NEWP

WP-1

NE-165

PRIVATE STRATEGIES, PUBLIC POLICIES & FOOD SYSTEM PERFORMANCE

STRATEGIC MANAGEMENT AND THE INTERNAL ORGANIZATION OF FOOD MARKETING FIRMS

by

Richard T. Rogers and Julie A. Caswell

WP-1 September 1987

WORKING PAPER SERIES

A Joint USDA Land Grant University Research Project

STRATEGIC MANAGEMENT AND THE INTERNAL ORGANIZATION OF FOOD MARKETING FIRMS

by

Richard T. Rogers and Julie A. Caswell

WP-1 September 1987

This paper was originally presented in a symposium on Emerging Issues and Research Needs in the Food System held at the Northeastern Agricultural and Resource Economics Association meetings, Morgantown, West Virginia, June 1986.

The authors are assistant professors, Department of Agricultural and Resource Economics, University of Massachusetts at Amherst.

Strategic Management and the Internal Organization of Food Marketing Firms

Research on the post-farm food distribution system requires more tools than are commonly found in the economist's neoclassical toolkit. Neoclassical theory is well-defined at either end of the competitive spectrum but the bulk of food distribution activity takes place somewhere between those extremes. The competitive model has served the agricultural economics profession well largely because the profession's main interests have centered on the farm enterprise. Ignoring government involvement, the farm sector complies, as well as any in the economy, with the conditions of the competitive model since it is characterized by numerous small operators producing homogeneous products in markets with relatively easy entry. The food distribution sector, however, is characterized by a bimodal structure. For example, although there are over 17,000 food manufacturers in the country, the top 20 firms control nearly 30 percent of the sector's value-added. While neoclassical theory treats all firms as homogeneous except for scale, firms engaged in food distribution are heterogenous and compete in many ways other than price. To understand the food distribution system requires expanding the economist's toolkit to include non-price competition, business case studies, behavioral theories of the firm, and the new research, both theoretical and empirical, on strategic management.

Major research efforts by agricultural economists over the past two decades reported in National Commission on Food Marketing[1], Connor et al.[2], and Marion[3] have yielded a detailed description and extensive analysis of the organization of the post-harvest food system in the United States. Much is known about the structure of the food industries and that structure's relationship to several measures (some controversial) of economic performance.

Like traditional microeconomic theory, however, this fruitful body of work has treated the firm as a black box that somehow connects market structure with performance.

At this juncture, the major research need in studying the evolution of the food system is the development of what Leibenstein[4] refers to as a micro-microeconomic theory of the firm. How do agribusiness firms, and particularly the large marketing firms that increasingly dominate the sector, make strategic decisions to enter, expand in, or exit specific market segments? Once strategic decisions have been made, how does the firm organize itself to carry out those decisions? How does the internal organization of firms affect both company and economy wide performance? Strategic management and internal firm organization are major emerging issues in food system research because these choices, in themselves and as responses to changes in the firm's environment and opportunity set, are at the heart of dynamic change in the system.

Strategic Management as a Research Paradigm

Strategic management has been a hot topic in business circles for at least a decade. Strategic management is not really new in that it refers to the firm's process of developing and implementing a plan for success in the marketplace. Its importance has grown, at least in part, because more strategies are available to firms. In perfect competition the firm has no strategic choice. The pricing decision is eliminated since all surviving firms charge the prevailing price, produce where marginal revenue equals marginal cost, and refrain from individual advertising. As markets depart from the competitive model, firms may choose differing strategies regarding such key decisions as price and product differentiation. Of course, the rewards vary with each strategy and success is uncertain. But such variability and uncertainty is the risk that creates the financial incentive to engage in strategic management.

