

# Come Together: Firm Boundaries and Delegation\*

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## Abstract

We jointly study firm boundaries and the allocation of decision rights within them by confronting an incomplete-contracts model with data on vertical integration and delegation for thousands of firms around the world. Integration has an option value: it confers authority to delegate or centralize decision rights, depending on who can best solve problems that arise in the course of an uncertain production process. In line with the model's predictions, we find that firms are more likely to integrate suppliers that produce more valuable inputs and operate in industries with more dispersed productivity, and that firms delegate more decisions to integrated suppliers that produce more valuable inputs and operate in more productive industries.

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# 1 Introduction

Why do firms integrate suppliers? One benefit, of course, is to have control over production decisions: in the presence of contracting frictions, ownership rights allow top management to improve productive efficiency by imposing costly investments on suppliers, such as conforming to standards, re-tooling, or even relocating their plants.

Equally important, if less appreciated, integration confers greater control over the firm's internal organization. Among the residual decision rights bundled with owning an asset is the ability to re-assign its use or control to others. Over the course of a lengthy and uncertain production process, different types of problems are bound to arise, and top managers may wish to re-allocate decision rights among themselves and their suppliers to solve them according to their relative expertise. Within a firm's boundaries, management can do this relatively seamlessly, choosing to delegate production decisions to its integrated suppliers or to centralize those decisions, depending on which problem arises. This option is hardly available outside the firm, where suppliers maintain control of their production decisions as part of their ownership rights. Firm boundaries and the allocation of decision-making inside the firm are thus intrinsically linked.

The “control over control” that comes with ownership helps guarantee the firm a minimum quality and quantity of inputs, and thereby introduces a novel mechanism of supply assurance as a rationale for integration: the advantage of ownership is not so much that it can be used to force a supplier to provide an input that he might otherwise sell to someone else, but that it allows the firm to deploy control to the party best suited to using it. This greater flexibility of integration compared to outsourcing has been cited as one of the reasons why Apple has recently decided to integrate the design and development of computer chips.<sup>1</sup>

Failure to appreciate the interdependence between the firm boundaries and the internal power structure can be disastrous, as Boeing's infamous 787 Dreamliner fiasco starkly illustrates. In a departure from its practices with earlier models of aircraft, Boeing outsourced the design and manufacture of major components of the 787 (e.g., fuselage, wings, stabilizers) to independent suppliers. As it turned out, some of these suppliers were not competent to solve various design and procurement problems that arose during the course of production. The need for remedial fixes led to years of delivery delays and billions of dollars in cost overruns, which could have been avoided had it been able to step in at the early stages, as it was accustomed to doing under its previous ownership structure.<sup>2</sup>

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<sup>1</sup>The decision, announced in June 2020 at the Apple's annual Worldwide Developers Conference, was partly driven by Apple's desire to “[give] itself more flexibility and agility when it comes to future products” (see [“Apple Mac computers make jump to its own chips”](#)).

<sup>2</sup>Delays ran to 40-months, and overruns were estimated at \$12-18 billion. Boeing's organizational blunder

Despite their evident connection, the interplay between vertical integration and delegation has scarcely been explored. This paper brings these twin organizational design decisions together, both theoretically and empirically. It first develops a model to jointly study vertical integration and delegation. It then assesses the evidence in light of the model, combining information on vertical integration and delegation for thousands of firms in multiple countries and industries.

Our analysis is founded on a well-known conceptual distinction between outsourcing (non-integration) and delegation. While both are instruments for re-assigning control rights, the first is defined by formal titles of ownership and requires legal intervention to reverse, via an asset purchase. By contrast, delegation is a non-contractible act of relinquishing control that can in principle be revoked at will by owner fiat.<sup>3</sup> One contribution of this paper is to make this distinction operational by generating predictions about the differential response of these two organizational design elements to changes in the firm's environment.

In our theoretical model, firm boundaries and the internal allocation of control are the result of optimizing behavior by a headquarters (HQ) that produces a final good using several inputs, each sourced from a supplier. An input has to be adapted to the specific needs of HQ, and this requires coordinated production decisions involving both HQ and the input's supplier. Complicating this process are two main sources of uncertainty. The first is standard quantity or quality risk that clouds inference about underlying decision variables, rendering them non-contractible. The second source is central to the organizational design and concerns the day-to-day problems that may arise during the course of production: at the time when HQ and a supplier decide whether to integrate, they do not know the exact production needs and associated challenges — e.g., new designs, quality control or compatibility issues, supply chain interruptions, new hiring or capital equipment requirements — that they may encounter in the future.

HQ and the supplier differ in several dimensions. First, they have divergent abilities in solving the problems that may arise during the course of production: some will be easier for the supplier, others for HQ. This is modeled as variability in the amount of input that

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appears all the more egregious in light of the significant uncertainty surrounding the production of the 787, which “involved not merely the outsourcing of a known technology . . . [but] major technological innovations unproven in any airplane (see “[What Went Wrong At Boeing?](#)”). In light of our theory and evidence, circumstance such as these would make the case for in-house production all the more compelling. Part of Boeing's remedial reorganization for the Dreamliner was to acquire some of the major suppliers in order to have more direct control on the production of its inputs (see Tang and Zimmerman, 2009; Zhao and Xu, 2013; Tsay, 2014; and McDonald and Kotha, 2015).

<sup>3</sup>See for instance Williamson (1991) and Aghion and Tirole (1997). Indeed, non-integration has legal force, while delegation does not. The law not only regulates and registers asset sales, it frequently adjudicates disputes between parties who hold separate titles. Once they are integrated, however, the parties largely forego appeal to the law in many of their disputes.

can be produced as a function of the problem that arises during production, implying that organizational performance depends on the assignment of control over problem solving.<sup>4</sup> Second, the supplier and HQ have conflicting preferences over production standards, possibly due to differences in training, background, corporate culture, or managerial vision.<sup>5</sup> And third, contracting frictions imply that the supplier has smaller residual stakes in the enterprise profit than HQ.

Under integration, HQ owns the input production line and can therefore decide whether to solve problems and implement all production decisions (centralization) or instead to make the supplier in charge of problem solving as well as some — but not all — production decisions (delegation).<sup>6</sup> Since centralization puts decisions in the hands of one party, it tends to coordinate them well, but this comes at the expense of high private costs to the supplier as well as his forgone expertise. Because it is simply not feasible to put *every* decision in the hands of the supplier, delegation can take advantage of his competence, but at the cost of some coordination loss: the supplier chooses his preferred production standards, and HQ bears significant private cost to perfectly coordinate her residual decisions with his. Nevertheless, because of the ability to redeploy to the better decision maker as circumstance dictate, integration assures HQ of at least a minimal (expected) supply of the input.

By contrast, with non-integration, the supplier owns the line, so HQ has no option to centralize or delegate decision rights. Given his low residual stakes, the supplier avoids the private costs of doing things HQ's way by always choosing to retain control, even when the problems are those that HQ is better equipped to handle. Like delegation, non-integration suffers coordination losses, since it would be privately too costly for HQ to coordinate her decisions with the supplier's. What is more, supply of the input is less assured, since it depends on the supplier's competence, which may be low for some problems. But non-integration minimizes the costs of the supplier, who can always make production decisions in line with his preferences.

The model refines the “value principle” that emphasizes the role of pecuniary variables such as profitability and prices in the organizational design calculus, and extends it beyond the integration context where it has already been applied (Legros and Newman, 2013, 2017). The

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<sup>4</sup>In this respect, our setup resembles Garicano (2000)'s model of the organization of knowledge in production, though the mechanism by which problem solving is assigned to parties is different, as discussed below.

<sup>5</sup>Tensions about the way operations should be carried out within firms are emphasized by Van den Steen (2005), Hart and Holmström (2010), among others.

<sup>6</sup>An alternative mechanism for allocating control would be a contract that specifies for any contingency who makes each decision. In practice, verifying the identity of a decision maker, and of the circumstances in which she allegedly made a decision, appears to be very costly, and therefore the scope of such contracts is limited. We set them aside in our main analysis; see Section 3.2.2 (esp. Remark 3) for further discussion.

flexibility to reassign control makes integration into a kind of real option.<sup>7</sup> Thus, the option value of integration needs to be considered when ownership decisions are made.<sup>8</sup> Moreover, input value affects not only which suppliers HQ integrates, but also whether she delegates to subordinate suppliers or retains control over their production decisions.

The model also delivers several testable predictions about the exogenous determinants of integration and delegation choices. First, suppliers that for technological reasons contribute more to enterprise value should be more likely to be integrated; second within firm boundaries, top management should be more likely to delegate decisions to suppliers of more valuable inputs. The integration result occurs because the return to having an assured supply of an input increases when the input is more valuable, and it is therefore more likely to offset the supplier's private cost. The delegation result stems from the greater weight parties place on the common profit interest than on their private costs as value increases: HQ is less reluctant to delegate to a supplier when she anticipates that decisions will be more aligned with the organization's interest.

We also consider how uncertainty about which problems will arise during production affects organizational decisions. Since different problems will be solved with varying efficacy by the supplier, this translates into predicted relationships between a supplier's productivity distribution and organizational design. We show that first-order shifts in that distribution imply more delegation to an integrated a supplier because that means the supplier's productivity is more likely to exceed HQ's; but because that shift reduces both the value of integrating, as HQ is less likely to exercise the option to centralize, and the cost imposed on the supplier, for exactly the same reason, the effect on whether the supplier is integrated at all is ambiguous. And because of the convexity in the option value of integration, the model also suggests that the expected return to HQ of vertical integration must increase with the degree of risk about production problems.<sup>9</sup> By contrast, the model does not predict any systematic effect of risk on delegation.

To assess the evidence, we combine information from the WorldBase dataset by Dun & Bradstreet and the World Management Survey (WMS), which allows us to measure integration and delegation choices for firms in 20 countries. A first look at these data illustrates the conceptual distinction between outsourcing (non-integration) and delegation. In Figure

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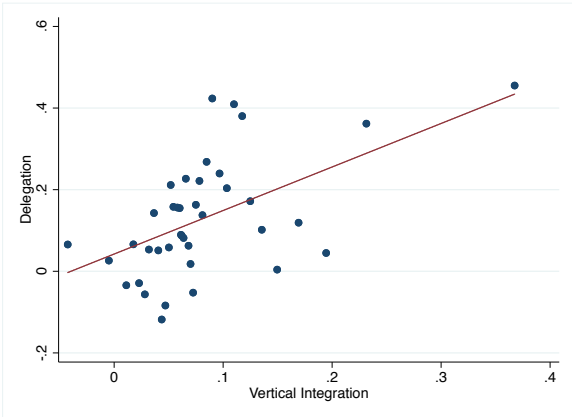
<sup>7</sup>More precisely, acquiring the supplier creates one option (HQ's), while destroying another (the supplier's), though as mentioned, in equilibrium a supplier that remains non-integrated never chooses to exercise the option, while HQ does.

<sup>8</sup>See Dixit and Pindyck (1994) for a general discussion of investment decisions under uncertainty in a real options framework.

<sup>9</sup>Though risk has an ambiguous effect on the expected private cost the supplier will have to bear (i.e., whenever HQ decides to centralize), and therefore on the cost of integration, the net effect favors integration for distributions close to lognormal, which our data approximate.

1 we correlate the degree of delegation granted to the manager of a firm’s typical integrated supplier, as measured by Bloom, Sadun and Van Reenen (2012), with the firm’s overall index of vertical integration, as defined in Alfaro *et al.* (2016).<sup>10</sup> As illustrated in the figure, there is a strong positive correlation between vertical integration and delegation (equivalently, a *negative* correlation between outsourcing and delegation).<sup>11</sup> This already makes clear that outsourcing and delegation are distinct: though they both involve shifting control from an HQ to a supplier, they cannot simultaneously be interchangeable and negatively correlated.<sup>12</sup>

Figure 1: Firm-Level Delegation and Vertical Integration



*Notes:* The figure is a binned scatterplot. It is constructed by regressing firm-level delegation and firm-level vertical integration on industry fixed effects, grouping the residuals into 40 bins, computing the mean for each bin and representing the resulting data in a scatterplot.

In our empirical analysis, we focus on the causal predictions generated by the model regarding the role of input value and uncertainty. To this purpose, we measure vertical integration at the firm-input level: for each firm, we identify the set of inputs needed to produce its final good and define the probability that the firm integrates each input within its boundaries. This measure reflects the choices faced by firms in our theoretical model, in which

<sup>10</sup>The firm’s overall vertical integration index is defined as the sum of the direct requirement coefficients of all the inputs that are owned by the firm. See footnote 41 in Section 4.3 for details. Note that, in principle, the number and value of suppliers an HQ owns has nothing to do with whether she grants one of them complete autonomy (fully delegates) or none, so the degree of vertical integration places no restriction on the degree of delegation we might observe: any relationship between delegation and integration is *a priori* possible.

<sup>11</sup>The positive relationship between delegation and integration is very robust: it continues to hold when including proxies for managerial capacity, other firm controls, and additional fixed effects, and when using different samples. See Appendix A-2.

<sup>12</sup>As it happens, the value principle can offer a rationalization for the positive correlation: delegation and integration could share a common (unobserved) driver in the form of enterprise value (e.g., HQ productivity or final good price). A simple application of our theoretical model suggests higher value enterprises should both vertically integrate more and grant more autonomy to their integrated suppliers.

HQ decides whether or not to integrate each input supplier. Our delegation measure captures the degree of autonomy granted by a firm to the managers of its integrated suppliers when faced with various production decisions (e.g., hiring a new full-time permanent shop floor employee, introducing a new product, making capital investments).

To test the model's predictions about the role of input value, we exploit exogenous variation in input-output coefficients (IO) using data from the US Bureau of Economic Analysis (BEA). IO coefficients capture exactly the role of input value in our model, since they measure the dollar value of each input used in the production of an output. To assess the role of uncertainty, we use measures of the mean and dispersion of the distribution of productivity of independent suppliers in an industry, which are exogenous to a firm's organizational choices.

The evidence confirms the role of input value for integration and delegation choices, in line with our theoretical model. We find that final good producers are indeed more likely to integrate suppliers of more valuable inputs, as proxied by input-output coefficients. Our finding that suppliers of inputs that contribute more value to the production of a firm's output are more likely to be integrated is in line with the results of previous studies on firm boundaries (e.g., Alfaro *et al.*, 2019; Berlingieri, Pisch, and Steinwender, 2020). In this paper, we show theoretically and empirically that input value also affects delegation choices within the firm boundaries: among integrated suppliers, more autonomy is granted to those producing more valuable inputs.

Also consistent with the theoretical model, we find that delegation increases with the mean productivity in the input industry, while riskiness of the input industry has no significant effect on delegation. Moreover, in line with the model's prediction the probability that firms integrate a particular input increases with the riskiness of the input industry.

The empirical results of our baseline regressions hold up in a series of robustness checks, e.g., using different samples of firms, including plant-level and firm-level controls, input-industry and output-industry fixed effects. In the integration regressions, we can also include firm fixed effects, exploiting variation within firms across input industries (in the riskiness of the industry or the value of the input) to identify the role of input value and input risk.

