Deciding when 'not' to maximize profits: How and why some corporations sabotage their own subsidiaries

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Corporate America may have a reputation for maximizing profits whenever possible, but a new study shows that's not always the case; companies sometimes deliberately leave money on the table in an effort to "get along" with and not upset their competitors. For the first time, we're learning how a company's top bosses are doing it.

Titled "Constrained Delegation: Limiting Subsidiaries' Decision Rights and Resources in Firms That Compete across Multiple Industries," (published in *Administrative Science Quarterly*), the research paper finds corporate heads "selectively intervene" in the everyday business of a subsidiary to deliberately sabotage decisions that could positively shift the balance of power in the marketplace.

"We showed how large multi-unit firms manage competition across markets which no study before has showed," says Boston College Carroll School of Management Assistant Professor Metin Sengul, the study's co-author. "There are two ways a corporation head can ensure a subsidiary plays nice. One is to watch over its subsidiary's shoulder everyday, which is very difficult for headquarters, especially if it has lots of different units. It's very costly and impractical.

"The other option is what we are arguing and that is to delegate decisions that will not trigger competitive aggressiveness to your units," says Professor Sengul, who argues corporations want subsidiaries to succeed

– to a point. "A corporate head might say to a subsidiary, 'I don't want you to anger my multimarket rivals so that we are hurt overall. Other than that, I want you to make money. Go, do good business. But whenever you are making big investment decisions - increasing your capacity by 30%, for example – stop. Come and ask me. Let's talk. And then I will tell you to do it or not. Don't decide on your own.' Corporations don't want to centralize everything, they just want to centralize big decisions."

To curtail any potential problems, Sengul says corporations not only limit a subsidiary's decision-making capacity, but also financially handcuff them.

"If you're one of those units that I want to behave," says Professor Sengul. "I don't leave lots of cash to your discretion because I don't want to come back next year and see that you created new factories because you had the cash and you had the autonomy. It's not good for the corporation if we are competing with the same rivals in multiple different businesses."

To be clear, a company that is a standalone entity will typically go after its competitors in an aggressive way when there is an attractive market opportunity; Professor Sengul argues it's the corporations competing with the same rivals in multiple businesses who aren't as aggressive. He argues this approach to decision making is part of a larger issue where corporations tacitly agree amongst themselves not to upset the collective apple cart; instead, the goal is to get along across all industries within a corporation's market place and avoid "competitive spillovers."

"Our study shows this happens across all industries, especially in industries where large firms dominate," says Professor Sengul, who goes on to describe a hypothetical scenario where General Electric decides to cut its light bulb prices by 10% and increase production by 20% in a bid

to gain market share. That move might hurt Siemens, also in the light bulb market. Professor Sengul says instead of matching the price drop and hurting its own bottom line in the light bulb industry, Siemens might instead go after GE in the MRI market, a space both companies compete in.

"Let's say that Siemens' MRI unit is relatively small compared to their light bulb unit," hypothesizes Professor Sengul. "Siemens' headquarters tells the MRI unit 'Cut your prices' because the moment the MRI unit of Siemens cuts its prices, then it increases competition in the MRI business. So now GE is hurt because as the competition escalates in the MRI market, GE starts losing money in that business and healthcare business is important for the entire GE portfolio. Note that although it all started with GE light bulb cutting its prices, the unit that is losing money is not GE light bulb but GE healthcare. In that way, the initial competitive action of one unit hurt another unit. That is what we call competitive spillover.

"Whenever corporate heads realize, 'OK my unit competes with other firms that can respond in other markets, then they tell those units, don't be too aggressive. You are part of my corporate umbrella, my corporate empire. Behave. Don't focus on market share, don't cut prices. Be nice. Focus on profits, focus on increasing the margins.'"

Professor Sengul calls this a "go along to get along" cooperative attitude.

"Live and let live," says Professor Sengul. "You step back, I step back. If you don't step back, I don't step back. That is called 'mutual forbearance.' We both forbear. We both take a step back."

Inside the corporate umbrella, this cooperative attitude toward multimarket rivals can lead to a restricted growth in certain businesses of the corporation, businesses that compete with units of other multimarket

firms.

"I'm intervening not to push my units to grow, I'm intervening basically to reduce their competitive aggressiveness. That is the objective. Because that is the objective and my units are getting less aggressive, that's why they are growing relatively less."

Professor Sengul argues in the end, it's the consumers that are taking a backseat.

"Collusive behavior rarely helps consumers. Profits go up usually at their expense. Mutual forbearance reduces competitive aggressiveness in the market place and less competition usually hurts consumers."

Data collection on this report began in 2005 and focused solely on French companies.

"We have data on every single subsidiary from every single firm in France," says Professor Sengul. "You can't get that kind of data in the United States – the laws are more restrictive here. Mutual forbearance happens in the U.S. every day, no doubt about it."

Provided by Boston College

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