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The Governance of Federations

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What's the Paper About?

Focus on business federations

- In a business federation, power is shared between a central enterprise and autonomous local organizations that own the central and are the primary users of its services
- This structure is often believed to be less efficient than one where the central enterprise owns and controls the local organizations
- Why do federations exist, and in some cases thrive, in situations where more efficient forms of governance are possible?

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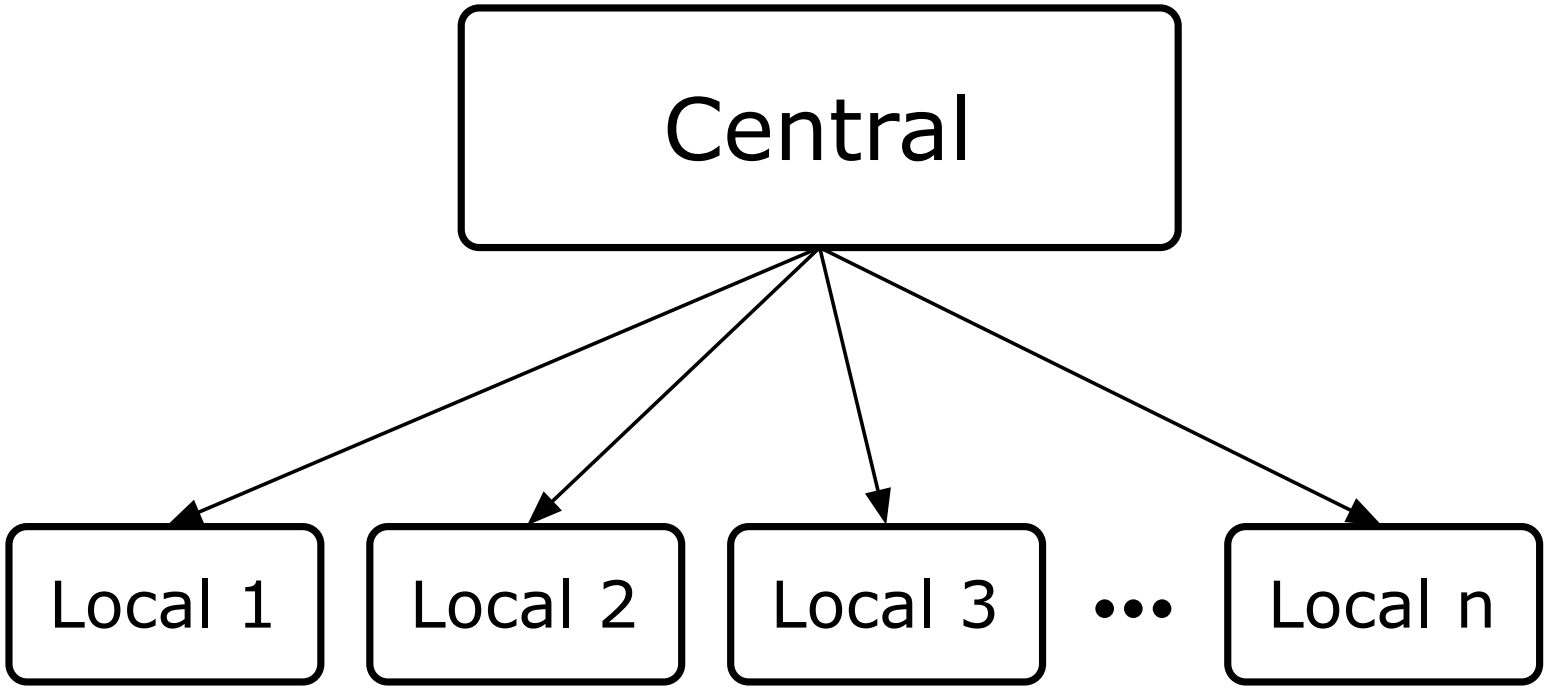
Centralized Structure