The structure of the paper is as follows. Section 2 briefly reviews the related literature. Section 3 presents the theoretical model. Section 4 describes the data and variables used in the empirical analysis. Section 5 presents the empirical results. Section 6 offers some concluding comments about the implications of our findings for the theory of the firm.

## 2 Related Literature

Our work is mainly related to two streams of literature. First, we build on the vast literature on the determinants of firm boundaries. Theoretical studies have looked at inter alia the technological/contractual determinants of vertical integration (e.g., Coase, 1937; Grossman and Hart, 1986; Hart and Moore, 1990; Holmström and Milgrom, 1991; Hart and Holmström, 2010).<sup>13</sup> A number of papers study legal/institutional determinants of integration (e.g., Acemoglu *et al.*, 2009, Macchiavello, 2012). Lafontaine and Slade (2007, 2013) provide an excellent overview of the empirical literature on firm boundaries.<sup>14</sup> Within this literature, our empirical analysis is close to papers emphasizing the relative technological importance of inputs for integration choices (e.g., Berlingieri, Pisch, and Steinwender, 2020; Hansman *et al.*, 2020) and supply assurance motives (e.g., Macchiavello and Miquel-Florensa, 2017).

Second, our paper is related to the literature on delegation within firms. Theoretical studies in this literature include, among others, Holmström (1984), Aghion and Tirole (1997), Dessein (2002), Hart and Moore (2005), Alonso, Dessein, and Matouschek (2008), Alonso and Matouschek (2008), and Marin and Verdier (2008).<sup>15</sup> Our approach to modeling delegation is closely related to work on the design of knowledge hierarchies (Garicano, 2000) and referrals (Garicano and Santos, 2004) insofar as we are concerned with allocation of decision making among the organization’s members according to the expertise at solving particular production problems.<sup>16</sup> On the empirical side, contributions include Acemoglu *et al.* (2007), Guadalupe and Wulf (2010), Bloom *et al.* (2012), McElheran (2014), Graham, Campbell, and Puri (2015), Wu (2017), and Katayama, Meagher, and Wait (2018).

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<sup>13</sup>The view of integration in our model is similar to that of Williamson (1975), and puts it in the “ex-post non-contractible” branch of incomplete-contracts economics (e.g., the 2002 version of Hart and Holmström, 2010; Aghion, Dewatripont, and Rey, 2002; Legros and Newman, 2008; Dessein, 2014). Another strand has focused on market determinants (e.g., McLaren, 2000; Grossman and Helpman, 2002; Legros and Newman, 2013; Conconi, Legros, and Newman, 2012). Earlier theoretical approaches include the resource-based view of Wernerfelt (1984), the routines-based theory of Nelson and Winter (1982), and the knowledge-based explanation of Kogut and Zander (1992).

<sup>14</sup>Some studies have examined the determinants of vertical integration using firm-level data within specific industries (e.g., Joskow, 1987; Woodruff, 2002; Baker and Hubbard, 2003), countries (e.g., Acemoglu *et al.*, 2010; Alfaro *et al.*, 2019), or across industries within countries (e.g., Acemoglu, Johnson, and Mitton, 2009).

<sup>15</sup>Much (but by no means all) of this literature views delegation as a means of achieving better outcomes by assigning decision rights to (ex-ante) better informed parties; often this helps to incentivize delegates to become more informed in the first place. In our simplified model of delegation, the assignment of control is instead a *response* to (symmetric) information: the (ex-post) sufficiently more capable (or possibly less time constrained) party gets it. The two approaches are complementary — the production decisions could involve the acquisition of further information — and our approach is mainly for tractability.

<sup>16</sup>In those papers the allocation of control is decided contingently through contracts rather than managerial authority, and they abstract from incentive problems, which play a key role in the comparative statics of our model. Moreover, they endogenize knowledge acquisition, while we take competence as given.



In this paper, we bring these organizational choices together. A number of papers have studied pairwise interactions of organizational design elements from the theoretical point of view. Examples include Holmström and Tirole (1991), Holmström and Milgrom (1991, 1994), and Friebel and Raith (2010), among others. Although some formal studies have emphasized the conceptual difference between integration and delegation (Baker, Gibbons, and Murphy, 1999; Hart and Holmström, 2010), there has been little theoretical work to operationalize these differences. And, to the best of our knowledge, there is no systematic empirical work along those lines.

### 3 The Model

#### 3.1 Production

Consider a production process in which a final good  $j$  is produced with  $n$  inputs indexed by  $i$ . An enterprise is composed of an HQ, who produces the final good, and  $n$  suppliers  $S_i$ , each comprising a manager (who will usually also be referred to as a supplier) and an indivisible productive asset that can be owned by the manager or by HQ. For empirical purposes, we shall think of each supplier  $S_i$  as representative of its industry: any supplier in industry  $i$  is like any other, though there are differences across industries. All players are risk neutral.

The expected value of a good produced by the enterprise can be written as

$$A_f P_j \sum_{i=1}^n \pi_{i,j} \mathbb{E}V_{i,j}. \quad (1)$$

$A_f$  represent the exogenous productivity of the HQ of the enterprise, capturing her entrepreneurial competence or the profitability of her product.  $P_j$  is the price of the final good and  $\pi_{i,j} \mathbb{E}V_{i,j}$  is the contribution of each supplier  $i$ . The latter is decomposable into an exogenous, technologically dictated value share  $\pi_{i,j}$  and an endogenous quantity  $\mathbb{E}V_{i,j}$  that will be shaped by production and organizational decisions made by HQ and supplier  $S_i$ . For now, we consider the relationship between HQ and a typical supplier and suppress the index notation; we also normalize  $A_f = 1$  and  $P_j = 1$ .

There are two sorts of uncertainty in this model. One is the standard contract-theoretic quantity or quality uncertainty that renders many decisions non-contractible. The second is more specific to the organizational design concerns in this paper, which is uncertainty over which specific problems will arise in the course of production — and therefore who is best suited to tackle them — that drives the delegation decision and is the source of the option

value of integration.

### 3.1.1 Technology

Production of the input proceeds in two stages: the first generates a basic input, and involves the active participation of the supplier. The second is the adaptation stage and is carried out by the HQ alone. Examples of these two stages might be part production and general assembly, or manufacturing and marketing. Each stage involves making production decisions represented by  $s \in [0, 1]$  for the first stage and  $h \in [0, 1]$  for the second. Examples include design, materials, style, brand adherence, even attitudes or employee culture. The main difference between  $s$  and  $h$  is that, while  $s$  can be decided by either party,  $h$  always remains with HQ. What they have in common is that they are difficult to specify ex-ante and even more difficult to verify in court; in other words, they are non-contractible. It is worth emphasizing that, no matter who makes the decisions, the cost of  $s$  is borne by the supplier and the cost of  $h$  is borne by HQ.

The decisions  $s$  and  $h$  affect input characteristics and need to be coordinated to ensure maximal value. Specifically, a unit of input is successfully adapted to HQ's needs (yields the return  $\pi$ ) with probability  $p(|s - h|)$  and fails (yields zero) otherwise. Assume that  $p(\cdot)$  is decreasing, concave, and differentiable, with  $p(0) = 1$  (for instance,  $p(|s - h|) = 1 - (s - h)^2$ ). Thus, the generated value of inputs depends not so much on the magnitudes of  $s$  and  $h$  as on the difference between them. This specification provides a simple way to capture coordination problems within firms.<sup>17</sup>

The obstacle to perfect coordination is that HQ and the supplier have opposite preferences on how to carry out basic input production and find it costly to accommodate the other's approach. This could be due to differences in background, technologies, or "vision," possibly arising from the fact that they are in different industries.<sup>18</sup> Specifically, HQ has private cost  $d(h)$  per unit of input, while the supplier has private cost  $c(1 - s)$ , where the costs  $c(\cdot)$  and  $d(\cdot)$  have standard properties:  $c(0) = d(0) = 0$ , they are differentiable on  $[0, 1]$ , strictly increasing and convex, and satisfy the Inada conditions. Hence, HQ prefers the production standards  $s$  to be close to 0, while the supplier likes them close to 1.

The quantity uncertainty mentioned above is manifested in two ways: both the number of usable basic inputs that the supplier can deliver after the first stage, and the success of the HQ's own production decision in adapting usable inputs in the second stage are non-

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<sup>17</sup>This way to model coordination problems is common in the organizations literature (e.g., Dessein and Santos, 2006; Alonso, Dessein, and Matouschek, 2008; Legros and Newman, 2013).

<sup>18</sup>See Hart and Holmström (2010) for further discussion of production standards and private costs for organizational design.

verifiable, making it impossible to write contracts contingent on these outcomes.<sup>19</sup> In turn, this limits the means by which control can be allocated and plays a role in the determination of transfer prices between the supplier and HQ.

In addition, HQ and the supplier are uncertain about the various possible challenges that may arise in the course of input production, and have different expertise in overcoming them. This source of uncertainty is modeled by a set  $\theta \in [0, 1]$  of potential “problems” (or opportunities) that affect the basic stage of production. These can be interpreted broadly: examples might be new designs for the input, quality control or compatibility issues, sourcing of sub-inputs, or hiring new employees. Problems arise according to an absolutely continuous distribution  $F(\theta)$ .

The choice of standard  $s$  and the solution to the problem  $\theta$  are linked: either HQ or the supplier can address  $\theta$ , but whoever does must select  $s$  in the course of doing so. If HQ controls this process,  $z(\theta)$  expected units of usable inputs are generated; if the supplier is in charge, the expected productivity is instead  $y(\theta)$ . Assume  $y(\cdot)$  is strictly increasing (i.e., just label the problems in increasing order of the supplier’s competence at solving them).

HQ is a generalist, equally adept at addressing all problems ( $z(\theta) \equiv z$ ; this can be relaxed), while the supplier is a specialist, better than HQ at solving some problems, worse at solving others:  $y(0) < z \leq y(1)$ .<sup>20</sup> HQ is on average better at solving problems than the supplier, a convenient and plausible assumption though not strictly necessary for our results:

$$\mathbb{E}_F y(\theta) < z. \tag{A1}$$

$F(\theta)$  induces an absolutely continuous distribution  $G(\hat{y}) := F(y^{-1}(\hat{y}))$  over quantities  $\hat{y}$  (from here on, unspecified expectations are with respect to the productivity distribution  $G$ ). As noted above, the supplier is representative of his industry, so  $F(\cdot)$ ,  $y(\cdot)$ , and therefore  $G(\cdot)$  are specific to that industry.

HQ’s competence  $z$ , as well as the supplier’s competence function  $y(\cdot)$  are common knowledge; each party knows exactly how well the other would perform in any given situation  $\theta$ ; there is only uncertainty as to which situation will arise, as represented by the distribution  $F(\theta)$  and corresponding productivity distribution  $G(y)$ .

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<sup>19</sup>Even if the HQ’s aggregate profits are verifiable, the supplier’s contribution to them is too small to form the basis for meaningful incentives.

<sup>20</sup>The problem-arrival setup is similar to that in Garicano (2000), but the capability function  $y(\theta)$  has a continuous range rather being binary-valued; other differences have already been discussed in Section 2.

### 3.1.2 Contracting

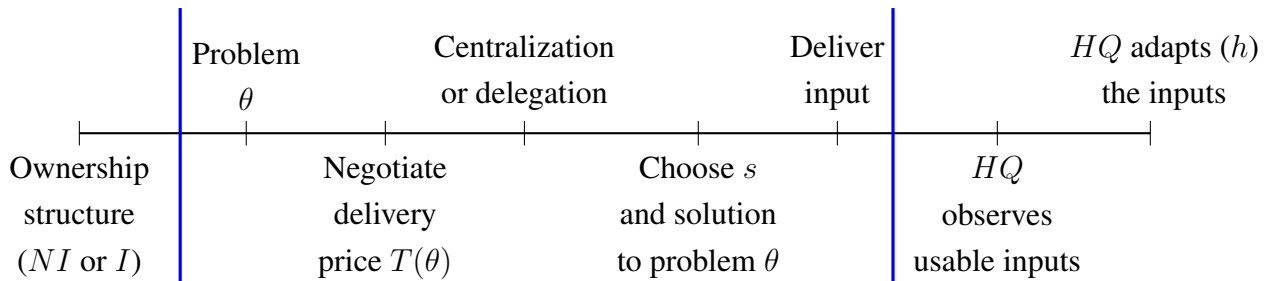
Contracting is limited to transfers of ownership and monetary payments for delivery of a batch of basic inputs. Nothing else is contractible, including the identity of decision makers/problem solvers, the usability (and therefore the number delivered) of inputs after the first production stage, the decisions  $s$  and  $h$ , or whether the input was successfully adapted. Once  $\theta$  is realized, the supplier and HQ negotiate a transfer for the batch (modeled with Nash bargaining), in general dependent on  $\theta$ , but not on the outcome of any stage of production, and payable upon delivery. Note that by this point in the production process the two parties are “locked in” to each other; a particularly difficult (low- $y$ ) problem realization cannot be eluded by finding a new supplier, as the problem would remain to be solved, and since all suppliers of particular input are identical, the new supplier would be no better at it than the old one.

When negotiating ownership, the supplier and HQ take account of the expected costs that will ensue. We assume that both parties have sufficient cash at the time of ownership contracting to make any side payments needed to settle the distribution of surplus required to strike a deal. Thus we will be considering “efficient” ownership choices in what follows.

### 3.1.3 Timing

The sequence of events is illustrated in Figure 2.

Figure 2: Timing of Events



There are three main phases for each input used in the production of the final output (delineated by the blue lines in the figure).

(1) Ownership choice.

- HQ and the supplier decide on the ownership structure. The owner (the supplier if non-integration, HQ if integration) has the right to make decisions during the input production stage or to delegate them to someone else.

(2) Input production.

- The two parties learn problem  $\theta$  and Nash bargain over the monetary transfer  $T(\theta)$  for the delivery of input.
- The owner chooses whether to make the productive decisions (problem solution and standard  $s$ ) or to delegate them to the other party.
- A batch of inputs is produced and delivered to HQ.

(3) Adaptation.

- HQ learns the number of usable inputs (on average  $y(\theta)$  if the supplier made the decision or  $z$  if HQ made the decision), and chooses the adaptation effort  $h$  for each usable unit in the batch.
- Usable inputs are adapted with probability  $p(|s - h|)$ .

To summarize, the surplus is  $[\mathbb{H}z + (1 - \mathbb{H})y(\theta)][\pi p(|s - h|) - d(h)] - c(1 - s)$ , where  $\mathbb{H}$  is an indicator whether HQ controls the production standard  $s$  and the problem solution,  $p(|s - h|)$  is the probability of successful adaptation, and  $d(\cdot)$  and  $c(\cdot)$  are HQ's and the supplier's private costs.<sup>21</sup> Of course, the production choices  $s$  and  $h$  are affected by the governance structure (which includes the choice of  $\mathbb{H}$ , the purview of the asset's owner), as we now describe.

