions under which it should be transformed and commercialised, etc. Marketing the product also required contracting with thousands of bakers who would commit to follow strict rules (e.g., using only the high quality flour delivered by these millers, never selling products that have been frozen, etc.). The millers established a joint entity, with each miller represented on the board of directors, to define the requirements, to develop new products (e.g., mixing different cereals), to market the brand, and to control quality and prevent free-riding. However, disciplining parties remained a major issue. To make control more efficient, the millers implemented a private court, delegating to three of them the power to investigate cases in which one party or the other would have cheated and to penalise the free riders, up to the point where one could be excluded from the network. So we have an arrangement in which parties are sharing some major decision rights and some property rights (e.g. over the brand name, over the investments required by the joint venture), while remaining legally and economically

halshs-00556728, version 1 - 17 Jan 2011

autonomous. Indeed, the millers are also competitors: for example, eight of them are competing to attract well-located bakers for selling their products in metropolitan Paris.

Of course this is not a unique example, although it has its own specificity. Strategic alliances in the airline industry, groups of producers committing to deliver high-quality products in the agri-food industry, partners creating joint ventures for R&D projects in high-tech industries, etc., are confronted with similar problems and find solutions in implementing modes of governance that differ markedly from those implemented in integrated firms while not primarily relying on market prices.

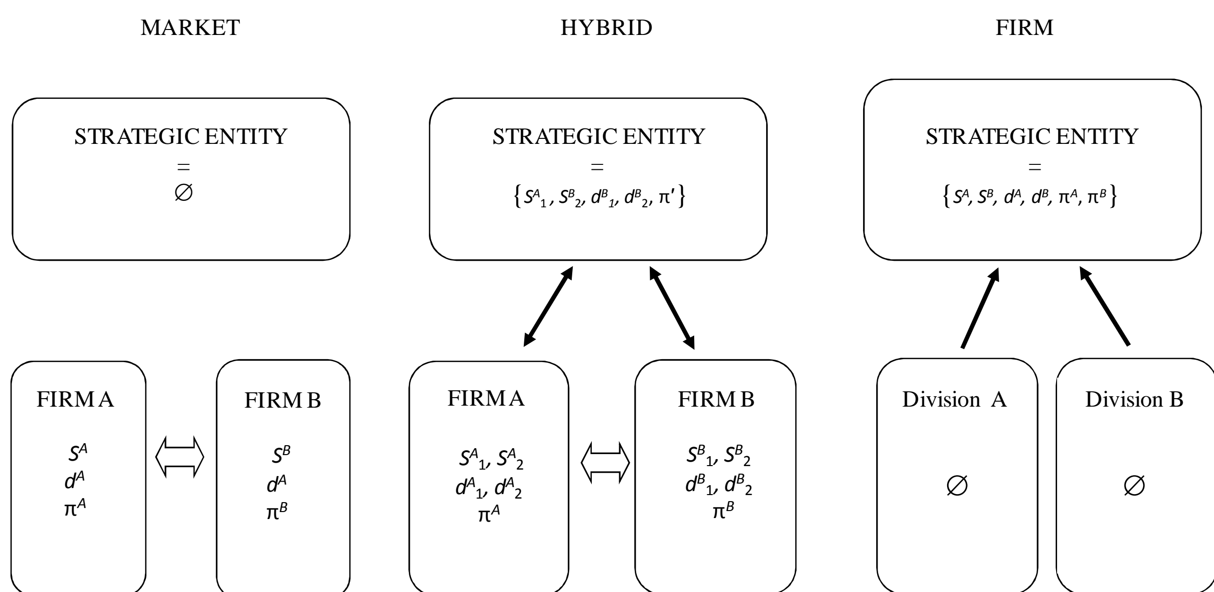
We can generalise the underlying logic of these 'facts' as follows. Assume three players, *A, B,* and *C*. Let $\boldsymbol{S}^A$, $\boldsymbol{S}^B$, and $\boldsymbol{S}^C$ be vectors of the respective specific assets they hold, let $\boldsymbol{d}^A$, $\boldsymbol{d}^B$, and $\boldsymbol{d}^C$ be the vectors of their respective decision rights, and π^A, π^B, and π^C be the payoffs associated with their respective property rights. Now, assume these parties pool specific investments s_h^A, s_i^B, and s_j^C and decision rights d_h^A, d_i^B, and d_j^C, these joint activities generating a joint payoff $\pi'^{A,B,C}$, the allocation of which is not fully contractible ex ante. Forms of governance must then be implemented to monitor joint decisions and sharing rules, with rights that are pooled and uncertainties in the allocation of payoffs determining the choice of means of coordination and control that shape these forms.