Despite the connection between economic theory and strategic management, the fields remain somewhat separated. All business school students take economic theory courses but many wonder why since little of the subject material is directly applicable to their main interest--the running of a business firm. Such questioning is understandable because the black box treatment of the firm in neoclassical theory does say little about the actual operation of a firm. The only major behavioral assumption used is that firms maximize profits. Homogeneous except for scale, firms are left to select the input levels required to produce the profit maximizing output level given known prices. The theory does not explain how firms grow, which is of vital interest to business managers, or recognize that firms may seek to maximize growth or sales rather than profits. Such differences of focus stem largely from the differing objectives of business management and economics. Business policy is concerned with the heterogeneity of firms and how to best manage their different resource bundles. Neoclassical economic theory, on the other hand, tries to provide a general understanding of resource allocation in a freely operating price system. It is feared that incorporating the rich detail of business heterogeneity into economic theory would blur observations on the essential workings of the price allocation system. Good theory needs simplifying assumptions and to criticize neoclassical theory because it assumes away too much of reality is not appropriate. However, managers need guidance for decision making and economics can provide an important foundation.

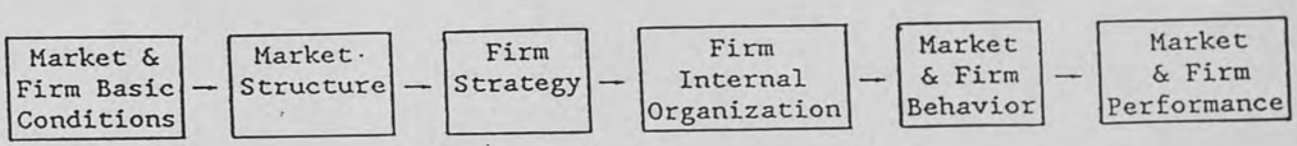
Industrial Organization economics (IO) emerged as a branch of microeconomics that stresses greater realism by recognizing increasing departures from the competitive model. Initially this realism came at the expense of theoretical rigor. The branch began with a call for case studies of industries with diverse structures to uncover universal truths linking market structure to market performance. When generalizable truths did not become apparent, IO research turned to the cross-sectional industry and firm studies that have marked the majority of the last 20 years' work. The current research effort incorporates more advanced theory with empirical modeling of individual industries. Such models are often able to capture some aspects of firm heterogeneity. The cumulative research to date has supported the basic IO paradigm relating market structure to market performance but controversy remains over interpretation of the findings. Chicago school economists still question whether the relationship between concentration and profits, for example, demonstrates confirmation of the market power or efficiency-of-larger-firms hypotheses. Even after price is used as the performance variable the controversy remains because some argue that higher prices reflect higher quality not necessarily greater market power.

Strategic management has not been bothered by these controversies and has proceeded to blend together neoclassical economics, industrial organization, business case studies, and behavioral theories of the firm to guide business decision making. While neoclassical theory and even IO fail to reveal much about firm behavior, strategic management has emphasized it. The traditional IO model consists of a simple triad linking industry or market STRUCTURE-

CONDUCT-PERFORMANCE. Often, conduct is ignored. In contrast, the strategic management paradigm focuses on firm level capabilities, strategy, organization, and performance in the context of the structure, conduct, and performance of markets. An expanded IO model incorporating the insights of strategic management looks like Figure 1 (with feedback loops not shown).[5] Proponents of strategic management have whole-heartedly accepted the link between market structure, firm strategy, and firm performance. The work of Porter[6] at the Harvard Business School perhaps best typifies this approach and demonstrates the importance of IO theory and research to the firm.

Strategic management's emphasis on firm strategy and organization has shown the way for economic research to open the black box that contains market and firm conduct in neoclassical economic theory and the traditional IO paradigm. For example, firms decide whether or not to advertise and in time such advertising, if successful, will create product differentiation which becomes an aspect of market structure. Firm decisions and their outcomes can change market structure.