## 3.2 Input Value and Organizational Design

Suppose that problem  $\theta$  arose and HQ has received the  $y(\theta)$  usable units of input from the supplier. The transfer  $T(\theta)$  for the batch is then sunk, so HQ chooses  $h$  to maximize the continuation payoff  $y(\theta)[\pi p(|\hat{s} - h|) - d(h)]$ , where  $\hat{s}$  is the supplier's equilibrium choice of the production standard.

### 3.2.1 Non-Integration

As the supplier owns the input before agreement to delivery, his Nash bargaining disagreement payoff is some generic market value  $P_0$  times the quantity he expects to produce  $y(\theta)$ , while HQ's is zero, since she would have to do without the input in case of disagreement. As

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<sup>21</sup>The expression reflects that HQ only incurs a cost on each unit she discovers to be usable during the adaptation stage. The supplier's cost is effectively fixed — for instance the cost of adopting a new method — or could be thought of as proportional to the size of a batch of rough inputs, which in turn is independent of  $\theta$  or the identity of the problem solver. Other specifications of supplier costs would yield similar results.

$s$  is not contractible, the payment from HQ to the supplier cannot depend on it. The supplier incurs expected cost  $c(1-s)$  and therefore chooses  $s$  to solve  $\max_s T(\theta) - c(1-s)$ , resulting in a choice  $s^N \equiv 1$  and cost  $c(0) = 0$ .<sup>22</sup>

HQ, knowing the equilibrium value of  $s$  to be  $s^N = 1$ , generates continuation value  $y(\theta)v(\pi)$  where  $v(\pi) \equiv \max_h [\pi p(|1-h|) - d(h)]$  (our assumptions on  $d(h)$  ensure the existence of an interior solution  $h^N$  to HQ's problem). Note that  $v(\pi)$  is increasing and convex with  $v(0) = 0$ : by the envelope theorem  $v'(\pi) = p(|1-h^N|)$ ; this is increasing by standard monotone comparative statics arguments, which imply that  $h^N$ , and therefore  $p(|1-h^N|)$  increase with  $\pi$ .

The (symmetric) Nash bargaining transfer  $T(\theta)$  for the batch of input is equal to half of the continuation value  $v(\pi)y(\theta)$  plus half of  $P_0y(\theta)$ ; thus the supplier's sales are

$$y(\theta)(v(\pi) + P_0)/2. \quad (2)$$

At the time of the ownership decision, non-integration yields an expected surplus of

$$v(\pi) \cdot \mathbb{E}y.$$

### 3.2.2 Integration and the Delegation Decision

When HQ owns the supplier's asset, since she already controls the produced input, her disagreement payoff is simply the continuation surplus  $[\mathbb{H}z + (1-\mathbb{H})y(\theta)[\pi p(|\hat{s}-h|) - d(h)]$ , while the supplier's is zero. We use this observation to assess the delegation decision within the integrated relationship.

HQ can choose to centralize, retaining control of  $s$ , in which case she ignores the supplier's cost and solves

$$\max_{h,s} z[\pi p(|s-h|) - d(h)],$$

resulting in the solution  $h^C = s^C = 0$ . Her monetary payoff is equal to  $z\pi$ , while the supplier incurs the private cost  $\bar{c} \equiv c(1)$ .

Alternatively, HQ can delegate, letting the supplier control the production-and-problem-solving process. Anticipating the delivery transfer of zero (more generally, one that does not

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<sup>22</sup>Since the non-integrated supplier receives a fixed transfer  $T(\theta)$  upon delivery, he has no incentive to delegate to HQ; if he did, anticipating her choice of  $s < 1$ , he would receive the same payment but incur the higher cost  $c(1-s) > 0$ . While delegation may be surplus enhancing for low values of  $\theta$ , the supplier cannot commit not to interfere and, contrary to usual principal-agent settings, there is no verifiable output that can serve as a basis for inducing  $S$  to delegate to  $HQ$  (contracting directly on the control allocation has already been ruled out). By contrast, because  $HQ$  is the full residual claimant on the value of adapted inputs, she internalizes the benefits of delegating to  $S$  under integration.

depend on the continuation value), the supplier will choose his least-cost standard  $s^D = 1$ , in which case HQ's maximized expected surplus is the same as under non-integration, namely  $\max_h y(\theta)[\pi p(|1 - h|) - d(h)] = y(\theta)v(\pi)$ , and her choice is  $h^D = h^N$ . HQ therefore delegates when  $\pi z < v(\pi)y(\theta)$ , or  $y(\theta) > y^*(\pi) := z \frac{\pi}{v(\pi)}$ . From the convexity of  $v(\pi)$ , the ratio  $\frac{\pi}{v(\pi)}$ , and therefore the cutoff value  $y^*(\pi)$ , are decreasing functions of  $\pi$ . It follows that

**Result 1.** *The probability  $1 - G(y^*(\pi))$  that HQ delegates a decision to an integrated supplier is increasing in the value of the input produced by the supplier.*

This result is driven by HQ's improving incentives (increasing willingness to sacrifice private benefits for profit) as the value of the HQ-supplier relationship increases. Were it not for the incentive problem, HQ would delegate whenever the supplier's competence on a problem exceeded her own, but here  $y^*(\pi)$  strictly exceeds  $z$  by the factor  $\frac{\pi}{v(\pi)}$  to take account of the "incentive wedge." Higher values of  $\pi$  reduce that wedge, as HQ increasingly sets aside her private costs in favor of profit.<sup>23,24</sup>

Before proceeding to the determination of firm boundaries, it is worth remarking about this model's take on certain themes that pervade the literature on delegation.

**Delegation and productivity.** Delegation (or decentralization within firms) is often associated with better performance, i.e., higher generated value, though the direction of causality remains an open question. A frequent claim in the popular business press is that delegation increases value, for instance because it improves incentives or morale, and a few scholarly studies find evidence for causal links in this direction (e.g., Bresnahan, Brynjolfsson, and Hitt, 2002; Aghion *et al.*, 2021). The present model offers two mechanisms through which causality can run the opposite direction, from value generated to delegation: an incentive effect (higher value contributions, as captured by  $\pi$ , improve incentives, making HQ more willing to delegate); and a selection effect (delegation only occurs for the problems the supplier is sufficiently capable of addressing).

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<sup>23</sup>This result does not depend on the constancy of  $z$ , which could instead be any measurable function  $z(\theta)$ , provided neither  $y(\cdot)$  nor  $z(\cdot)$  dominates the other. For if  $y(\theta) > \frac{\pi}{v(\pi)}z(\theta)$ , then  $y(\theta) > \frac{\pi'}{v(\pi')}z(\theta)$  for  $\pi' > \pi$ , because  $\frac{\pi}{v(\pi)}$  is decreasing. Thus the measure of problems that will be delegated to the supplier is non-decreasing in  $\pi$ .

<sup>24</sup>While here it is only HQ who is setting aside her private costs (as she is the only one with a financial stake in the continuation value of the enterprise), the point applies more broadly to situations in which suppliers also have such stakes. Relating changes in input value to private cost functions in the manner of Result 1 is one way to operationalize an intuition in the literature that suggests delegation is more common when principals and agents are more consonant (Aghion and Tirole 1997; Dessein, 2002).

**Delegation vs. efficient decentralization.** In this model, the informal allocation of decision making afforded by integration implies that HQ ignores the costs she imposes on the supplier when she centralizes control — there is too little delegation. Contrast this situation with one in which some mechanism, formal or otherwise, exists to take account of both parties’ costs in allocating control. In this case of “efficient decentralization,” the supplier gets control when  $v(\pi)y(\theta) > z\pi - \bar{c}$ . For low levels of  $\pi$ , this is true for all  $\theta$ : HQ’s authority imposes fixed costs on subordinates, and incurring them when the value return is very low is inefficient, since the profit gain from centralizing could never be large enough to offset the cost. As the value increases, it becomes worthwhile to centralize the decision making on the problems at which the supplier is most inept, because that is where the profit gains are largest; as value increases further, the profit gains to centralizing become worth the fixed costs for larger sets of problems. Thus, efficient decentralization would be *falling* with  $\pi$ , at least in a range where  $\pi$  is small. As  $\pi$  increases further, the incentive-wedge effects discussed above may come to dominate, leading to a *non-monotonic* (U-shaped) response of efficient decentralization to value.<sup>25</sup> Our data display no evidence of either possibility.<sup>26</sup>

**The delegation commitment problem.** In many models of delegation, the decision to cede control to the agent precedes the arrival of information, and this creates a potential commitment problem for the principal: once the information is revealed through the agent’s choice, she would like to override his decision. Often the principal is assumed to have this commitment power. Occasionally the commitment mechanism is modeled: Baker, Gibbons, and Murphy (1999) shows how relational contracts may overcome renegeing temptations; Hart and Holmström (2010) employs behaviorally-motivated punishments, noting that renegeing will nonetheless sometimes occur, but only in “extreme” states, which admits the possibility of too much delegation rather than too little. Here there is no question of commitment, because the decision to delegate is made after information arrives.

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<sup>25</sup>Formally, efficient decentralization occurs when

$$y(\theta) > \frac{z\pi - \bar{c}}{v(\pi)};$$

for  $\pi \leq \bar{c}/z$  the right hand side of this expression is non-positive, so it is efficient to decentralize for all  $\theta$  there. Decentralization is then decreasing in  $\pi$  if the right-hand side is increasing, i.e., if  $1 > (\pi - \bar{c}/z)\frac{v'}{v}$ , which is clearly true for  $\pi$  in a right neighborhood of  $\bar{c}/z$ . This could remain true for all  $\pi$ , or, if eventually  $1 < (\pi - \bar{c}/z)\frac{v'}{v}$ , efficient decentralization would be non-monotonic.

<sup>26</sup>To be sure, the firm is unlikely to integrate at low levels of  $\pi$  (see below), so complete decentralization is accomplished via non-integration. But this is a blunt instrument: as soon as integration starts to happen, there is too little decentralization.



### 3.2.3 The Firm Boundary Decision

Since integration is decided before production begins, expectations with respect to problems  $\theta$  must be used to determine optimal ownership choices. The expected value of integration is  $\mathbb{E}\max\{\pi z, v(\pi)y\} - \bar{c}G(y^*(\pi))$ , while the expected value of non-integration is  $v(\pi) \cdot \mathbb{E}y$ . Integration occurs when its expected value exceeds that of non-integration:

$$\mathbb{E}\max\{\pi z - v(\pi)y, 0\} > \bar{c}G(y^*(\pi)). \quad (3)$$

The right-hand side of this “put-option” condition is decreasing with  $\pi$  by Result 1. Meanwhile the left-hand side is increasing in  $\pi$ .<sup>27</sup> We can thus state the following:

**Result 2.** *If there is integration at  $\pi$ , there is integration at  $\pi' > \pi$ .*

In other words, the likelihood that a supplier is integrated grows with the input’s contribution to total firm value. This result is similar to the one in Legros and Newman (2013) (with the value parameter  $\pi$  standing in for the market price used there), though in that model, the possibility of delegation is not considered (indeed, one could think of that model as a special case of this one in which  $y(\theta)$  never exceeds  $z$ ).

Looking back at expression (1) for the expected value of an enterprise, Results 1 and 2 imply that the suppliers with higher input value ( $\pi_{i,j}$ ) are the ones most likely to be integrated and, among those that are, to have higher degrees of delegation.

Other sources of variation in enterprise value would have similar effects as input value. In particular, we could allow value to vary across firms within an industry, e.g., if their HQs have different productivity ( $A_f$  in equation (1), which we have so far set equal to 1). Then  $A_f\pi$  would replace  $\pi$  in all the formal expressions above. The effects of variation in  $A_f$  on integration and delegation choices would be similar to those of input value: both the propensity to integrate suppliers within the firm boundaries and the propensity to delegate decisions to integrated suppliers would increase in HQ’s productivity. We could also allow the output price  $P_j$ , to vary across different industries. HQs in high-value industries would have higher propensities to integrate their suppliers and to delegate to them than would HQs

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<sup>27</sup>While both integration and non-integration increase in value with  $\pi$ , integration does so “faster”: where  $y$  exceeds  $y^*$ , a change in  $\pi$  affects both ownership structures equally, but for  $y < y^*$ , where on average HQ’s capability exceeds the supplier’s and the incentive wedge is absent, integration gets a larger boost. Indeed, the derivative of the left hand side of (3), using  $z\pi = v(\pi)y^*(\pi)$ , is

$$[z - v'(\pi)\mathbb{E}\{y|y < y^*(\pi)\}] \cdot G(y^*(\pi)),$$

which is positive: using (A1) and properties of  $v(\pi)$  from section 3.2.1,  $v'(\pi)\mathbb{E}\{y|y < y^*(\pi)\} \leq v'(\pi)\mathbb{E}y < v'(\pi)z = p(1 - h^N)z \leq z$ .

in low-value industries.<sup>28</sup>

These simple extensions of our model imply that *integration and delegation should covary positively*, in line with what we observe in our data (see Figure 1): more valuable firms (e.g., those that have more productive HQs) should integrate more suppliers and grant more autonomy to them.

Taken together, Results 1 and 2 help to underscore the distinction between the informal organizational decision to delegate and the formal one of outsourcing (non-integration). For even though both move decision-making away from the “center,” the degree of delegation increases, while the propensity to outsource decreases, in response to changes in the same variable, namely input (or enterprise) value. These opposite predicted responses thus help to operationalize the conceptual differences between them.

### 3.3 Uncertainty and Organizational Design

As has been noted elsewhere (Hart and Holmström, 2010), and as the present model illustrates, uncertainty plays an essential role in delegation choices. If the parties could perfectly anticipate  $\theta$  at the time of the integration decision, there would never be a strict incentive to integrate and subsequently delegate: either  $y(\theta)v(\pi) \leq z\pi - \bar{c}$ , in which case there will be integration with centralization, or  $y(\theta)v(\pi) > z\pi - \bar{c}$ , in which case non-integration performs at least as well as integration, strictly so if  $z\pi > y(\theta)v(\pi)$  (for then HQ would centralize) or if the acquisition of the supplier’s asset has even infinitesimal cost. Contrary to the data, no variation in autonomy among integrated suppliers would then be observed, as no HQ would delegate at all. And as we have already discussed, the ability to hedge against uncertainty via centralization affects the value of owning assets.

To be more precise about how uncertainty affects delegation and integration, we consider the comparative statics of (first-order) stochastic dominance and of (Rothschild-Stiglitz) risk in the distribution  $G(y)$ .<sup>29</sup>

#### 3.3.1 Delegation

The degree of delegation is equal to  $1 - G(y^*(\pi))$ , the probability that  $y$  exceeds the threshold  $y^*(\pi)$ . From the definition of stochastic dominance the following is immediate as well as intuitive:

<sup>28</sup>Evidence for this effect can be found in Alfaro *et al.* (2016), and McGowan (2017).

<sup>29</sup>A distribution  $\hat{G}$  is stochastically larger than  $G$  if  $\hat{G}(y) \leq G(y)$  everywhere, with strict inequality on a non-null set.  $\hat{G}$  is riskier than  $G$  if the two distributions have the same mean and  $\int^x \hat{G}(y)dy \geq \int^x G(y)dy$  for all  $x$ , with strict inequality on a non-null set.