There is indeed a large variety of possible combinations of the three dimensions identified above. Empirically, it is the presence or absence of a specific coordinating entity – call it a 'strategic centre' – and the extension of its authority when it exists that seems to differentiate arrangements on the wide spectrum of hybrid modes of organisation (I come back to what determines these choices below). To illustrate, subcontracting or supplier parks usually depend on a leading firm that operates as a 'buyer' imposing specification on goods or services, although the 'leader' may also hold some decision rights and even property rights on its partners. Franchise systems or joint ventures markedly differ in that they unambiguously

halshs-00556728, version 1 - 17 Jan 2011

rely on a coordinating centre, whether this centre gets its decision rights through delegation (joint ventures) or imposes its rules on participating partners (franchise). There are also the various forms taken by strategic alliances, supply chain systems networks, etc., which may restrict coordination to identifiable persons in charge of monitoring the agreement or may create bureaus or autonomous entities to control parties to the arrangement more or less tightly, as illustrated by the millers' case.

Notwithstanding their diversity, these forms qualify as hybrids in that they differ markedly from markets as well as from hierarchies. To simplify, using the notation above in the context of two parties, if we identify *SE* as a strategic entity that coordinates partners, we can characterise 'ideal types' (in a Weberian sense) as follows:



Why do parties delegate or even abandon part of their rights?

Given the above characterisation, why do holders of property and decision rights who could transact through markets renounce to significant rights in deciding to pool resources? From a certain point of view, this question has similarities with that of why employees transfer their decision rights to employers (Coase, 1937; Cheung, 1983). However, there is an important

halshs-00556728, version 1 - 17 Jan 2011

difference: in hybrid arrangements legally distinct entities also share some specific assets and property rights. Why do they engage in activities that seriously weaken their residual rights (so much so that finding an adequate sharing rule is a key issue, and often a source of instability in hybrids)? Three leading factors seem to be at work.

First, parties may accept to share rights in order to face complexity.[3] Complexity has two dimensions. It may result from the need to coordinate multiple interwoven transactions; or it may be due to a changing environment. In both cases, cooperation that involves the abandonment or delegation of some rights may prevail in order to overcome the resulting uncertainties or to develop an adequate buffer. For example, the tight networks developed by general contractors and their subcontractors in the construction industry are determined by the specificity of each project and the highly variable demand, both dimensions generating uncertainties that make adaptability among parties a key issue. More generally, unstable or unpredictable demand; technological changes; potential variations in the quality of inputs; risks of opportunistic behaviour; and unsecured institutional environments are all factors that might push partners to choose hybrid forms, mitigating uncertainty through buffer strategies, shared knowledge, common standards, and joint governance.