Figure 1: An Expanded Industrial Organization Model



Of course, market structure still limits the number of available firm strategies but those limits can be challenged. Strategies that seem inappropriate to most observers of the current structure carry the highest risk but if successful often yield substantial rewards. Agricultural economists have not thought of the poultry industry as being characterized by product differentiation but Frank Perdue has advertised his chickens and created, along with his rivals' responses, some brand recognition in the fresh chicken market. Such actions raise interesting research questions. For example, poultry is inspected and graded by USDA but firms are now replacing grades with brands. Is such a change a more cost effective way of providing consumers with quality assurance? Research that recognizes the important effects of firm decisions on market and firm performance should improve understanding of our modern food system.

Another exciting dimension of the strategic management paradigm is that it highlights the importance of change. Change in an industry's basic conditions creates opportunities for profit and provides the incentive for firms to try new strategies. To gain substantial returns the firm must correctly anticipate change and its ultimate effects, and move swiftly to enact its plans before others also see the opportunity. Research needs to model how firms try to anticipate, create, and react to change. For example, in the 1970s PepsiCo, like many food firms, pursued a strategy of conglomerate diversification acquiring companies such as North American Van Lines. Now PepsiCo has changed course shedding many of these acquisitions and seeking to acquire firms more closely related to its major lines of business. Is this strategy change in response to a changing antitrust environment, a realization that pure conglomerate diversification was not profitable, or both? Adding the richness of firm strategic choice certainly complicates our theory of the firm but allows a much broader scope of performance issues to be addressed. Perhaps the most intractable aspect of this richness will be assessing the welfare implications associated with models of firm and market performance that depart from the standard neoclassical theory.

Approaches to the Study of Firm Internal Organization

Agricultural economists often have a poor understanding of the modern corporation and the multitude of organizational structures used by corporations confounds an easy remedy to this situation. Within the food system we see a vast array of corporate organizational forms--from small investor-owned firms to cooperatives, fully vertically integrated firms, and multinational conglomerates--and further organizational differences exist within each form. Some firms continue to use the traditional U-form of organization which stresses a functional division of the work load, while others have adopted the multidivisional or M-form approach where functions are split among divisions operating as profit centers. Why do firms chose particular organizational forms to carry out their strategies? Are some organizational structures more efficient for particular firms and does firm efficiency translate into societal efficiency?

As the expanded IO model presented in the previous section indicates, a firm's internal organization is the link between firm strategy and performance. A centralized U-form firm, for example, may be unable to speedily implement strategies developed in response to change in a dynamic marketplace. It may also, more fundamentally, be unable to formulate the necessary new strategies. Given the advantages associated with first movers, speed is a valuable asset for the firm seeking to benefit from changes in the business environment. Yet, as Caves and Porter's[7] work indicates, not all firms in an industry need aspire to first mover status and different organizational forms may be suited to different strategies. Within markets in the food distribution system, for example, there are strategic groups such as national brand and private label producers. A firm that determines that the private label market is its best business option may want a functional internal organization that allows for greater cost scrutiny, since the firm with the lowest costs usually has a competitive advantage in this market niche. In contrast, a national brand producer may prefer a multidivisional firm structure to encourage marketing initiatives and new products. Moreover, there are usually even differences between firms in the same strategic group.

Internal organization not only deals with the firm's internal hierarchy but also with the boundary between what is produced within the firm and what is contracted for in markets. Many scholars view firms and markets as alternative means of organizing economic activity. Thus the study of internal organization is central to the study of vertical coordination. Why, for example, is the poultry industry characterized by fully integrated firms yet most other food processors avoid investing in primary agriculture and rely on contracts or markets for their inputs?

There are two schools of thought (for emphasis, only the extremes are discussed) on the driving forces behind organizational forms. One school views firms as striving to gain market power. Any new form of organization is adopted for its market power potential and therefore potential for greater profit. For example, firms become conglomerates because further horizontal acquisitions are foreclosed by antitrust enforcement and because the conglomerate form allows them to engage in business strategies such as cross-subsidization that are unavailable to the single line firm. This market power view clearly raises public policy concerns with organizational forms.