**Result 3.** *Stochastic increases in the supplier productivity distribution  $G(y)$  lead to a higher probability of delegation.*

When problems are more likely to land in the supplier’s sphere of competence, it is more likely that he will be the one asked to solve them.

However, because the cumulative probability at any given interior  $y$  value —  $y^*(\pi)$  in particular — can increase or decrease with increases in risk (risk-comparable c.d.f.’s cross at least once), there is no general prediction about the effects of risk on delegation: increasing risk tends to fatten both upper and lower tails, meaning only that there is a reduced likelihood that problems that crop up will be the ones in the supplier’s “domain of mediocrity.” Likely as not, they will play to his strengths as to his weaknesses, yielding an ambiguous change in HQ’s willingness to delegate.

### 3.3.2 Integration

The integrand  $\max\{\pi z - v(\pi)y, 0\}$  from the put-option condition (3) is decreasing and convex in  $y$ . So the relative value of integration over non-integration is decreasing with stochastic increases in  $G(y)$ : the more likely the supplier will be the one better able to solve the problem that arises, the less valuable is the option to centralize, and with that, the lower is the value of integration. The cost of integration (proportional to the likelihood of centralization) decreases as well, however, so the net effect on integration appears to be difficult to determine without more specific information about the distributions.

As would be expected from the theory of options, where more uncertainty increases option value, more risk in the supplier’s capacity to solve problems raises the value of integration. But again, the cost of integration  $\bar{c}G(y^*(\pi))$  could rise or fall with increases in risk. Despite this ambiguity, the effects on integration of changes in the riskiness of  $G(y)$  can be signed for certain classes of distributions, in particular the lognormal family, which is salient for our empirical analysis. Within that class, the relative benefit effect dominates the cost effect, even if it happens to be countervailing, so we have:

**Result 4.** *If there is integration at lognormal  $G(y)$ , there is integration at a riskier lognormal  $\hat{G}(y)$ .*

For the proof of this result, see the Theoretical Appendix.

Results 3 and 4 imply that delegation and integration co-vary with different moments of the productivity distribution: roughly speaking, delegation co-varies with the mean, but not with risk; integration co-varies with risk, but not with the mean. These results underscore once again the conceptual distinction between delegation and outsourcing.

Before moving on to testable implications of this model, we conclude by noting that this model delivers a slightly unconventional message about one of the costs of integration. It has long been argued (Coase, 1937) that managerial authority under integration can lead to various kinds of rigidities. How does this square with the flexibility of integration that is being emphasized here? In the present model, *centralized* decisions are indeed rigid:  $h = s = 0$  independent of any parameter. However, this is not the case for  $h$  under delegation, which varies with the parameter  $\pi$ ; for the decision whether to delegate in the first place, which depends on  $\theta$ ; or for  $s$ , which varies with the governance structure. In light of the model, it may thus be more accurate to say that it is centralization, rather than integration *per se*, that is rigid.

### 3.4 Testable Implications

According to the theoretical model (Results 1 and 2), both integration and delegation choices should depend on input value. Suppliers of more valuable inputs should be more likely to be integrated with firms; among the integrated suppliers, those producing more valuable inputs should be delegated more decisions. These results lead to the following testable predictions, which we will bring to the data in Section 5.1:

**P.1:** Firms should be more likely to delegate production decisions to integrated suppliers that produce more valuable inputs.

**P.2:** Firms should be more likely to integrate suppliers that produce more valuable inputs.

The model also suggests that delegation and integration choices should depend on characteristics of the distribution  $G_i(y)$  in each input industry  $i$ . For a large number of ex-ante identical suppliers, observed differences in productivity can be attributed to different production problems  $\theta$  having arisen for each supplier. In our empirical analysis, we will measure  $G_i(y)$  with the distribution of labor productivity (sales/worker) of independent suppliers in an input industry  $i$  (recall from expression (2) in Section 3.2, supplier sales are proportional to  $y(\theta)$ , so sales and employment data can serve as proxies for productivity in the model). As shown in Figure A-3 in the Empirical Appendix, this distribution approximates a lognormal distribution.

In addition to validating the hypothesis of Result 4, lognormality allows for simple parametric measurement of stochastic dominance and risk in terms of the mean and coefficient of variation (see Levy, 1973), which will be employed in the empirical analysis. In particular,

controlling for the coefficient of variation, differences in the mean productivity of suppliers in input industries proxies for first-order stochastic differences in  $G_i(y)$ . Moreover, controlling for the mean, differences in the coefficient of variation proxy for differences in Rothschild-Stiglitz risk.

In Section 5.2, we will assess the validity of the following predictions that correspond to the theoretical Results 3 and 4:

**P.3:** Firms should be more likely to delegate to their integrated suppliers that operate in stochastically more productive input industries.

**P.4:** Firms should be more likely to integrate suppliers that operate in riskier input industries.

## 4 Data and Variables

### 4.1 Datasets

In what follows, we describe the datasets used in our empirical analysis to construct firm-level integration and delegation measures and to assess the role of input value and uncertainty in shaping these decisions.

#### WorldBase

The first dataset used in the empirical analysis is WorldBase, which provides coverage of public and private firms in more than 200 countries and territories.<sup>30</sup>

The WorldBase dataset has been used extensively in the empirical literature on firm boundaries (e.g., Acemoglu, Johnson, and Mitton, 2009; Alfaro *et al.*, 2019). The unit of observation in the dataset is the establishment/plant, namely a single physical location where industrial operations or services are performed or business is conducted. Each establishment in WorldBase is identified by a unique nine-digit sequence called Data Universal Numbering System (DUNS) number. For each establishment, WorldBase provides:

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<sup>30</sup>WorldBase is the core database with which D&B populates its commercial data products that provide information about the “activities, decision makers, finances, operations and markets” of the clients’ potential customers, competitors, and suppliers. The dataset is not publicly available but was released to us by Dun and Bradstreet. The sample was restricted to plants for which primary SIC code information and employment were available (due to cost considerations). For more information see: [http://www.dnb.com/us/about/db\\_database/dnbinfquality.html](http://www.dnb.com/us/about/db_database/dnbinfquality.html).

- Industry information: the 4-digit SIC code of the primary industry in which each establishment operates, and the SIC codes of up to five secondary industries.
- Ownership information: information about the firms' family members (number of family members, domestic parent and global parent).<sup>31</sup>
- Additional information: location (country) of each plant, sales, employment, age.

WorldBase allows us to trace ownership linkages between establishments. In particular, we can use DUNS numbers to link all plants that have the same domestic or global parent. D&B defines a parent as a corporation that owns more than 50 percent of another corporation. To construct firm-level variables, we link all plants that have the same domestic ultimate owner.<sup>32</sup>

We use the 2005 WorldBase dataset and focus on the 20 countries that are also included in the World Management Survey described below. WorldBase contains 17,371,146 plants (corresponding to 16,718,199 parent firms). Median plant employment is 2, the mean is 288, and the standard deviation is 5,428 (see row “WorldBase dataset” in Table A-1).

## World Management Survey

The World Management Survey (WMS) is a large scale project aimed at collecting high quality data on organizational design of firms around the world and has been used in many studies (e.g., Bloom, Sadun, and Van Reenen, 2012).

The survey is conducted through phone interviews with plant managers. Several features of the survey design are meant to guarantee the quality of the data. First, the survey is “double blind”, i.e., managers do not know they are being scored and interviewers do not know the plant's performance.<sup>33</sup> This enables scoring to be based on the interviewer's evaluation of the firm's actual organizational practices, rather than their aspirations, the manager's perceptions, or the interviewer's impressions. Second, each interviewer ran 85 interviews on average. This allows to include interviewer fixed effects, which help to address concerns over the reliability and consistency of the answers. Third, information on the interview process itself (duration,

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<sup>31</sup>D&B also provides information about the firm's status (joint-venture, corporation, partnership) and its position in the hierarchy (branch, division, headquarters).

<sup>32</sup>A “Domestic Ultimate” is a subsidiary within the global family tree which is the highest ranking member within a specific country and is identified by a “domuduns” code. A “Global Ultimate” is the top most responsible entity within the global family tree and is identified by “gluduns” code. The two codes only differ in the case of multinational firms. In the case of multinational corporations, we follow Alfaro *et al.* (2016) and split them into several corporations, considering the domestic ultimate in each country as the relevant headquarters.

<sup>33</sup>The interviewers were given the name and contact details of the firm, but no financial details.

day-of-the-week), and on the manager (seniority, job tenure and location) was collected. These survey metrics are used as “noise controls” to help reduce measurement error.

The main wave of interviews was run in the summer of 2006, followed by smaller waves in 2009 and 2010.<sup>34</sup> The survey achieved a 45% response rate, which is very high for company surveys.<sup>35</sup> Overall, the WMS contains around 11,691 plants in 20 countries. The sampling frame was drawn to be representative of medium sized manufacturing firms in each country: median plant employment is 150, mean plant employment is 277, with a standard deviation of 405 (see row “WMS dataset” in Table A-1).

For each firm, only one (randomly selected) plant is surveyed in the WMS. Thus, we do not observe variation in delegation across plants belonging to the same firm. In a few cases, the same plant was interviewed again in the later waves.

## 4.2 Samples

In the empirical analysis, we use two samples constructed from the datasets described above.

### WorldBase Sample

This sample is constructed exclusively from the WorldBase dataset. It is used to test the predictions related to integration. We exclude firms that have less than 20 employees, to correct for differences in the coverage of small firms across countries (see also Klapper, Laeven, and Rajan, 2006). Since the WMS contains exclusively manufacturing plants, we restrict the attention to firms that have a primary SIC code in manufacturing (between SIC 2000 and 3999). To be able to exploit within-firm variation across inputs, we select firms that integrate at least one input different from their primary output  $j$ .

The WorldBase sample includes 67,111 plants, corresponding to 66,102 firms, operating in 459 sectors, located in 20 countries. Table A-2 reports the number of observations (at the firm-input level) by country. This sample features more variation in plant size compared to the matched sample: median plant employment is 42, the mean is 147, and the standard deviation is 3,187 (see row “WorldBase Sample” in Table A-1).

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<sup>34</sup>A minority of the plants (668) have been interviewed in more than one wave of the WMS. The sample excludes plants where the CEO and the plant manager were the same person (only 4.9% of the interviews).

<sup>35</sup>The high success rate is due to the fact that (i) the interview did not discuss firm’s finances, (ii) there were written endorsement of many institutions like the Bundesbank, Banque de France, UK Treasury, and World Bank, and (iii) high quality MBA-type students were hired to run the surveys.



## Matched Sample

This is the sample that is used to test the predictions related to delegation, constructed by combining information from WorldBase and the WMS. Notice that we are not able to use the full WMS to test the model's predictions concerning the role of input value and uncertainty on delegation choices. This is because testing predictions P.1 and P.3 requires information on ownership and input-output linkages between the plant surveyed in the WMS and its central headquarters, which we can only get for plants that are also in the WorldBase sample.

For the US and Canada we have linked plants interviewed in the WMS to plants in WorldBase using a common plant identifier (the DUNS number). For the remaining countries, there is no common plant identifier, so we have used a string matching algorithm based on company names and location information to link plants in the WMS to firms in WorldBase. We then manually checked the results of the matching process. To construct firm-level variables, we have used ownership information from WorldBase to identify the parent of any matched plant.

As mentioned above, the WMS is focused on medium-sized manufacturing plants, while WorldBase contains lots of very small plants. The matched sample includes 3,444 plant observations located in 20 countries, operating in 574 sectors, and corresponding to 2,883 firms.<sup>36</sup>

As shown in Table A-1, this is a representative sample from the WMS: median plant employment is 150, the mean is 254, and the standard deviation is 367 (see row labeled "WMS sample"). Table A-3 reports the number of observations (at the plant level) by country in the matched sample. Using information for all the countries in the sample is key to having a sufficient number of observations for our econometric analysis. Even the country with the maximum number of observations (the United States) accounts for only 18 percent of the sample.

## 4.3 Key Variables

In what follows, we define the main variables used in the empirical analysis. Tables A-5 and A-4 in the Empirical Appendix present summary statistics for these variables.

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<sup>36</sup>The remaining plants in WMS could not be matched to a firm in WorldBase, either because they are not in the WorldBase sample, or because they could not be uniquely assigned to a specific firm based on the string matching algorithm. Since the success of the algorithm is random, the matched sample corresponds to a random subsample of the WMS. Note that, even though in principle only one plant per firm was interviewed in the WMS, a few plants were interviewed more than once. This explains why the number of firms is smaller than the number of plant observations. In a handful of cases, 2 plants (which according to WorldBase belong to the same firm) were interviewed in the WMS.



## Integration

To distinguish between integrated and non-integrated inputs, we build on the methodology developed by Fan and Lang (2000), combining information on firms' reported activities with Input-Output tables. As explained below, in our empirical analysis, we measure vertical integration at the firm-input level, in line with our theoretical model: for each firm, we identify the set of inputs needed to produce its final good and estimate the probability that the firm produces each input within its boundaries.

Given the difficulty of finding highly disaggregated input-output matrices for all the countries in our dataset, we use U.S. input-output tables to provide a standardized measure of input requirements for each output sector.<sup>37</sup> The data are from the Benchmark Input-Output Tables of the Bureau of Economic Analysis (BEA), which include the make table, use table, and direct and total requirements coefficients tables. We employ the Use of Commodities by Industries after Redefinitions 1992 (Producers' Prices) tables. The BEA uses six-digit industry codes, while the classification of production activities in WorldBase follows the SIC classification. We convert the input-output data at the 4-digit SIC level, using the concordance guide provided by the BEA.<sup>38</sup>

We use the primary SIC4 code reported by a firm in WorldBase to identify the relevant output sector  $j$ . For each sector  $j$ , the I-O Tables report the dollar value of  $i$  used directly as an input in the production of \$1 of  $j$ , also known as the direct requirements coefficient,  $IO_{i,j}$ . We can use these coefficients to identify the set of 4-digit SIC inputs  $S(j)$  — including both manufacturing and non-manufacturing inputs — that are used in the production of  $j$ , namely:  $S(j) = \{i : IO_{i,j} \geq 0\}$ .

To identify which inputs a firm integrates, we define  $I(f) \subseteq S(j)$  to be the set of the primary and secondary SIC codes reported by firm  $f$  and all its subsidiaries (if any) in WorldBase, that are inputs in the production of the firm's output. This set identifies the integrated inputs, which the firm can in principle obtain within its ownership boundaries. The complement set  $NI(f) = S(j) \setminus I(f)$  identifies the non-integrated inputs, i.e., the inputs required in the production of the firm's output that are not included in  $I(f)$ . Each establishment in WorldBase reports a primary activity and up to five secondary SIC codes that are produced at the location of the production facility. A firm with a headquarters and  $k$  affiliates can thus in principle report up to  $5 + 6 * k$  integrated secondary activities.<sup>39</sup>

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<sup>37</sup>As pointed out by Acemoglu, Johnson and Mitton (2009), assuming that the U.S. input-output structure carries over to other countries mitigates concerns about the endogeneity of technology.