Second, parties may view mutual dependence as a source of value, notwithstanding the fact that they often remain competitors, as strategic alliances in the airline industry illustrates. Several factors can motivate firms to endorse mutual dependence in holding pooled assets. The size of investments required may exceed their individual capacity, and/or economies of scale may be expected, as in many R&D projects. Complementarity may offer strategic responses to resource dependence, securing access to existing resources or facilitating access to new ones. Learning effects might also be anticipated, each firm becoming a portfolio of skills that networking allows to transfer and recombine more efficiently. Also, joint investments may help building a reputation with an expected snowball effect on revenues.

halshs-00556728, version 1 - 17 Jan 2011

Third, payoff expected from interaction among parties may not be contractible ex ante, with specific contributions difficult to assess, so that partners look for organisational solutions that facilitate ex post negotiations to share rents with the lowest possible transaction costs. Indeed, because standard incentive contracts would perform poorly and measurement problems may be at stake, defining rules that allows a satisfactory split of the gains is not trivial. Some hybrid forms seem to have found relatively standardised solutions to the implementation of adequate sharing rules, as in franchise systems. However, many other forms rely on ex post negotiations and on noncontractible rules such as fairness or 'perceived equity.' Unfortunately and notwithstanding recent developments in experimental economics, we still know little about how such rules work effectively.

Governance mechanisms

What is clear, though, is that hybrid arrangements need monitoring. This is so because of high risks of opportunistic behaviour and free riding, which is the dark side of the forces pushing towards cooperation. Hence selecting the right partners, building trust through relational ties, and developing credible threat in case of misbehaviour might impose specific mechanisms of governance. Indeed, there is a continuing tension between the search for stability and the pressure coming from opportunistic temptations. In that respect, different devices can be implemented, with varying degree of authority over partners who can always exit.

At the loose end of the authority spectrum, *information systems* such as integrated logistics, joint buying procedures, shared transportation facilities, etc. offer the possibility to reduce information asymmetries among partners, reducing risks of opportunism and facilitating mutual control. They also provide means for shaping the interface with the environment through the implementation of shared routines, standards facilitating communication, devices allowing conversion, and translation of protocols at low cost. Although information technologies play an important role in that respect, numerous studies

halshs-00556728, version 1 - 17 Jan 2011

also show the significance of informal relationships such as social ties in building and sharing appropriate information that contributes to organising and consolidating hybrid arrangements.[4]

The existence of formal contracts represents a step forward in tightening coordination. As emphasised by Macaulay (1963), contracts mainly provide a framework, a blueprint facilitating decisions and orienting joint actions. In doing so, contracts help delineate a stable environment within which partners can plan collaboration, set reciprocal expectations, and reduce misunderstandings and costly missteps. At the same time, contracts suffer the limitations of blueprints, leaving most decisions on tasks and process aside and often opening the way to adjustments through legally unenforceable clauses (e.g., arbitration provisions waiving rights to bring disputes before the courts).[5]

However, most hybrids are not composed solely of independent entrepreneurs operating an outside structure governed solely by formal contracts. Other devices complement and interfere. One is the possibility of exogenous regulators initiating, implementing and eventually monitoring coordination among partners. In many cases, public authorities provide the backbone to hybrid arrangements, either directly through bureaus or agencies, as illustrated by the *Galileo* project, a global satellite navigation system developed by a network of firms at the initiative of the European Commission to compete with the GPS system; or indirectly, as when public authorities provide subsidies and other incentives conditional to cooperation among the benefactors (e.g., the so-called technology parks). However, such exogenous monitoring often mixes public and private interests. A good example is provided by the French certifying organisations, in which representatives of the government, producers, consumers, and distributors define standards and allocate rights associated with the identification of networks delivering high quality products (the successful ‘red label’ system).

halshs-00556728, version 1 - 17 Jan 2011

Last, but not least, hybrids often coordinate through a formal body that operates as depository of authority for monitoring their joint actions. The simplest case is that of joint ventures, in which parent companies monitor their 'child' through a Board of Administration that they control. More complex forms also develop in which a strategic centre might operate along rules that exceed the power of individual partners to control joint activities, as illustrated by the example of the millers. A governing body with rules of its own can be implemented in charge of defining collective actions and joint strategies, designing enforcement mechanisms and implementing rules. Such entities can take different forms, e.g., co-owners assemblies (as in the condominium model), delegates composing an autonomous board, or a specific permanent entity. All of these arrangements involve centralisation of key decisions, a non-negligible level of formal rules, and partial control over property rights.