The second school of thought maintains, as Williamson[8] states, that "the modern corporation is mainly to be understood as the product of a series of organizational innovations that have had the purpose and effect of economizing on transaction costs (p. 1537)." Under this view the evolution of corporate structures is explained by firms seeking to lower their costs. Firms shifted from the U- to the M-form organizational structure to eliminate rigid bureaucratic layers of management that limited their ability to grow to super size. Under the M-form structure, top management could concentrate on strategic planning and act as a substitute capital market internally redirecting capital to promising divisions. Hence, as the argument goes, conglomerates were formed, in part, to get around an imperfect capital market.

A specialized and especially virulent strain of the transaction costs approach is the agency theory work of researchers such as Fama and Jensen.[9] They state that "absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs. This is the telling dimension on which the economic environment chooses among the organizational forms (p. 327)." They argue that corporate structure evolves to minimize the agency costs arising from the fact that contracts cannot be entirely specified, hence requiring some sort of monitor or enforcer. These researchers, in effect, put forth a "Corporate Darwinism Theory" in relation to organizational forms--that which survives is most efficient.

In reality, the two forces driving the evolution of organizational forms, the seeking of market power and efficiency, are not mutually exclusive. A firm often gains market power from adopting a structural form that lowers its transaction costs. Moreover, a firm may pursue a strategy such as vertical integration with the intent of using its market power to extract lower transaction costs from its suppliers. Lowering firm transaction costs through organizational innovation is a socially useful goal that public policy should encourage. However, a public policy dilemma emerges if firms gain market power in the process. A similar antitrust dilemma is well known regarding the desire that firms benefit from all economies of scale but not grow so large that the market becomes concentrated.

What is missing from the pure transaction costs approach to organizational form is a recognition of the corporation's ability not only to adapt to change but also to influence and shape it through adoption of new strategies and forms of internal organization. In fact, it is a credit to management science and a frustration to the economist's competitive model that firms have continually managed to expand in size. The competitive model relies on the firm facing U-shaped cost curves that limit its expansion and allow new entry. The eventual upturn in these curves is vaguely explained as being caused by management's inability to manage ever larger operations effectively. Without U-shaped cost curves the economist loses the self-adjusting market that underlies much of optimal resource allocation theory. Rather than face the upward portion of the cost curve, firms have adopted new organizational forms that allow continued expansion.

Integral to the issue of internal firm organization and its motivations is the question of who exercises control over the corporate hierarchy.

Business strategies are determined by those who control the corporation, but as research by Caswell[10] on the agribusiness sector shows, who controls a Fortune 500 corporation is not a simple matter to determine. The corporate control debate has been dominated by attention to stockholding but other important control avenues exist as well such as: holding upper level management positions; being an important creditor, input supplier, or buyer of finished goods; or holding some other strategic position vis-a-vis the firm. More recently, the market for corporate control operating through mergers and takeovers has been proposed as a more important limit on management discretion than who exercises internal control. The threat of takeover clearly catches management's attention and helps insure against poor management. It cannot prevent it, however, because management and the firm's existing control structure have the power to enact measures to insulate themselves from an unwanted takeover. Passage of anti-takeover clauses, a spate of leveraged buyouts taking firms private, and the use of poison pills, white knights, golden parachutes and other devices are all evidence of this insulating ability.

The leading firms in the food system are powerful corporations that, to a large extent, shape their own destiny. Such firms are not likely to disappear by their own mistakes. The operation of their internal organizations determines firm and, ultimately, market performance. Economic research is needed to explore the black box of firm behavior in order to assess the balance of gains in market power, firm efficiency, and societal efficiency from organizational innovation.

Research Directions

Involving economists in strategic management and firm internal organization research should prove useful in two ways. First, the research should assist business managers in their decision making. For example, a group of blueberry growers may be considering forming a marketing cooperative. What development and organizational strategy makes the most sense? How should the tobacco industry adjust to decreasing domestic cigarette sales? Research cannot provide certain answers to such questions but it can offer reasoned advice.