<sup>38</sup>The concordance table is based on the SIC 1987 classification. For codes for which the match is not one-to-one, we have randomized between possible matches.

<sup>39</sup>Note that right censoring is not a problem in the analysis. Only 0.01 percent of plants in the WorldBase sample report 5 secondary SIC codes.

Having identified the set of integrated and non-integrated inputs for each firm  $f$ , we can then construct our main integration measure used to test P.2 and P.4:  $Integration_{f,i,j}$  is a dummy variable equal to 1 if firm  $f$  producing primary output  $j$  integrates a supplier in input industry  $i$  within its boundaries.

In our empirical analysis, we will exploit variation in  $Integration_{f,i,j}$  within and across firms to study how input risk and input value shape integration choices. To keep the analysis tractable and exclude cases of mechanic integration (almost all sectors use their own output as an input), we will limit the sample to firms that integrate at least one input different from their primary output  $j$ , and to the top 100 inputs  $i$  used by  $j$ , as ranked by the IO coefficients (see also Alfaro *et al.*, 2019).<sup>40</sup> Most firms in the WorldBase sample only have a single establishment, but they still report up to five secondary activities that have been vertically integrated.<sup>41</sup>

The BEA input-output table that we are using is highly disaggregated (based on 935 4-digit SIC industries). As a result, even when focusing on the top 100 inputs, the average probability that a firm integrates any input is only around 1 percent (see Table A-5).<sup>42</sup>

## Delegation

Our measure of delegation comes from the WMS. Plant managers were asked several questions about the extent to which their central headquarters grant them autonomy in carrying out various activities. Notice that the design of the survey implies that delegation is only measured for integrated suppliers. This is in line with our theoretical model, in which the control of the production of the input can be delegated to a supplier only within firm boundaries.<sup>43</sup>

In the survey conducted by Bloom, Sadun, and Van Reenen (2012), plant managers were asked to state the degree of autonomy they have when hiring a new full-time permanent

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<sup>40</sup>To the extent that an individual firm's production technology differs from the average technology in the US (used to construct IO coefficients), this will introduce measurement error in our explanatory variable and thus an attenuation bias, making it harder to find an effect of input value on integration (P.1).

<sup>41</sup> Following Alfaro *et al.* (2016), we also construct a firm's overall integration index, which measures the fraction of inputs used in the production of a firm's final good that can be produced in house. For each firm  $f$  with primary activity  $j$ , we construct the variable  $IO_{ij}^f \equiv IO_{ij} * I_i^f$ , where  $I_i^f \in \{0, 1\}$  is an indicator variable that equals one if and only if firm  $f$  owns plants that are active in sector  $i$ . A firm with primary activity  $j$  that reports  $i$  as a secondary activity is assumed to supply itself with all the  $i$  it needs to produce  $j$ . Then the firm's vertical integration index is given by  $Vertical\ Integration_f = \sum_{i \in I(f)} IO_{ij}^f$ , which is the sum of the IO coefficients for each input industry in which firm  $f$  is active. This measure is used to produce Figure 1 in the Introduction, but not in the rest of the empirical analysis.

<sup>42</sup>Outside manufacturing, the correspondence between BEA and SIC industry codes is not always unique and this may induce measurement error in the IO coefficients. In fact, the effect of input value on integration is even stronger for manufacturing inputs, where the correspondence is one to one.

<sup>43</sup>In the case of non-integration, there is de-facto decentralization of production of the input: HQ does not have the authority to centralize production decisions, and the supplier has no incentive to give control to HQ.

shop floor employee, introducing a new product, or in sales and marketing decisions. These qualitative variables were scaled from a score of 1 (defined as all decisions taken at the corporate headquarters), to a score of 5 (defined as complete autonomy granted to the plant manager). They were also asked how much capital investment they could undertake without prior authorization from the corporate headquarters. This is a continuous variable enumerated in national currency that is converted into dollars using PPPs.<sup>44</sup> Since the scaling may vary across questions, we have standardized the scores from the four autonomy questions to z-scores, by normalizing each question to mean zero and standard deviation one.<sup>45</sup>

The variable  $Delegation_{f,p}$  is the average across the four z-scores for plant  $p$  belonging to firm  $f$ . We use information on ownership linkages from the WorldBase dataset to link a plant to its parent firm. Figure A-1 in the Empirical Appendix shows the distribution of  $Delegation_{f,p}$  in the matched sample.

In the empirical analysis, we will examine whether firms are more likely to delegate decisions to suppliers of more valuable inputs. We will use the primary SIC4 code of the parent firm to identify the output industry  $j$  and the primary SIC4 code of the plant to identify the input industry  $i$ . As mentioned before, the WMS typically contains information on one plant per firm. This implies that, in the case of multi-plant firms, we can only observe the degree of autonomy granted by central headquarters to the manager of one their plants. In the case of single-plant firms, we can measure the degree of autonomy that the owner/CEO gives to the plant manager. We will thus rely on cross-firm variation in  $Delegation_{f,p}$  to identify the role of input value.

## Input Value

To examine how input value affects delegation and integration choices, we will use the variable  $IO_{i,j}$  described above. This is the direct requirement coefficient for the pair of sectors  $i$  and  $j$ , which captures the dollar value of input  $i$  used in the production of one dollar of  $j$ . The IO coefficients  $IO_{ij}$  correspond to the empirical counterpart of  $\pi_{ij}$ .

Figure A-2 in the Empirical Appendix shows the distribution of  $IO_{i,j}$  in the WorldBase sample. Not surprisingly, given that the BEA input-output tables are highly disaggregated,

<sup>44</sup>In Appendix Figure A-6, we detail the individual questions in the same order as they appear in the survey.

<sup>45</sup>The continuous measure of delegation using in the empirical analysis stands in apparent contrast to the binary delegation choice in the theoretical model. However, the two can be reconciled by supposing that the production process is subdivided into a number of tasks, each of which is subject to a problem shock, and can be delegated or centralized. HQ delegates a task whenever the supplier's productivity on it exceeds the threshold  $y^*(\pi)$ , and centralizes otherwise. Interpreting the number or fraction of tasks delegated as the degree of delegation yields a measure that has identical salient properties to the probability of delegation in the baseline model. See Section A-1.2 in the Theoretical Appendix for the details.

the average  $IO_{i,j}$  is only 4 cents in the matched samples, and 5 cents in the WorldBase sample (see Tables A-5 and A-4). In the empirical analysis, we focus on the top 100 inputs  $i$  used by  $j$ , as ranked by the IO coefficients and we include both manufacturing and non-manufacturing inputs.

## Uncertainty in Input Industries

In the theoretical model, the contribution of a non-integrated supplier depends on his ability to solve the problem  $\theta$  that comes up during the production run. He produces on average  $y(\theta)$  usable units, so his productivity is proportional to  $y(\theta)$ . Under the assumption that problems encountered are i.i.d. among suppliers in the same industry, the observed productivity distribution of non-integrated suppliers in industry  $i$  thus approximates the fundamental distribution  $G_i(y)$ .

By contrast, the model suggests that the observed productivity distribution of the integrated suppliers in industry  $i$  is not a good proxy for  $G_i(y)$ . This is because the contribution of an integrated supplier depends on whether or not HQ centralizes, which she does whenever the problem encountered is one for which the supplier has low competence. In that case it is HQ's own competence  $z$  that determines productivity. The observed productivity of integrated suppliers is thus left-censored. This can cloud the relationship between various orderings (most saliently, Rothschild-Stiglitz riskiness) of the observed distributions and orderings of the underlying distribution  $G_i(y)$ .<sup>46</sup>

We thus focus on non-integrated suppliers of input  $i$  and use information from the full WorldBase dataset on their labor productivity (sales per employee) to proxy for the distribution  $G_i(y)$ .<sup>47</sup> To minimize measurement error, we consider all plants that report SIC4 code  $i$  as their only production activity.<sup>48</sup>

The distribution of labor productivity of input suppliers approximates a lognormal distribution (see Figure A-3 in the Empirical Appendix).<sup>49</sup>

To test prediction P.3, we construct the variable *Mean Productivity* $_{i,c}$ , the arithmetic average of labor productivity of suppliers of input  $i$  in country  $c$ . As mentioned in Section 3.4,

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<sup>46</sup>Recall that non-integrated suppliers endogenously do not delegate, so there is no censoring problem for them. In addition to the theoretical reasons for not including integrated suppliers, transfer pricing effects may also distort their measured labor productivity.

<sup>47</sup>As shown in an earlier version of the paper, the results are robust to using data from Bloom *et al.* (2018) on stock market returns of US firms to capture cross-industry variation in supplier productivity.

<sup>48</sup>The results continue to hold if we consider all plants that report SIC code  $i$  as one of their production activities, including those integrated in larger firms.

<sup>49</sup>This figure has been constructed by regressing log labor productivity (sales/employee) of all independent suppliers in WorldBase on 4-digit-industry  $\times$  country dummies. It thus shows within-industry-country variation in log labor productivity.

this is a proxy for the mean of  $G_i(y)$  in our model. Figure A-4 in the Empirical Appendix shows the distribution of  $Mean\ Productivity_{i,c}$  in the WorldBase sample.

To assess the validity of prediction P.4, we use  $CV\ Productivity_{i,c}$ , the coefficient of variation of productivity of suppliers in the same input industry. Controlling for the mean of supplier productivity, this variable can be used as a proxy for riskiness of the input industry in the Rothschild-Stiglitz sense (see Levy, 1973). Figure A-5 in the Empirical Appendix shows the distribution of  $CV\ Productivity_{i,c}$  in the WorldBase sample.

In robustness checks, we construct  $Mean\ Productivity_{i,c}$  and  $CV\ Productivity_{i,c}$  after winsorizing labor productivity at the 5th and 95th percentile.

## 5 Empirical Results

### 5.1 The Effects of Input Value

In this section, we assess our model’s predictions concerning the effects of input value on delegation and integration choices.

We first test prediction P.1 and verify how the value contributed by an input affects delegation choices. To this purpose, we exploit exogenous variation in value contributions as captured by the the input-output coefficients  $IO_{i,j}$  and estimate

$$Delegation_{f,p,i,j,c} = \alpha_1 IO_{i,j} + \alpha_2 \mathbf{X}_p + \alpha_3 \mathbf{X}_f + \delta_i + \delta_j + \delta_c + \epsilon_{f,p,i,j,c}, \quad (4)$$

using the matched sample. The dependent variable in (4) is the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by parent firm  $f$  (with primary activity  $j$ , located in country  $c$ ). The main control of interest is  $IO_{i,j}$ , the direct requirement coefficient for the sector pair  $ij$ . Some specifications include vectors of plant-level controls ( $\mathbf{X}_p$ ), firm-level controls ( $\mathbf{X}_f$ ), input-sector and output-sector fixed effects ( $\delta_i$  and  $\delta_j$ ), and country fixed effects ( $\delta_c$ ).<sup>50</sup> Plant-level controls include the percentage of the plant’s employees with a bachelor’s degree or higher and the plant’s share of the firm’s employment.

<sup>50</sup>As mentioned in Section 4, the WMS does not allows us to observe variation in delegation across plants belonging to the same firm. As a result, we cannot identify  $\alpha_1$  by comparing the degree of autonomy granted by firm  $f$  producing good  $j$  (e.g., automobiles) to the managers of two of its plants, one producing input  $i$  (e.g., plastics materials and resins), the other producing input  $i'$  (e.g., engines). We can, however, identify the role of input value by exploiting cross-firm variation in the degree of delegation. In particular, we can compare the degree of autonomy granted by two firms producing the same output (e.g., automobiles) to the managers of one of their plants, one producing input  $i$  (e.g., plastics materials and resins), the other producing input  $i'$  (e.g., engines). We can also compare the degree of autonomy granted to two plants producing the same input  $i$  (e.g., plastics materials and resins) who belong to firms making different final goods (e.g., automobiles and fabricated pipe and fittings).

Firm-level controls include the employment and age of the parent firm. We cluster standard errors at the firm level.<sup>51</sup> Our theoretical model suggests that a producer of good  $j$  should delegate more decisions to integrated suppliers that produce more valuable inputs, implying that the  $\alpha_1$  coefficient should be positive and significant.

The results of estimating (4) are reported in Table 1. We present first a specification that includes the key control variable with input-industry fixed effects (column 1), and then further include country fixed effects (column 2), output-industry fixed effects (column 3), and the plant and firm controls (column 4).

Table 1  
Delegation and input value

	(1)	(2)	(3)	(4)
$IO_{i,j}$	0.9865*** (0.3789)	0.9371** (0.3795)	0.9801** (0.4522)	1.0475** (0.4443)
Input FE	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes
Firm controls	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes
Number of observations	3,179	3,179	3,179	3,179

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects are respectively the primary activities of the parent and of the plant (defined at 3-digit SIC). Standard errors clustered at the firm level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels respectively.

As expected, the coefficient of  $IO_{i,j}$  is positive and significant across all specifications, indicating that suppliers of more “important” inputs (i.e., those with larger value contributions) are granted more authority from central headquarters. In terms of magnitude, based on the estimates reported in column 3 of Table 1, increasing the input-output coefficient by 1 standard deviation increases delegation by around 0.035 standard deviations.<sup>52</sup>

<sup>51</sup>The results are practically identical if we cluster at the industry-pair level.

<sup>52</sup>The standard deviation of  $IO_{i,j}$  in the matched sample is 0.035, so  $0.980 \times 0.035 = 0.034$ . This effect might appear to be a small, but can be compared to the effect of other covariates. For example, the coefficient of log

It is interesting to compare these results with those of Bloom, Sadun and Van Reenen (2012), who use the same measure of within-firm delegation (which they refer to as decentralization). They find that trust is a key driver of the internal allocation of decision rights and has larger effects than any of the other covariates in their study (which do not include value measures): when including the full set of these covariates, they find that a 1 standard deviation increase in trust is associated with a 0.07 standard deviation increase in delegation. Our results indicate that input value is also an important driver of delegation, as its effect is half as large as that of trust. Notice that, in our analysis, the role of trust is absorbed by the country fixed effects. Concerning the auxiliary controls included in Table 1 (coefficient estimates not reported), we find that larger and older firms are more likely to delegate decisions to their suppliers and that plants that are larger and have a more educated workforce are granted more autonomy, in line with Bloom, Sadun and Van Reenen (2012).

As shown in Table A-7, the results of Table 1 are robust to using more disaggregated industry fixed effects (defined at the SIC4 level) to control for the primary activities of the plant and of its parent firm. The coefficient  $\beta_1$  remains positive and significant, in line with prediction P.1. One may be concerned that our baseline results include single-plant firms, for which the primary activity of the parent (identifying output  $j$ ) coincides with the primary activity of the plant (identifying input  $i$ ). For these firms, the role of input value is identified by variation along the diagonal of the IO matrix. To address this concern, we have verified that our results are robust to excluding single-plant firms (see Table A-8) and further restricting the analysis to plants that operate in a different SIC3 industry than their parent firm (see Table A-9). Notwithstanding the much reduced sample size, the coefficient of  $IO_{i,j}$  remains positive and significant in all but one specification.