A typology of hybrid arrangements

These different mechanisms of governance suggest a trade-off among hybrid arrangements, from forms that involve loose coordination, with separation of decision rights and property rights among partners, to forms that impose very tight control, with strictly monitored shared rights. The variety of franchise systems illustrates this spectrum well.

On the one hand, the richness of observable arrangements may suggest a continuum of hybrid forms spread between spot markets and the command-and-control hierarchical firm. At the same time, forms such as strategic alliances differ from franchises or joint ventures. To capture this intuition, one possibility is to hypothesise the existence of discrete structural forms that could relate to the characteristics identified so far. The underlying model could be synthesised as in Figure 1:

[Figure 1 about here]

halshs-00556728, version 1 - 17 Jan 2011

More explicitly, the degree of transfer of property rights and decision rights should translate into the need for coordinating devices that imply different costs of governance, determining different types of hybrids. Specifically: (1) the more concentrated are property rights over relationship-specific assets, the easier it is to coordinate, although at higher costs of governance; (2) the more concentrated are joint decision rights, the tighter the coordination involved, but also the more costly the associated governance mechanism; and (3) the more centralised is control over residual gains, the easier it is to coordinate, but this also pushes costs upwards.

Using a deeply revised version of a representation provided by Williamson (1996 [1991]), I would then suggest that hybrid forms tend to crystallise around four typical arrangements, determined by their dominant governance mechanism (which does not preclude the presence of elements of the other mechanisms). Figure 2 illustrates these arrangements.

[Figure 2 about here]

If we assume that partners to hybrid arrangements target the maximisation of the expected value of their joint activities while minimising the associated costs of governance, then they will want to make a trade-off that keep them on the inferior frontier of the cost curve associated with the different governance mechanisms they can select.

Problems raised by hybrid arrangements

In all modern market economies, hybrid modes of organisation proliferate because the advantages of cooperation and coordination often overcome the gains associated to market competition, while the capacity for partners to maintain their autonomy of decision and their control over the core of their residual rights provides more flexibility and better incentives than what to expect from an integrated structure. However, the very nature of these arrangements blurs the frontiers of the firm as well as it challenges the standard representation

halshs-00556728, version 1 - 17 Jan 2011

of markets. Unfortunately theories encompassing the nature and variety of these arrangements remain remarkably poor. Moreover, we still miss adequate data for estimating precisely the weight and dynamics of these forms, even for a form as well defined and extensively studied as franchising. We also need to understand better why in so many sectors hybrids co-exist with integrated firms, apparently without one prevailing over the other even in the long run. Another issue has to do with the role institutional environments, e.g., rules governing property rights, may play in that coexistence as well as in the comparative degree of development of hybrid arrangements and of specific forms of hybrids. Last but not least, hybrids almost always involve vertical as well as horizontal restrictions, which seriously challenge standard competition policies still largely built around the trade-off between markets and hierarchies. In-depth revision of these policies is therefore likely to be needed in the near future.

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Figure 1: Discrete Structural Forms