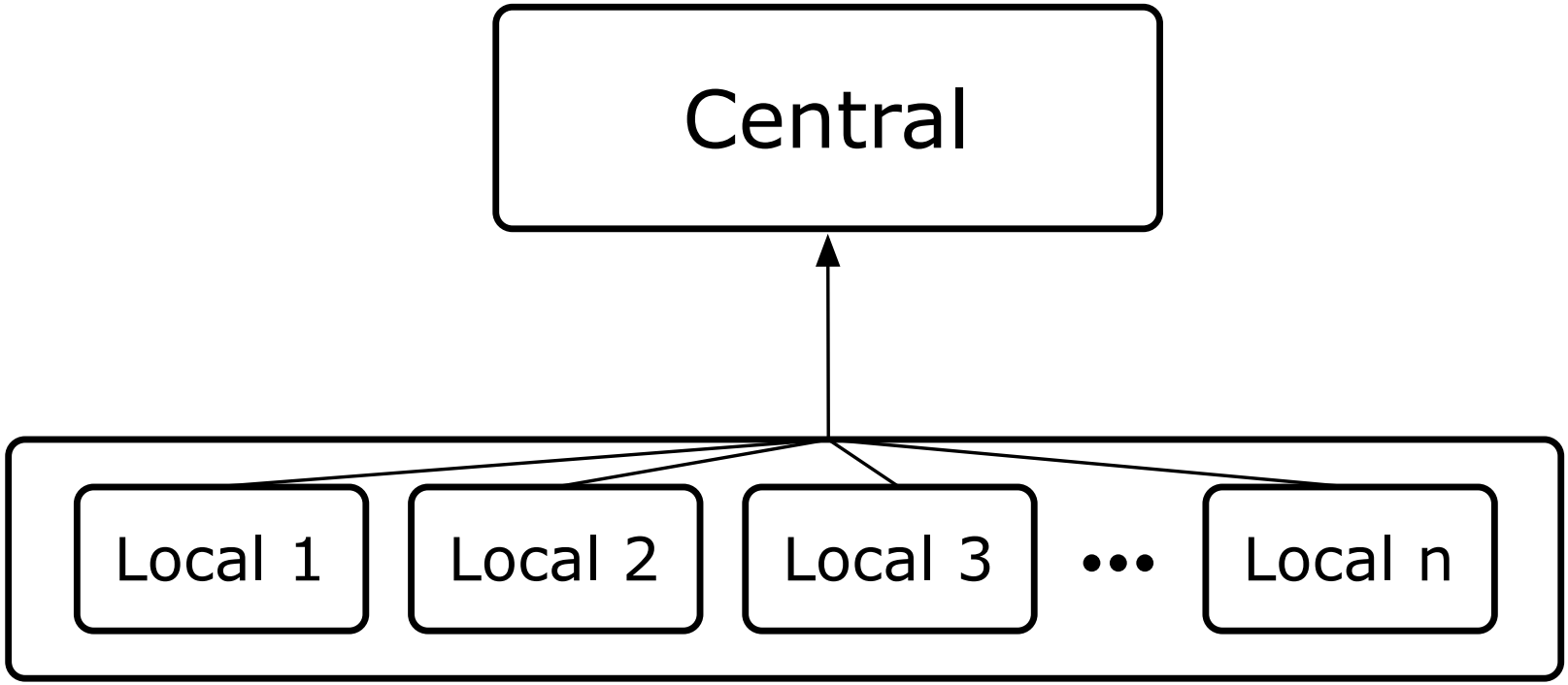
A central organization owns and controls the local units



Centralized Ownership and Control
(Integration Forward)

Federated Structure

The local organizations (units) own and control the central organization



Federated Ownership and Control
(Integration Backward)

Examples of Business Federations

Business Federations Thought to Be Less Efficient

Political and economic reasons

- When overseeing decisions made at the central level, representatives of the local organizations may favor their own organization rather than the system
- No guarantee of good quality board members (or correct mix) being selected by local organizations to oversee central
- More time and resources required for the local organizations to reach consensus
- Individual local organizations may act opportunistically – e.g., buy services elsewhere or fail to uphold a standard

- Why then do business federations exist and thrive?

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Why Might Federations Exist and Thrive?

Reasons developed in a paper by Pohler, Fairbairn and Fulton

- Create norms of behavior and identity that encourage co-operation among the local organizations
- Reduce monitoring costs because owners are users (Hueth and Marcoul 2015)
- Productive heterogeneity within the group of local organizations
- Local information is critical to the decision making
- Local organizations value local control and autonomy

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Local Organizations Value Local Control and Autonomy

Pose two questions

1. Can a federated structure be chosen even if it is less economically efficient?
2. Can a centralized structure be chosen even if it is less economically efficient?

What is Governance?

- *The set of formal and informal arrangements by which power is allocated and exercised in any system with interdependent actors (e.g., a society, market, network, or organization).*
- Parts of governance may be formally enshrined in constitutions, statute, case law and/or organizational bylaws
- Governance also consists of the informal institutions, rules, norms, behaviors, and practices that determine how power is assigned to different, and usually unequal, actors and stakeholders

