15.320 Strategic Organizational Design

Internal markets
How can activities be linked?

• Networks
  - People are motivated to cooperate for various reasons (trading favors, cultural expectations, etc.)

• Hierarchies
  - People are motivated to do what managers tell them

• Markets
  - People are motivated to make mutually beneficial exchanges involving some kind of currency
Types of markets

• Prediction markets

• Resource markets
  – External
    » Outsourcing
  – Internal
    » Transfer pricing
    » Internal markets
Why are internal markets becoming more desirable?

• Markets often have more efficient and flexible results than hierarchies.

• Markets can use more information and more people’s minds simultaneously than centralized hierarchies.

• IT lowers the costs of running markets and thus makes them more feasible in more situations.
## Market prices for product futures

<table>
<thead>
<tr>
<th>Product (100 units)</th>
<th>Location</th>
<th>Time (weeks)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bid</td>
<td>Ask</td>
<td>Bid</td>
<td>Ask</td>
<td>Bid</td>
</tr>
<tr>
<td>A</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>A</td>
<td>2</td>
<td>5</td>
<td>8</td>
<td>6</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>B</td>
<td>1</td>
<td>10</td>
<td>11</td>
<td>10</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>B</td>
<td>2</td>
<td>10</td>
<td>11</td>
<td>10</td>
<td>11</td>
<td>12</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Copyright © 2007 Thomas W. Malone
When are internal markets desirable?

<table>
<thead>
<tr>
<th>Structure</th>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
</table>
| Internal Markets | • **Efficiency**  
Maximizing your own benefits, results in efficient overall allocation (the invisible hand)  
• **Flexibility**  
More information and minds applied to figuring out how to adjust Individual variation can be accommodated  
• **Motivation**  
People are often more motivated and creative when they are rewarded directly for the results of their own actions | • **Incentive problems**  
Sometimes agreements that would be good overall aren’t in the individual interests of one or both parties involved.  
• **Communication**  
Lots of communication usually needed to find and compare alternatives and to negotiate agreements. |

### When should you decentralize?

<table>
<thead>
<tr>
<th>Potential benefits</th>
<th>Potential costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Motivation</td>
<td>Difficulties in...</td>
</tr>
<tr>
<td>• Creativity</td>
<td>• Making decisions quickly</td>
</tr>
<tr>
<td>• Many minds on same problem</td>
<td>• Managing risk and quality</td>
</tr>
<tr>
<td>• Flexibility</td>
<td>• Exploiting economies of scale</td>
</tr>
<tr>
<td>• Individualization</td>
<td>• Sharing knowledge effectively</td>
</tr>
</tbody>
</table>

- Potential benefits:
  - Motivation
  - Creativity
  - Many minds on same problem
  - Flexibility
  - Individualization

- Potential costs:
  - Making decisions quickly
  - Managing risk and quality
  - Exploiting economies of scale
  - Sharing knowledge effectively