We next examine whether final good producers are more likely to integrate suppliers of more valuable inputs, in line with prediction P.2. To test this, we estimate the following linear probability model:

$$\text{Integration}_{f,i,j,c} = \alpha_1 IO_{i,j} + \alpha_2 \mathbf{X}_f + \delta_i + \delta_j + \delta_c + \epsilon_{f,i,j,c}. \quad (5)$$

The dependent variable is the probability that firm  $f$  (with primary activity in sector  $j$  and located in country  $c$ ) integrates input  $i$  within its boundaries,  $\mathbf{X}_f$  is a vector of firm-level controls, and  $\delta_i$ ,  $\delta_j$ , and  $\delta_c$  denote input-industry, output-industry, and country fixed effects. In the most demanding specifications, we exploit only within-firm variation to identify the

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firm employment, one of the firm controls included in column 4 of Table 1, is 0.088, which indicates that an increase in firm employment of 40% is only associated with a  $0.088 \cdot 0.4 = 0.036$  standard deviation change in the decentralization index.



role of input value. In these specifications, we replace output-sector and country fixed effects with firm fixed effects ( $\delta_f$ ), which allow us to account for the role of unobservable firm characteristics. We cluster standard errors at the input-output level, the same as  $IO_{i,j}$ , the key variable of interest.<sup>53</sup> Our theoretical model suggests that a producer of good  $j$  should be more likely to integrate suppliers of more valuable inputs, implying that  $\alpha_1 > 0$ .

Table 2  
Integration and input value

	(1)	(2)	(3)	(4)	(5)
$IO_{i,j}$	0.1443*** (0.0205)	0.1445*** (0.0206)	0.1704*** (0.0247)	0.1702*** (0.0247)	0.1922*** (0.0278)
Input FE	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	No
Country FE	No	Yes	Yes	Yes	Yes
Firm FE	No	No	No	No	Yes
Firm controls	No	No	No	Yes	No
Observations	7,042,966	7,042,966	7,042,966	7,042,966	7,042,966

*Notes:* The dependent variable is  $Integration_{f,i,j,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the firm. Output and input fixed effects defined at 3-digit SIC. Standard errors clustered at the input-output level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

The results based on the WorldBase sample are reported in Table 2.<sup>54</sup> We first regress  $Integration_{f,i,j,c}$  against the key control of interest,  $IO_{i,j}$ , and input-industry fixed effects (column 1).<sup>55</sup> We then add country fixed effects (column 2), output-industry fixed effects (column 3), and additional firm-level controls (column 4). In the last specification, we include firm fixed effects, exploiting only within-firm variation in integration choices (column 5). In this specification, firm controls as well as country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity).

<sup>53</sup>The results of are unaffected if we use two-way clustering at the input and firm level: changes in the standard errors are minimal and  $IO_{i,j}$  is always positive and significant at the 1 percent level.

<sup>54</sup>Recall that the WordlBase sample focuses on manufacturing firms that integrate at least one input different from their primary output. In these regressions, we do not include firms from Greece. This is because establishments in Greece only report their primary SIC codes. As a result, we cannot use within-firm variation to study the determinants of integration choices.

<sup>55</sup>Recall that, for each industry  $j$ , we focus on its top 100 inputs in terms of (strictly positive) IO coefficients.



Across all specifications, the coefficient of  $IO_{i,j}$  is positive and significant at the 1 percent level, confirming that final good producers are more likely to produce in house more valuable inputs, in line with prediction P.2 of our model. The coefficients of the auxiliary firm controls (not reported), indicate that larger and older firms are more likely to integrate inputs within their boundaries.

In terms of magnitude, based on the specification of column 3, moving the input-output coefficient by 1 standard deviation increases the probability of vertical integration by 0.6 percentage points — a 60 percent increase compared to the baseline probability of one percentage point.<sup>56</sup>

We have carried out a series of additional estimations to verify the robustness of the results of Table 2. First, we verify the results are robust to using more disaggregated industry fixed effects (see Table A-10). Second, we consider alternative samples of firms. We first restrict the analysis to single-plant firms. Some concerns have been raised in the literature about the measurement of vertical integration, particularly for multi-plant firms (Atalay, Hortaçsu, and Syverson, 2014). Measurement error should work against us, making it harder to find a significant effect of input value on vertical integration. Nevertheless, we verify that the effect of input risk on the integration probability holds even when the sample is restricted to single-plant firms. The coefficient of  $IO_{i,j}$  remains positive and significant (see Table A-11). The results are also robust to restricting the analysis to firms included in the matched sample (see Table A-12).

Finally, we control for contracting frictions at the industry, country, and industry-country level, as in Nunn (2007) (see Table A-13). In these regressions, the sample is restricted to manufacturing inputs, for which the variable  $Contract Intensity_i$ , measuring the fraction of inputs that are differentiated, can be constructed. Following Nunn (2007), we interact this variable with,  $Rule of Law_c$ , a measure of each country's judicial quality. The coefficient of  $IO_{i,j}$  remains highly significant and increases substantially in magnitude. This is because measurement error in IO coefficients is substantially smaller for manufacturing inputs compared to others (see Section 4.3) and thus the attenuation bias is less severe. Note that the coefficient on the interaction of  $Contract Intensity_i$  with  $Rule of Law_c$  is negative and highly significant, in line with previous studies (e.g. Acemoglu *al.*, 2009).

Overall, the results of Tables 1 and 2 and the corresponding robustness checks support the model's predictions about the effects of input value on delegation and integration choices.

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<sup>56</sup>The standard deviation of  $IO_{i,j}$  is 0.036. Thus,  $0.170 \cdot 0.036 \cdot 100 = 0.612$ .

## 5.2 The Effects of Uncertainty

The model implies that uncertainty in input industries should affect both organizational choices. We first consider the impact of uncertainty on delegation choices and use the matched WorldBase-WMS sample to estimate

$$\begin{aligned} \text{Delegation}_{f,p,i,j,c} = & \beta_1 \text{Mean Productivity}_{i,c} + \beta_2 \text{CV Productivity}_{i,c} + \\ & + \beta_3 \text{IO}_{i,j} + \beta_4 \mathbf{X}_p + \beta_5 \mathbf{X}_f + \delta_i + \delta_j + \delta_c + \epsilon_{f,p,i,j,c}. \end{aligned} \quad (6)$$

As in (4), the dependent variable in (6) is the degree of autonomy granted to plant  $p$  by parent firm  $f$ . The main control of interest is *Mean Productivity* $_{i,c}$ , the mean labor productivity of independent suppliers in industry  $i$  located in country  $c$ . According to prediction P.3, when controlling for *CV Productivity* $_{i,c}$ , the coefficient of *Mean Productivity* $_{i,c}$  should be positive.

When estimating (6), we always include input-sector fixed effects to exploit variation in mean supplier productivity in a given input sector across countries. Some specifications additionally include vectors of plant-level controls ( $\mathbf{X}_p$ ), firm-level controls ( $\mathbf{X}_f$ ), output-sector fixed effects and  $\delta_j$ ), and country fixed effects ( $\delta_c$ ), as well as *IO* $_{i,j}$ , the direct requirement coefficient for the sector pair  $ij$ . We report standard errors clustered at the input level.

The results of estimating (6) are reported in Table 3. The coefficient of *Mean Productivity* $_{i,c}$  is always positive and significant, confirming the predicted effect of first-order stochastic dominance on delegation choices (prediction P.3). In terms of magnitude, based on the estimates reported in column 3 of Table 3, increasing mean supplier productivity by 1 standard deviation increases delegation by around 0.032 standard deviations.<sup>57</sup> Recall that the theory has no implications for the effect of *CV Productivity* $_{i,c}$  on delegation choice. As it happens, the coefficient of this variable is not statistically significant.

We have verified that the results of Table 3 are robust to using more disaggregated industry fixed effects (see Table A-14). We have also constructed the variables *Mean Productivity* $_{i,c}$  and *CV Productivity* $_{i,c}$  after winsorizing labor productivity at the 5th and 95th percentile (Table A-15) In all specifications, the coefficient of the variable *Mean Productivity* $_{i,c}$  remains positive and significant, in line with prediction P.3.

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<sup>57</sup>The standard deviation of *Mean Productivity* $_{i,c}$  in the matched sample is 0.97, so  $0.033 \times 0.97 = 0.032$ . Again, we can compare this magnitude with the effect of employment: according to the specification in column 4 of Table 3, a 40% change in the parent firm's employment is associated with a  $0.095 \times 0.4 = 0.038$  standard deviation change in the delegation index.

Table 3  
Delegation and uncertainty

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Mean Productivity $_{i,c}$	0.0280** (0.0114)	0.0284** (0.0112)	0.0326** (0.0131)	0.0344** (0.0153)	0.0266** (0.0116)	0.0276** (0.0115)	0.0332** (0.0134)	0.0355** (0.0156)
CV Productivity $_{i,c}$	0.0032 (0.0040)	0.0026 (0.0040)	0.0032 (0.0045)	0.0040 (0.0050)	0.0025 (0.0040)	0.0020 (0.0040)	0.0026 (0.0045)	0.0037 (0.0045)
IO $_{i,j}$					0.9863** (0.3938)	0.9729** (0.3932)	1.1332** (0.4681)	1.2088*** (0.4592)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Noise controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Plant controls	No	No	No	Yes	No	No	No	Yes
Firm controls	No	No	No	Yes	No	No	No	Yes
Observations	2,928	2,928	2,928	2,928	2,889	2,889	2,889	2,889

*Notes:* The dependent variable is *Delegation* $_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ). *Mean Productivity* $_{i,c}$  is the mean of supplier productivity. *IO* $_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . *CV Productivity* $_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

To assess the validity of prediction P.4 on the impact of risk on integration, we estimate the linear probability model

$$\text{Integration}_{f,i,j,c} = +\alpha_1 \text{Mean Productivity}_{i,c} + \alpha_2 \text{CV Productivity}_{i,c} + \alpha_3 \text{IO}_{i,j} + \beta_4 \mathbf{X}_f + \delta_i + \delta_j + \delta_c + \epsilon_{f,i,j,c}, \quad (7)$$

using the WorldBase sample. As in (5), the dependent variable is the probability that firm  $f$  (with primary activity in sector  $j$  and located in country  $c$ ) integrates input  $i$  within its boundaries. The main control of interest is  $CV \text{ Productivity}_{i,c}$ , the coefficient of variation of labor productivity of independent suppliers in input industry  $i$  in country  $c$ . According to prediction P.4, when controlling for  $Mean \text{ Productivity}_{i,c}$ , the coefficient of this variable should be positive and significant.

The results are reported in Table 4. We present first a specification that includes the key control variables with input-industry fixed effects (column 1), further include country fixed effects (column 2), the IO coefficient (column 3), output-industry fixed effects (column 4), and the firm controls (column 5). In the last specification, we replace country and output-industry fixed effects with firm fixed effects (column 6).

In all specifications, the estimated coefficient for  $CV \text{ Productivity}_{i,c}$  is positive and significant at the 1 percent level. This finding is robust to including additional controls and different sets of fixed effects. In particular, it continues to hold when including firm fixed effects. In this specification, the coefficients  $\alpha_1$  is identified by exploiting only within-firm variation in the dispersion of supplier productivity across input industries.

These results provide strong support for prediction P.4. Increases in risk increase the option value of integration: when there is more uncertainty about the problems that will arise during production HQ attaches greater value to the option of being able to centralize or delegate production decisions. When productivity is distributed lognormally, as it is the case in our data, this effect dominates the (ambiguous) effect on the cost of integration, so firms should be more likely to integrate suppliers in riskier input industries.

As for the economic magnitude of the effects, based on the specification in column 3, a one-standard-deviation increase in  $CV \text{ Productivity}_{i,c}$  increases the probability of integrating a supplier by around 0.34 percentage points. This corresponds to a 34% increase relative to the baseline integration probability of one percentage point.<sup>58</sup>

<sup>58</sup>The standard deviation of  $CV \text{ Productivity}_{i,c}$  is 4.63, thus  $0.0007 * 4.63 * 100 = 0.342$ .

Table 4  
Integration and uncertainty

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)
CV Productivity $_{i,c}$	0.0006*** (0.0001)	0.0008*** (0.0001)	0.0008*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)
IO $_{i,j}$			0.1499*** (0.0134)	0.1791*** (0.0145)	0.1789*** (0.0145)	0.2030*** (0.0161)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	No
Observations	6,644,884	6,644,884	6,644,884	6,644,884	6,644,884	6,644,884

*Notes:* The dependent variable is  $Integration_{f,i,j,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

We have performed a series of additional estimations to verify the robustness of the results reported in Table 4. We verify that the results continue to hold when using more disaggregated industry fixed effects (see Table A-16). We construct the variable *CV Productivity*<sub>*i,c*</sub> after winsorizing labor productivity at the 5th and 95th percentile (Table A-17). We restrict the analysis to single-plant firms (see Table A-18). As mentioned before, for these firms, measurement error in the integration variable should be less of a concern. We focus on the matched sample instead of using the larger WorldBase sample (Table A-19). We also constructed the variables *CV Productivity*<sub>*i,c*</sub> and *Mean Productivity*<sub>*i,c*</sub> after restricting the analysis to input industries in which there are at least 50 suppliers in each input industry-country (Table A-20), to rule out that the results of Table 4 are due to demand-driven supply assurance motives for integration (see discussion in Section 5.3). Finally, we control for the extent of contracting frictions at the industry, country, and industry-country level (see Table A-21).<sup>59</sup> In all these robustness checks, the coefficient of the variable *CV Productivity*<sub>*i,c*</sub> remains positive and highly significant.

### 5.3 Discussion

Our empirical analysis establishes the following regularities: (i) firms delegate more decisions to integrated suppliers that produce more valuable inputs; (ii) firms are more likely to integrate suppliers of more valuable inputs; (iii) firms delegate more decisions to integrated suppliers in more productive input industries; (iv) firms are more likely to integrate inputs in industries in which supplier productivity is more dispersed.

These results can be rationalized by our theoretical model, in which integration creates a real option for HQ to centralize or delegate decisions according to comparative advantage, and the value of this option increases with the degree of uncertainty about the severity of problems that may arise during the production process.

Existing alternative models could provide a rationale for some — but not all — of our empirical findings. For instance, as suggested earlier, the model in Legros and Newman (2013) could explain the finding that the likelihood that a supplier is integrated grows with the input’s contribution to total firm value. However, that model does not consider the possibility of delegation and thus cannot rationalize the findings about its determinants; nor does it account for the empirical effects of risk on integration.

The finding that the likelihood that a supplier is integrated grows with the riskiness of the input industry is related to the literature on supply assurance motives for integration (e.g.,

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<sup>59</sup>Since *Contract Intensity*<sub>*i*</sub> is only available for manufacturing inputs, the sample size is reduced substantially in this case.