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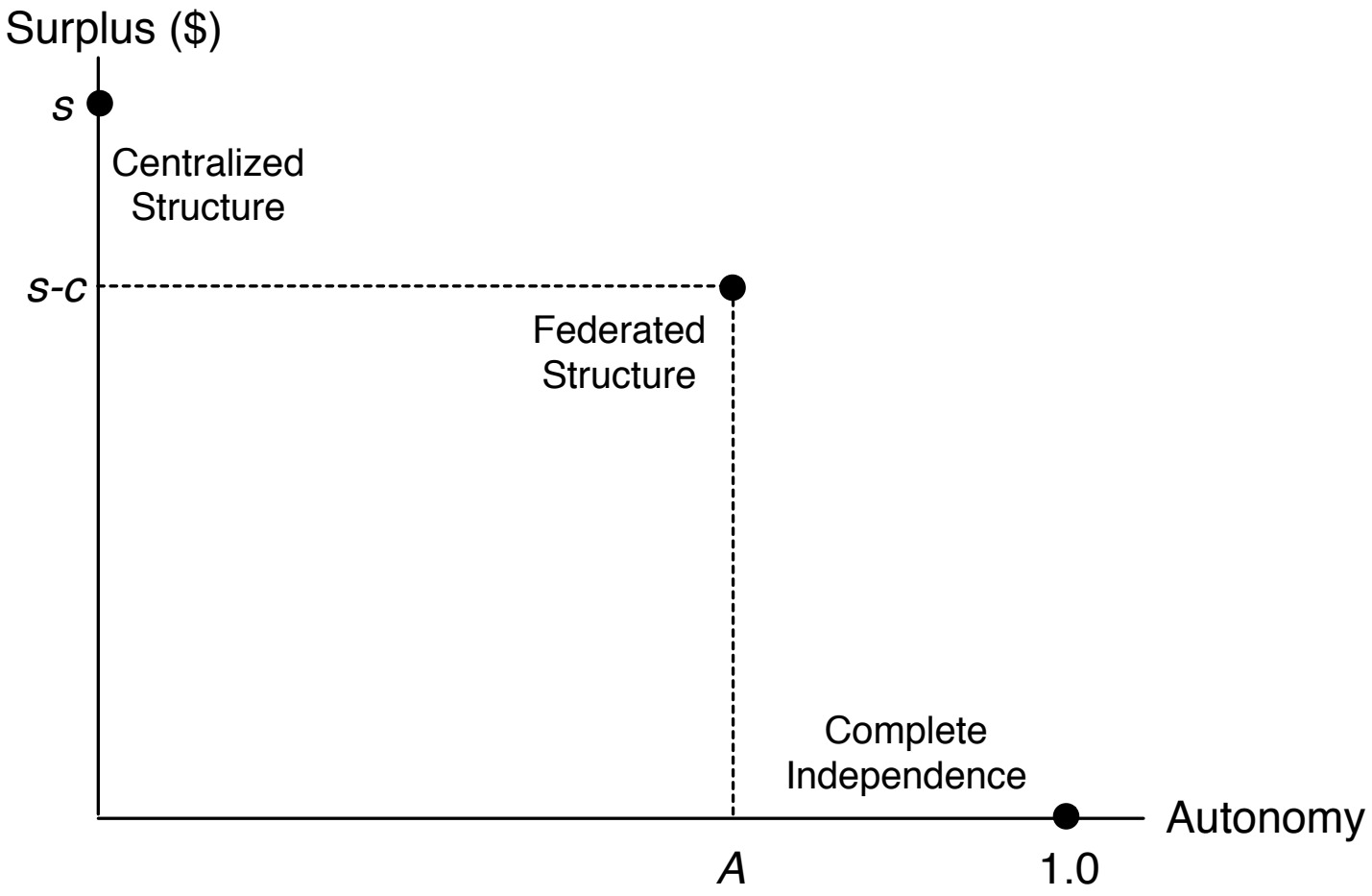
Governance of Business Federations

- Federated governance is distinguishable from other forms of governance by how power is allocated and exercised among and between the players
- Compared to a centralized organization, a federation provides the local organizations with more power over more decisions
- Choice of a federation or a centralized organization is thus a governance choice, since it determines how power and autonomy are allocated

The Setup – The Production Possibilities

- Group of n identical local units that provide goods and services
- If units operate independently, they each earn surplus of zero
- If units operate in conjunction with a central unit, each local unit earns a surplus of $s > 0$. Central earns zero.
- Increased surplus comes from coordination of activities which results in economies of scale, maintenance of a brand, etc.
- If central owns/controls the locals, cost of coordination $c = 0$
- If local units own and control the central, $c > 0$

