

Note on Managing the Value Chain: Governance, Location, and Firm Scope Decisions

Understanding and mapping a firm's value chain is just one step in the strategy formulation process. After identifying the firm's value activities, benchmarking each against rivals, and considering how each relates to the firm's overall strategy, the manager is faced with several decisions about each activity:

- What are the linkages (if any) to other value activities?
- Should the firm perform this activity itself, or contract with another firm to do so? and
- Where should the activity be performed?

Taken together, the answers to these questions determine a firm's vertical, horizontal, and geographic scope.

This note is organized into five sections. Following this introduction, the second section provides a brief introduction to transactions cost economics (TCE), a framework that helps explain firm governance and scope decisions. The third section links TCE considerations to decisions about a firm's vertical and horizontal scope – that is, the make vs. buy decision. The fourth section explores the issue of where to locate activities. The fifth section concludes.

Transactions Cost Economics

Few firms directly control all activities associated with the product or service that they ultimately deliver to customers. One important decision for managers is what tasks to have their firm perform directly, and which to source from other firms. Doing so requires the manager to consider at least two distinct types of costs:

1. Production and distribution costs – those costs involved in manufacturing and selling goods or developing and delivering services.
2. Transactions costs – those are the costs incurred in making an economic exchange.

Taken together, these determine the total cost of an activity.

The two economists most closely associated with transactions cost economics are Ronald Coase and Oliver Williamson. Coase first laid out the fundamentals of transactions costs economics (TCE) in a 1937

Published by WDI Publishing, a division of the William Davidson Institute (WDI) at the University of Michigan.

©2010 Robert Kennedy. This note was prepared by Robert E. Kennedy, the Tom Lantos Professor of Business Administration at the University of Michigan.