Carlton, 1979; Bolton and Whinston, 1993). In these models, the assurance motive is driven by uncertainty resolved after input production (e.g., product demand), possibly augmented by the supplier's hold-up behavior. Broadly speaking, one would expect less integration when there is less of a risk of suppliers coming up short, for technological or behavioral reasons. These might also account for the positive coefficient of  $CV\ Productivity_{i,c}$  in Table 4.

However, we should expect these demand-driven mechanisms, particularly the variants in which suppliers opportunistically sell to other buyers, to be less relevant when firms can source inputs from many suppliers. Against this hypothesis, the coefficient of  $CV\ Productivity_{i,c}$  remains positive and highly significant when focusing on input industries with large numbers of suppliers (see Table A-20). Moreover, the result holds when we include output industry fixed effects, which account for product market uncertainty (see columns 4 and 5 of Tables 4 and the corresponding specifications in Tables A-16–A-20) and firm fixed effects, which account for demand for inputs by other firms in the same country-output sector (see column 6 of Tables 4 and the corresponding specifications in Tables A-16–A-20).

Moreover, while existing models of supply assurance could in principle explain why suppliers in riskier industries are more likely to be integrated, they do not rationalize the other empirical findings, since they neither have anything to say about delegation, nor address the role of input value in integration decisions.

In a similar vein, transaction-cost reasoning might account for the risk-integration finding (Lafontaine and Slade, 2007 summarizes the evidence from a few single-industry studies.) A rationale along these lines is that more uncertainty leads to more contractual incompleteness, which in turn leads to more integration. Aside from the tenuousness of some steps in the argument,<sup>60</sup> we have already discussed how our results on input risk are robust to including controls for the degree of contractibility at the industry-country level, as in Nunn (2007) (Table A-21). Finally, like classical supply assurance, this approach appears to be silent on the drivers of delegation and the organizational effects of input value.

As discussed in the introduction, the data show that more vertically integrated firms tend to delegate more (see Figure 1 and results in Section A-2 in the Appendix). Our model provides a rationale for this finding. As mentioned in Section 3.2.2, higher value enterprises (e.g., that have more productive HQs or can sell their goods at higher prices) should be more vertically integrated while simultaneously granting more autonomy to their subordinates.

The covariation of delegation and integration could potentially be rationalized by manage-

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<sup>60</sup>One could think of mechanisms through which uncertainty could enhance rather than reduce contractibility, e.g., if greater risk encourages more investment in verification technologies. In our data, input risk (as measured by  $CV\ Productivity_{i,c}$ ) is uncorrelated with contracting frictions (as measured by the interaction between  $Contract\ intensity_i$  and  $Rule\ of\ Law_c$ ).

rial capacity models in which an HQ's attention is a scarce corporate resource (e.g., Geanakoplos and Milgrom, 1991; Aghion and Tirole, 1995): if vertical integration increases the scope of decisions in a firm, HQ may simply need to cede control to lower-level managers. However, there are grounds for skepticism. Among them, the positive correlation between delegation and integration is robust to controlling for measures of firm size and workforce education that could proxy for, or at least correlate with, managerial capacity. Those measures are themselves positively correlated with delegation (see Table 1), whereas a managerial capacity model would tend to predict that firms with more capacity should delegate less. Finally, capacity-constrained HQs would tend to keep control of the decisions regarding more important inputs and delegate decisions concerning less important ones, which goes against the evidence in result (i) above: more autonomy is granted to suppliers who contribute more, rather than less value to the enterprise.

## 6 Conclusion

Organizations are complicated. Understanding them entails simplification, and a lot has been learned by isolating distinct organizational design elements. But there are costs to isolation. Formally similar models that focus only on one dimension or another of the organization (integration or centralization) can mislead when embedded in two dimensions (integration and centralization might be predicted to covary positively, unlike in our model or in the data).

In this paper, we have brought integration and delegation together, both theoretically and empirically. A number of insights emerge from the exercise, which is founded on the well-known conceptual distinction between informal delegation and formal outsourcing. First, the two respond differently to exogenous environmental parameters: outsourcing decreases with an input's value contribution, delegation increases. They also respond to distinct dimensions of uncertainty.

Second, it is often argued that managerial authority under integration leads various rigidities that are in turn the cost of integration. Our analysis suggests that, on the contrary, integration may actually increase managerial flexibility, because it facilitates the re-allocation of decision-making across different parts of the organization in light of new information. In the more nuanced view that emerges from a multidimensional approach, it is only a particular form of integrated ownership structure — centralization — that appears rigid.

Third, studying integration and delegation together reveals a novel mechanism by which supply assurance motivates integration: redeployment of control to the most competent solver of problems that present themselves ensures a minimal level of productivity. Formally, this



places the evaluation of the costs and benefits of ownership in the rubric of real options.

Finally, the framework helps to uncover unifying themes in the analysis of organizational design. In particular, it extends the value principle, already applied to integration in previous work, to delegation: the value of an input or the profitability of a firm affect how much autonomy the input's supplier will be given. This mechanism suggests that productivity could be driving delegation, rather than the other way round, wherever they are observed to covary. This is because exogenously more productive firms should be more willing to delegate, and subordinates with more autonomy may be ones who have encountered problems they are good at solving.

As evidence mounts that organization matters for the performance of individual firms, industries, and aggregate economies, it is becoming ever more imperative to understand the functioning of organizations as a whole rather than just their parts. Studying firm boundaries together with other aspects of the firm's internal organization helps to illuminate interdependencies that are crucial for understanding the functioning and guiding the design and regulation of organizations. For instance, if recent global growth in uncertainty is manifested as higher input risk, a wave of vertical mergers may be on the horizon, as the option value of owning suppliers increases. By increasing flexibility, integration allows firms to better cope with this uncertainty, increasing productivity and product quality.

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# Appendices

## A-1 Theoretical Appendix

### A-1.1 Integration, Risk, and the Log-normal Distribution

Integration occurs if

$$\frac{z\pi - \bar{c}}{v(\pi)} \geq \mathbb{E}[y|y < y^*(\pi)].$$

It increases (in the sense that it occurs for a larger set of parameters  $\bar{c}, z, \pi$ ) in response to changes in distribution if  $\mathbb{E}[y|y < y^*(\pi)]$  decreases. In general, changes in this conditional expectation resulting from changes in the riskiness of the underlying distribution could have either sign, but we can be more definitive for certain families.

If  $y$  is drawn from the family of log-normal distributions with parameters  $\mu, \sigma$ , then the c.d.f. is  $\Phi(\frac{\ln y - \mu}{\sigma})$ , where  $\Phi(\cdot)$  is the standard normal c.d.f, which is log-concave. The conditional expectation can be written (notationally suppressing dependence of  $y^*$  on  $\pi$ )

$$e^{\mu + \frac{\sigma^2}{2}} \cdot \frac{\Phi(\frac{\ln y^* - \mu}{\sigma} - \sigma)}{\Phi(\frac{\ln y^* - \mu}{\sigma})}.$$

One lognormal  $(\mu', \sigma')$  is riskier than another  $(\mu, \sigma)$  if their means  $e^{\mu' + \frac{\sigma'^2}{2}}$  and  $e^{\mu + \frac{\sigma^2}{2}}$  are equal and  $\sigma' > \sigma$ . Denoting  $m = \mu + \frac{\sigma^2}{2}$ , and rewriting  $\mathbb{E}[y|y < y^*]$  in terms of  $m$  and  $\sigma$ , higher risk lowers the conditional expectation if and only if

$$\frac{\partial}{\partial \sigma} e^m \cdot \frac{\Phi(\frac{\ln y^* - m}{\sigma} - \frac{\sigma}{2})}{\Phi(\frac{\ln y^* - m}{\sigma} + \frac{\sigma}{2})} < 0. \quad (8)$$

Straightforward computation reveals that this condition is equivalent to

$$\frac{\phi(\frac{\ln y^* - m}{\sigma} + \frac{\sigma}{2})}{\Phi(\frac{\ln y^* - m}{\sigma} + \frac{\sigma}{2})} \left( \frac{1}{2} - \frac{\ln y^* - m}{\sigma^2} \right) - \frac{\phi(\frac{\ln y^* - m}{\sigma} - \frac{\sigma}{2})}{\Phi(\frac{\ln y^* - m}{\sigma} - \frac{\sigma}{2})} \left( \frac{1}{2} + \frac{\ln y^* - m}{\sigma^2} \right) < 0,$$

where  $\phi(\cdot)$  is the standard normal density.

Now, logconcavity implies  $\frac{\phi(\frac{\ln y^* - m}{\sigma} + \frac{\sigma}{2})}{\Phi(\frac{\ln y^* - m}{\sigma} + \frac{\sigma}{2})} < \frac{\phi(\frac{\ln y^* - m}{\sigma} - \frac{\sigma}{2})}{\Phi(\frac{\ln y^* - m}{\sigma} - \frac{\sigma}{2})}$ . And because  $y^* = z \frac{\pi}{v(\pi)} > z$ , under the maintained hypothesis that  $z > \mathbb{E}y$ ,  $\ln y^* > m$ , so  $\frac{1}{2} + \frac{\ln y^* - m}{\sigma^2}$  is positive and exceeds  $\frac{1}{2} - \frac{\ln y^* - m}{\sigma^2}$ . It follows that condition (8) is satisfied, and we conclude that increasing riskiness of lognormal distributions implies more integration.



## A-1.2 Multiple Tasks Extension

In the model described in Section 3, delegation is a binary variable: HQ either centralizes or delegates the production of an input to an integrated supplier. Below we extend the model to allow for multiple tasks to be performed by each supplier. This allows us to generate a continuous delegation choice, in line with the measure of delegation used in our empirical analysis.

Suppose that the basic input production stage is subdivided into many tasks  $t \in \{1, \dots, T\}$ . Problem  $\theta$  arises at the beginning of the stage, at which time negotiation over the delivery price proceeds (thus is dependent on  $y = y(\theta)$ ).

For each task there is also a set of “sub-problems”  $\eta \in [0, 1]$ ; the supplier deals with them with efficacy  $\epsilon(\eta)$ , a function that like  $y(\theta)$  is known to both the supplier and HQ (and as with  $y(\cdot)$ , assume  $\epsilon(\cdot)$  is increasing). Examples of the different tasks might include developing processes to manufacture a new product (where the product itself is represented by  $\theta$ ), acquiring machinery to produce it, and hiring employees to operate the machines. The main problem  $\theta$  and the sub-problems  $\eta_t$  combine to generate a productivity on each task  $x_t = X(y(\theta), \epsilon(\eta_t))$ , where  $\theta$  has the distribution  $F$  (and  $y = y(\theta)$  the distribution  $G$ ) from the text, the  $\epsilon_t$  are i.i.d. across  $t$ , and independent of  $y$ , such that  $\mathbb{E}x_t|y = y$  (for instance,  $x_t = y + \epsilon_t$ , with  $\mathbb{E}\epsilon_t = 0$ , or  $x_t = y \cdot \epsilon_t$ , with  $\mathbb{E}\epsilon_t = 1$ ). Let  $H(x_t)$  denote the c.d.f for  $x_t$ .

The  $\epsilon_t$  are realized and observed after the single draw of  $y$ , but before task assignment. HQ has capability  $z$  on all tasks, and can separately delegate or retain control over each of them. Tasks contributes equally and additively to the overall supplier value, and costs of decisions  $s_t, h_t$  on each task are also weighted by  $1/T$ . Thus, overall surplus generated by HQ and the supplier is

$$\sum_t \frac{1}{T} \{ [\mathbb{H}_t z + (1 - \mathbb{H}_t) X(y(\theta), \epsilon_t)] [\pi p(|s_t - h_t|) - d(h_t)] - c(1 - s_t) \},$$

where  $\mathbb{H}_t$  indicates whether HQ controls task  $t$ .

Similar to the text, centralizing a task results in choices  $h_t = s_t = 0$  with payoff to HQ equal to  $z\pi/T$ , and cost imposed on the supplier  $\bar{c}/T$ . Under delegation the supplier chooses  $s_t = 1$ , resulting in zero cost to himself, and HQ responds with  $h_t$  that maximizes  $(1/T)x_t[\pi p(|1 - h_t|) - d(h_t)]$ , which yields her  $(1/T)x_t v(\pi)$ .

The delegation decision rule is similar as well: HQ delegates task  $t$  whenever  $x_t v(\pi)/T > z\pi/T$ . In other words,  $x_t$  replaces  $y$  in the benchmark model, and delegation occurs when  $x_t > y^*(\pi)$ . The probability of centralizing a task is  $H(y^*(\pi))$ , increasing in  $y^*(\pi)$ , therefore decreasing in  $\pi$ . So the task is delegated with probability  $1 - H(y^*(\pi))$ , increasing in  $\pi$ .

In this setting, the degree of delegation is simply the number (or fraction) of tasks delegated, which is very close to the delegation measure employed in our empirical analysis. It is a binomial random variable with parameters  $(1 - H(y^*), T)$ , which like the delegation

probability of Result 1 is (stochastically) increasing in  $\pi$ .

This formulation modifies the integration calculation somewhat. For each task, HQ obtains value  $\frac{1}{T} \max\{\pi z, v(\pi)x_t\}$ , while the supplier bears cost  $\bar{c}/T$  with probability  $H(y^*(\pi))$ . Thus the expected surplus from integration is

$$\sum_t \frac{1}{T} [\mathbb{E}_H \max\{\pi z, v(\pi)x_t\} - \bar{c}H(y^*(\pi))]. \quad (9)$$

Meanwhile, by reasoning analogous to that in the text, non-integration generates

$$\mathbb{E}_H \sum_t \frac{1}{T} [v(\pi)x_t]. \quad (10)$$

Note that expectations are with respect to  $H$  because the  $x_t$  are identically distributed. So integration occurs if expression (9) exceeds expression (10), which happens if and only if

$$\mathbb{E}_H \max\{\pi z - v(\pi)x_t, 0\} - \bar{c}H(y^*(\pi)) \geq 0,$$

where the choice of  $t$  is arbitrary because the expectations are equal for all  $t$ . This is formally identical to the condition (3) in the text, with  $x_t$  replacing  $y$ , and  $H$  replacing  $G$ . In particular, Result 2 on the dependence of integration  $\pi$  remains true here, because it depends only on the properties of  $v(\pi)$  and  $y^*(\pi)$ , which are unchanged, and the fact that  $z > \mathbb{E}_H x$ , which, since  $\mathbb{E}_H x = E_G y$ , follows from the assumption that  $z > \mathbb{E}_G y$ .

As far as the effects of risk and stochastic dominance are concerned, it is now the effects of changes in the distribution  $H$ , rather than  $G$ , that matter. However, since delivery prices are based only on  $y$  (with bargaining occurring after  $y$  but before the  $\epsilon_t$  are realized, the expected surplus to be split is  $\mathbb{E}[\sum_t \frac{1}{T} v(\pi)x_t | y] = v(\pi)y$ , so a typical non-integrated supplier's sales are proportional to  $y$  and independent of the  $\{\epsilon_t\}$ ), it is effectively  $G$  that we observe in the data. So the question is whether riskier (stochastic dominant)  $G$  implies riskier (stochastic dominant)  $H$ .