Production Possibilities for Different Governance Structures



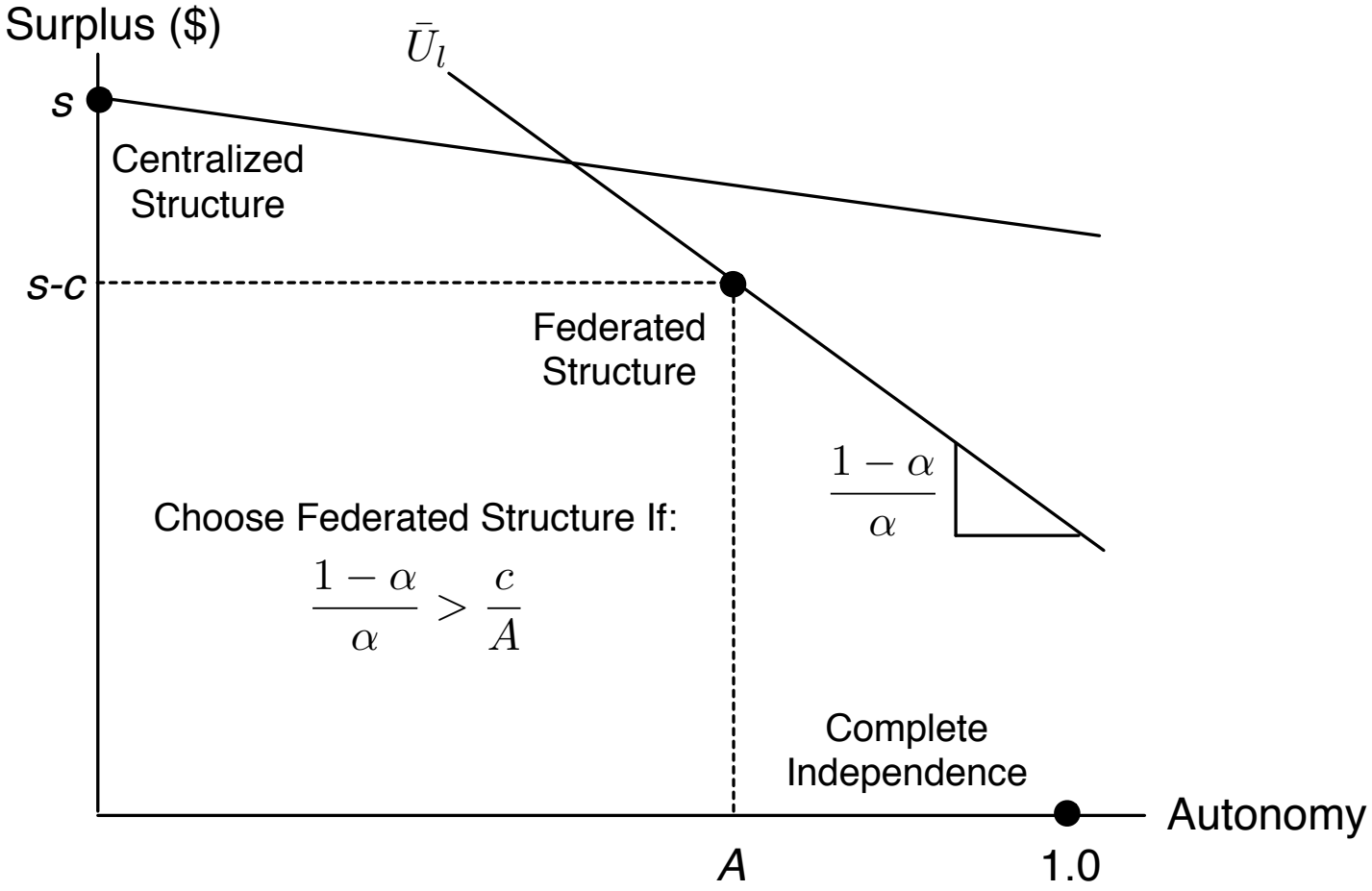
The Setup – Preferences

- Suppose owners of the local units have utility defined over surplus s and local autonomy A
- $U_l = \alpha s + (1 - \alpha)A$
- Utility from federated structure is greater than utility from central structure if:

$$\alpha(s - c) + (1 - \alpha)A > \alpha s$$

$$\frac{1 - \alpha}{\alpha} > \frac{c}{A}$$

Production Possibilities and Preferences for Different Governance Structures



Comments on the Model and Its Outcomes

- Starting point matters. If central is formed first, it will likely remain
- If α is large, central structure could emerge by local owners selling to an entrepreneur wishing to operate a central
- Federated structure allows local units to retain autonomy
  - Entrepreneur could make money by buying local units for $s - c + \varepsilon$ and then putting them together to earn s
  - Federated structure means entrepreneur needs to purchase all or most of the local units at the same time
  - This requirement bids up the price and allows local units to decide collectively if they want to sell
- Federated structure is only stable with some form of imperfect competition at the local level

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What if Federated Structure is More Efficient, Not Less Efficient?

Will a federated structure emerge?

- If the starting point is a federation, then yes
- If the starting point is a centralized structure, then maybe not

Final Observations

- Choice of governance structure depends on the way the structure allocates power and authority, and the manner in which owners trade off power and authority with economic benefits
- The governance structure chosen may not maximize economic benefits
- Initial choice of governance structure matters – there is a form of path dependency
- Brings into question the applicability of the Coase Theorem to organizational structure

Thank You