



BUREAUCRATIC LIMITS OF FIRM SIZE: PRACTITIONERS' SUMMARY

Dr Staffan Canbäck, Henley Management College

Managerial diseconomies of scale are often discussed but seldom studied. The purpose of the current research is to open up avenues of inquiry into this potentially important topic. The research is the foundation for the doctoral thesis “Bureaucratic Limits of Firm Size: Empirical Analysis Using Transaction Cost Economics” presented by Staffan Canbäck at Henley Management College/Brunel University in 2002. The thesis can be downloaded from <http://canback.com/henley.htm>.

Data from the 784 largest US manufacturing companies in 1998 were statistically analysed to test whether diseconomies of scale exist and whether they can be moderated. The underlying framework is based on transaction cost economics, a discipline within organisational economics, which has become increasingly important over the last thirty years. Leading academics in the discipline include Oliver Williamson and Nobel Prize winners Ronald Coase and Douglass North, who heavily influenced the approach taken here.

The research shows that diseconomies of scale do indeed exist. They strongly hamper large corporations' ability to grow and they reduce their profitability. The research also shows that successful large corporations strive to minimise

the diseconomies of scale while leveraging moderating mechanisms.

Background

If diseconomies of scale do not exist, then we would presumably see much larger companies than we do today. Why are there no corporations with ten million, a hundred million or even a billion employees?

At the time of the research, no business organisation in the United States had more than one million employees or more than ten hierarchical levels. Related to this, the concentration in the US manufacturing sector has changed little or has declined over much of the last century. Further, no corporation has ever been able successfully to compete in multiple markets with a diverse product range over a long time period.

Common sense tells us that there are limits to corporate size. Common sense does not, however, prove the point. Unfortunately, scientific inquiry has not yet focused on finding such proof.

Limits to corporate size pose real and difficult problems for business executives. The cost of being too large is significant. For example, up to 25 per cent of the cost of goods sold of a large

manufacturing company is attributable to organisational slack, often arising from communication problems, bureaucratic inefficiencies and other dysfunctions described below. Moreover, large corporations have a tendency slowly to decline and disappear.

Findings

The research shows that there are four major categories of diseconomies of scale:

Atmospheric consequences. As companies expand, there will be increased specialisation, but also less commitment on the part of employees. The employees often have a hard time understanding the purpose of corporate activities, as well as the small contribution each of them makes to the whole.

Bureaucratic insularity. As companies increase in size, senior managers are less accountable to the lower ranks of the organisation and to shareholders. They thus become insulated from reality and will often strive to maximise their personal benefits rather than overall corporate performance.

Incentive limits. Large corporations tend to base incentives on tenure and position, rather than on merit, because of the difficulty to structure well-functioning incentive programmes. This especially affects executive positions and product development functions, putting large corporations at a disadvantage when compared with smaller enterprises in which employees are often given a direct stake in the success of the company.

Communication distortion. A single manager cannot understand every aspect of a complex organisation. Thus, it is impossible to expand a company without adding hierarchical layers. Information passed between layers inevitably becomes dis-

torted. This reduces the ability of high-level executives to make decisions based on facts.

While the four categories relating to diseconomies of scale impose size limits on corporations, three factors tend to moderate diseconomies of scale:

Economies of scale. In industries where there are high fixed-overhead costs, economies of scale tend to offset the diseconomies of scale. Economies of scale in production are not important though.

Organisation form. Diseconomies of scale can be reduced by organising appropriately. In general, a multidivisional organisation performs better than a functional organisation. In addition, well-designed governance policies help offset diseconomies of scale.

Asset specificity. Corporations that focus on the core business outperform diverse corporations. Asset specificity measures the degree of focus and it can be optimised along three dimensions: geographic reach, product breadth and vertical depth.

The framework below captures these influences. An additional factor, the choice of industry, is included as well. While this is not an important factor in the manufacturing sector studied here, it is important in the services sector.

CONCEPTUAL FRAMEWORK