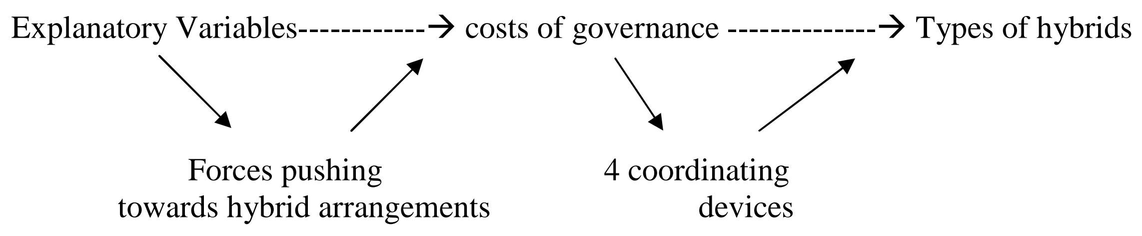
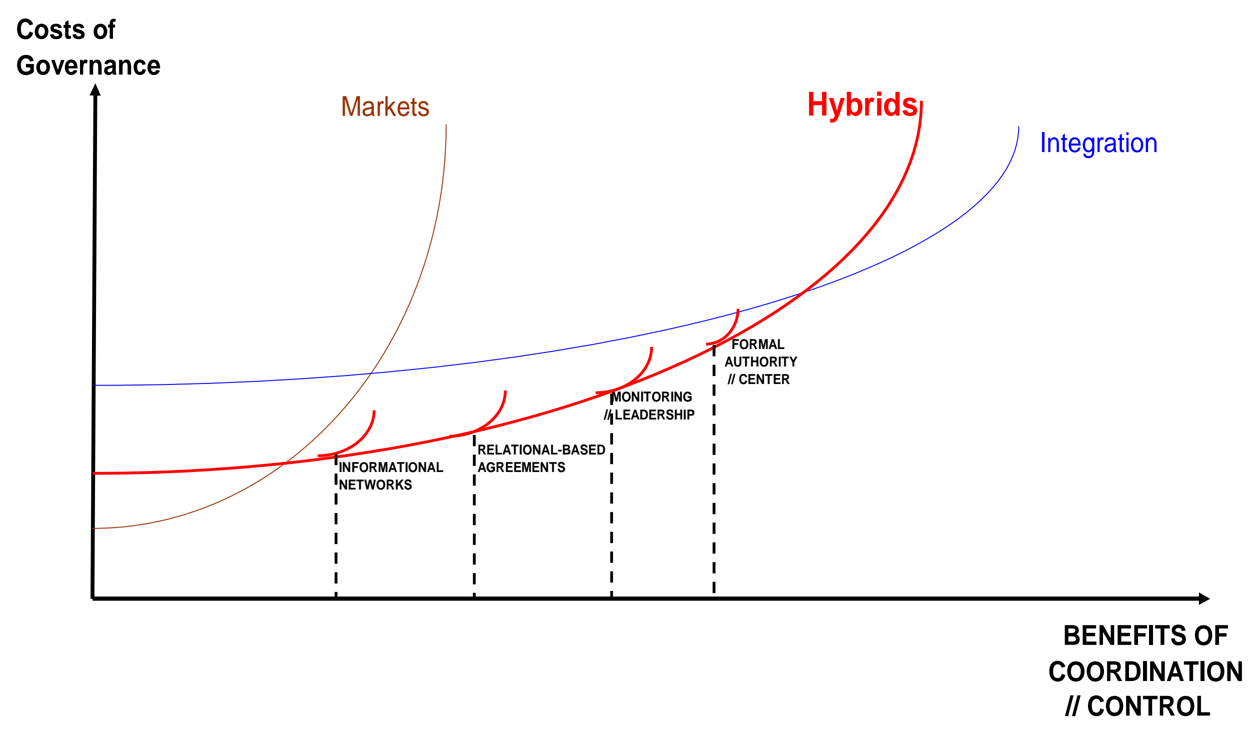


Figure 2: Hybrids and Governance Costs



Notes

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[1] This terminology is convenient in that it embeds hybrid types of organizational arrangements in a well defined framework, as argued below. It also has its drawbacks in suggesting that these forms could be interpreted as a simple mixture of ingredients coming from the pure forms that are markets and hierarchies, although the biological connotation of the term should clearly indicates that specific process and forms are at stake in hybrids.

[2] This case is extensively described in Raynaud (1997)

[3] This was the argument already developed by Simon (1951) to explain the employment contract.

[4] Greif (1993) provides a nice example of how a network can depend on informal information channels in a particularly challenging institutional environment.

[5] Ryall and Sampson (2006) illustrate this aspect well.

halshs-00556728, version 1 - 17 Jan 2011