Second, economists are well-trained to conduct research that provides an assessment of the overall economic performance of various strategic approaches and organizational structures with an eye toward making public policy recommendations. For example, what restrictions, if any, should be placed on the operation of the market for corporate control? Does the current system have a self-adjusting, corrective mechanism much like that of the competitive model? Will corporate raiders, leveraged buyout specialists, labor markets for top managers, and other private institutions and actions adequately monitor the overall performance of our economic system?

Economists who venture into the areas of strategic management and internal organizational forms should be rewarded by addressing issues of pressing importance to both firms and society.

References

1. National Commission on Food Marketing, Food From Farmer to Consumer, U.S. Government Printing Office, Washington, D.C., 1966.

2. J.M. Connor, R.T. Rogers, B.W. Marion, and W.F. Mueller, The Food Manufacturing Industries: Structure, Strategies, Performance, and Policies, Lexington Books, Lexington, Ma., 1985.

3. B.W. Marion and the NC 117 Committee, The Organization and Performance of the U.S. Food System, Lexington Books, Lexington, Ma., 1986.

4. H. Leibenstein, "A Branch of Economics is Missing: Micro-Micro Theory," Journal of Economic Literature, 17, 477-502, (1979).

5. See also R.W. Cotterill, "The Economic Efficiency of Alternative Forms of Business Enterprise," in Economic Efficiency in Agricultural and Food Marketing, R. Kilmer and W. Armbruster, eds., Iowa State University Press, Ames, Iowa, 1987.

6. M.E. Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors, The Free Press, Macmillan Publishing Co., New York, 1980.

7. R.E. Caves and M.E. Porter, "From Entry Barriers to Mobility Barriers," Quarterly Journal of Economics, 91, 241-261, (1977).

8. O.E. Williamson, "The Modern Corporation: Origins, Evolution, Attributes," Journal of Economic Literature, 19, 1537-1568, (1981).

9. E.F. Fama and M.C. Jensen, "Agency Problems and Residual Claims," Journal of Law and Economics, 26, 327-349, (1983).

10. J.A. Caswell, "Dominant Forms of Corporate Control in the U.S. Agribusiness Sector," American Journal of Agricultural Economics, 69, 11-21, (1987).

NE-165

PRIVATE STRATEGIES, PUBLIC POLICIES & FOOD SYSTEM PERFORMANCE

Working Paper Series

Purpose: The NE-165 Working Paper Series provides access to and facilitates research on food and agricultural marketing questions. It is intended to be a publication vehicle for interim and completed research efforts of high quality. A working paper can take many forms. It may be a paper that was delivered at a conference or symposium but not published. It may be a research report that ultimately appears in full or abbreviated form as a journal article or chapter in a book. Using the working paper series enables a researcher to distribute the report more quickly and in more extensive detail to key research users. A working paper may also be an end product in itself, for example, papers that collate data, report descriptive results, explore new research methodologies, or stimulate thought on research questions.

Procedures: Working papers may address any issues in the food and agricultural marketing area as described in the NE-165: Private Strategies, Public Policy and Food System Performance, project statement. This research agenda is available from Professor Ronald Cotterill, Executive Director of NE-165 at the address given below. A prospective working paper should be forwarded to the Executive Director who will coordinate a review of the paper by two research peers. Alternatively authors may submit two independent peer reviews with their paper. Based upon independent reviewer comments the Executive Director may accept, accept with revisions, or reject the submission. If accepted the Executive Director will issue working paper covers, and a mailing list to the author who shall have responsibility for preparing and distributing copies to all persons and organizations on the mailing list. Additional copies of working papers are available from the author or from the office of the Executive Director at The University of Connecticut.

Professor Ronald W. Cotterill, Executive Director NE-165
Department of Agricultural Economics and Rural Sociology
Box U-21
The University of Connecticut
Storrs, Connecticut 06268