We restrict attention to the lognormal case because that approximates the data as well as resolving a theoretical ambiguity in the effects of risk on integration. Suppose then that  $x_{it} = y_i \epsilon_t$ , and that not only  $y_i \sim \text{LN}(\mu_i, \sigma_i^2)$  but also the  $\epsilon_t \sim \text{LN}(0, \tau^2)$  (the notation signifies that variation across sectors  $i$  in the characteristics of the observed productivity distributions is driven entirely by variation in the  $y_i$  distribution, which according to the model is what is observed). Then  $x_{it} = y_i \epsilon_t \sim \text{LN}(\mu_i, \sigma_i^2 + \tau^2)$ , and changes in the  $y_i$  distributions have the desired effects: higher  $\mu_i$  holding  $\sigma^2$  (and  $\tau$ ) fixed correspond to stochastic increases in both the  $y_i$  and  $x_i$  distributions, while  $(\mu_i + \frac{1}{2}\sigma_i^2)$ -preserving increases in  $\sigma_i^2$  and decreases in  $\mu_i$  are also  $(\mu_i + \frac{1}{2}[\sigma_i^2 + \tau^2])$ -preserving and  $\sigma_i^2 + \tau^2$ -increasing, and therefore correspond to increases in the the riskiness of both  $y_i$  and  $x_i$ .

## A-2 Empirical Appendix

### A-2.1 Descriptive Statistics

Table A-1  
Size of plants

	Mean	Median	Standard deviation	N. plants
WorldBase dataset	288	2	5,428	17,371,146
WMS dataset	277	150	405	11,691
WorldBase sample	147	42	3,187	67,111
Matched sample	254	150	367	3,444

*Notes:* The table reports statistics on the plants included in the WMS and WorldBase datasets, and in the samples used in our empirical analysis.

Table A-2  
Observations by country, WorldBase sample

Country	Number of Observations	Percentage
Argentina	17,081	0.26
Australia	61,489	0.93
Brazil	3,857	0.06
Canada	149,022	2.24
Chile	4,570	0.07
China	558,337	8.40
France	35,617	0.54
Germany	1,985,864	29.89
India	101,107	1.52
Italy	412,315	6.20
Ireland	5,804	0.09
Japan	1,088,345	16.38
Mexico	30,865	0.46
New Zealand	44,824	0.67
Poland	28,116	0.42
Portugal	142,727	2.15
Sweden	17,319	0.26
United Kingdom	156,962	2.36
United States	1,800,663	27.10
Total	6,664,884	100.00

*Notes:* The table reports the number of observations by country in the WorldBase sample. The observations are at the firm-input level. For each firm in the WorldBase sample, we consider the top 100 inputs (based on the IO coefficients) necessary to produce the firm's output.

**Table A-3**  
Observations by country, matched sample

Country	Number of Observations	Percentage
Argentina	100	2.90
Australia	133	3.86
Brazil	234	6.79
Canada	207	6.01
Chile	95	2.76
China	64	1.86
France	212	6.16
Germany	224	6.50
Greece	104	3.02
India	104	3.02
Italy	106	3.08
Ireland	75	2.18
Japan	102	2.96
Mexico	86	2.50
New Zealand	118	3.43
Poland	27	0.78
Portugal	78	2.26
Sweden	330	9.58
United Kingdom	432	12.54
United States	613	17.80
Total	3,444	100.00

*Notes:* The table reports the number of plant observations by country in the matched sample.

**Table A-4**  
Descriptive statistics of variables used in delegation regressions

	Mean	Median	Standard deviation	N. firms
Delegation <sub><i>f,p</i></sub>	0.13	0.07	0.99	2,883
IO <sub><i>i,j</i></sub>	0.04	0.04	0.035	2,428
Mean Productivity <sub><i>i,c</i></sub>	0.27	0.17	0.97	2,253
CV Productivity <sub><i>i,c</i></sub>	3.16	1.45	6.37	2,253
Share Employment <sub><i>p</i></sub>	0.61	0.60	0.89	2,621
% Workers with College Degree <sub><i>p</i></sub>	15.20	10.00	16.34	2,655
Employment <sub><i>f</i></sub>	674.89	300.00	1,043.32	2,883
Age <sub><i>f</i></sub>	40.08	30.00	35.02	2,883

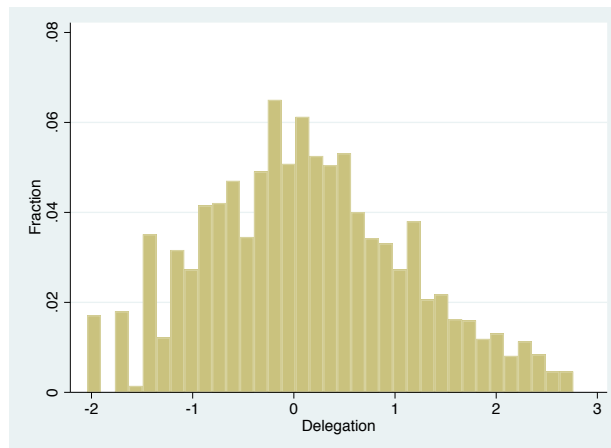
*Notes:* The table reports descriptive statistics of the main variables used in the regressions of Tables 1, 3, and A-6. *Delegation<sub>f,p</sub>* is the overall degree of autonomy granted to plant *p* by the parent firm *f*. *IO<sub>i,j</sub>* is the direct requirement coefficient for the sector pair *ij*, measured at the 4-digit SIC level for the top 100 inputs of each industry *j*. *Mean Productivity<sub>i,c</sub>* is the mean of labor productivity of the independent suppliers in input industry *i* located in country *c* (in millions of US Dollars), while *CV Productivity<sub>i,c</sub>* is the coefficient of variation of labor productivity. *Share Employment<sub>p</sub>* is the plant's share of the firm's employment. *% Workforce with College Degree<sub>p</sub>* is the percentage of the plant's employees with a bachelor's degree or higher. *Employment<sub>f</sub>* measures the number of employees of firm *f*. *Age<sub>f</sub>* is the number of years since the firm was established.

**Table A-5**  
Descriptive statistics of variables used in integration regressions

	Mean	Median	Standard deviation	N. firms
Integration <sub><i>f,i,j</i></sub>	0.01	0.00	0.11	66,102
IO <sub><i>i,j</i></sub>	0.05	0.05	0.036	66,102
Mean Productivity <sub><i>i,c</i></sub>	0.50	0.30	10.50	66,102
CV Productivity <sub><i>i,c</i></sub>	3.04	1.94	4.63	66,102
Employment <sub><i>f</i></sub>	206.38	45.00	4,903.87	66,102
Age <sub><i>f</i></sub>	33.56	26.00	28.98	66,102

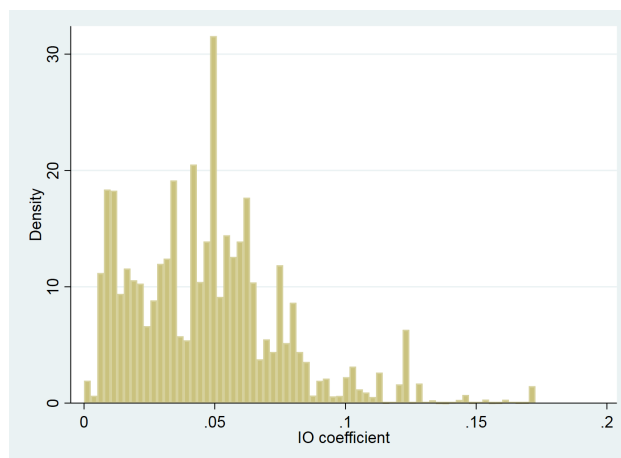
*Notes:* The table reports descriptive statistics of the variables used in Tables 2 and 4 (and robustness checks), based on the WorldBase sample. *Integration<sub>f,i,j</sub>* is a dummy equal to 1 if firm *f* producing final product *j* integrates input *i* within its boundaries. *IO<sub>i,j</sub>* is the direct requirement coefficient for the sector pair *ij*, measured at the 4-digit SIC level for the top 100 inputs of each industry *j*. *Mean Productivity<sub>i,c</sub>* is the mean of labor productivity of the independent suppliers in input industry *i* located in country *c* (in millions of US Dollars), while *CV Productivity<sub>i,c</sub>* is the coefficient of variation of labor productivity. *Employment<sub>f</sub>* measures the number of employees of firm *f*. *Age<sub>f</sub>* is the number of years since the firm was established.

Figure A-1: Delegation



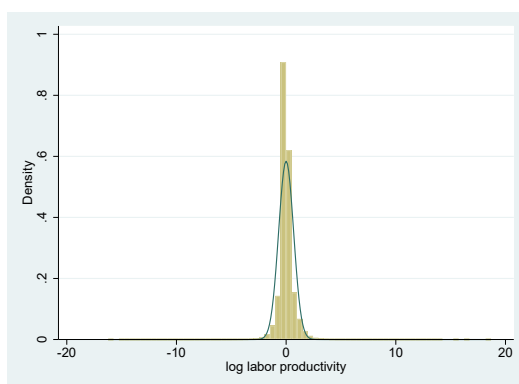
Notes: The figure shows the distribution of  $Delegation_{f,p}$  in the matched sample.

Figure A-2: Input Value



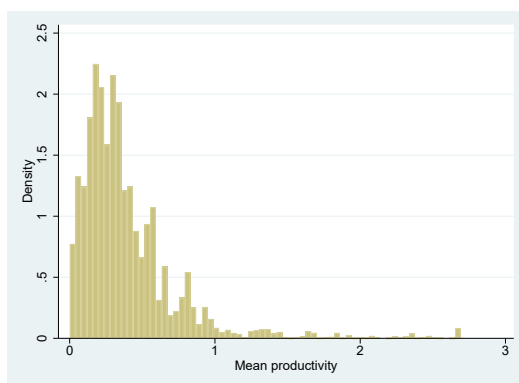
Notes: The figure shows the distribution of  $IO_{i,j}$  in the WorldBase sample.

Figure A-3: Productivity Distribution of Suppliers



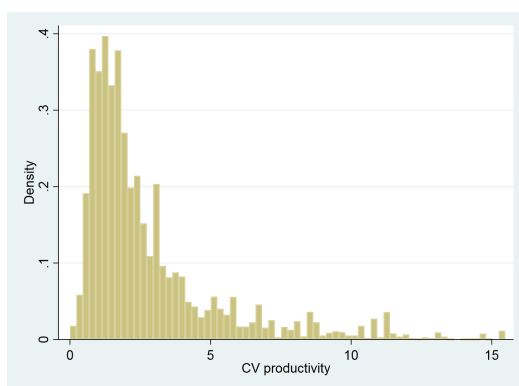
Notes: The figure shows the distribution of log labor productivity independent firms in the WorldBase sample. It has been constructed by regressing log labor productivity of all independent suppliers in WorldBase on 4-digit-industry  $\times$  country dummies. It thus shows within-industry-country variation in log labor productivity.

Figure A-4: Mean Productivity



Notes: The figure shows the distribution of  $Mean\ Productivity_{ic}$  in the WorldBase sample.

Figure A-5: Input Risk



Notes: The figure shows the distribution of  $CV\ Productivity_{ic}$  in the WorldBase sample.

## Figure A-6: Survey on Delegation

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For Questions D1, D3, and D4 any score can be given, but the scoring guide is only provided for scores of 1, 3, and 5.

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**Question D1: “To hire a FULL-TIME PERMANENT SHOPFLOOR worker what agreement would your plant need from CHQ (Central Head Quarters)?”**

Probe until you can accurately score the question—for example if they say “It is my decision, but I need sign-off from corporate HQ.” ask “How often would sign-off be given?”

Score 1

Score 3

Score 5

Scoring grid:

No authority—even for replacement hires

Requires sign-off from CHQ based on the business case. Typically agreed (i.e. about 80% or 90% of the time).

Complete authority—it is my decision entirely

---

**Question D2: “What is the largest CAPITAL INVESTMENT your plant could make without prior authorization from CHQ?”**

Notes: (a) Ignore form-filling

(b) Please cross check any zero response by asking “What about buying a new computer—would that be possible?” and then probe...

(c) Challenge any very large numbers (e.g. >\$4m in US) by asking “To confirm your plant could spend \$X on a new piece of equipment without prior clearance from CHQ?”

(d) Use the national currency and do not omit zeros (i.e. for a U.S. firm twenty thousand dollars would be 20000).

---

**Question D3: “Where are decisions taken on new product introductions—at the plant, at the CHQ or both?”**

Probe until you can accurately score the question—for example if they say “It is complex, we both play a role,” ask “Could you talk me through the process for a recent product innovation?”

Score 1

Score 3

Score 5

Scoring grid:

All new product introduction decisions are taken at the CHQ

New product introductions are jointly determined by the plant and CHQ

All new product introduction decisions taken at the plant level

---

**Question D4: “How much of sales and marketing is carried out at the plant level (rather than at the CHQ)?”**

Probe until you can accurately score the question. Also take an average score for sales and marketing if they are taken at different levels.

Score 1

Score 3

Score 5

Scoring grid:

None—sales and marketing is all run by CHQ

Sales and marketing decisions are split between the plant and CHQ

The plant runs all sales and marketing

---

**Question D5: “Is the CHQ on the site being interviewed?”**

Notes: The electronic survey, training materials and survey video footage are available on [www.worldmanagementsurvey.com](http://www.worldmanagementsurvey.com)



## A-2 The Co-Variation of Integration and Delegation

As illustrated by Figure 1 in the Introduction, our matched dataset reveals that more vertically integrated firms tend to delegate more decisions to their integrated suppliers. To more systematically examine the relationship between delegation and integration, we estimate the following regression:

$$\text{Delegation}_{f,p,i,j,c} = \beta_1 \text{Vertical Integration}_f + \beta_2 \mathbf{X}_p + \beta_3 \mathbf{X}_f + \delta_i + \delta_j + \delta_c + \epsilon_{f,p,i,j,c}. \quad (11)$$

The dependent variable is the degree of autonomy granted by firm  $f$  (with primary activity  $j$ , located in country  $c$ ) to the manager of its plant  $p$  (with primary activity  $i$ ). The main control of interest is *Vertical Integration* $_{f,j}$ , the vertical integration index of firm  $f$ .  $\mathbf{X}_p$  and  $\mathbf{X}_f$  are vectors of plant- and of firm-level controls, while  $\delta_i$ ,  $\delta_j$  and  $\delta_c$  are respectively input-sector, output-sector (at the 3-digit SIC level), and country fixed effects.<sup>61</sup> We include input-sector (output-sector) fixed effects to control for the average amount of delegation to a given input industry (by a given output industry). We cluster standard errors at the firm level.

The results are reported in Table A-6. In column 1, we regress the degree of delegation within firm  $f$  against the vertical integration index of the firm, delegation, including only input-industry fixed effects. The estimated coefficient of *Vertical Integration* $_f$  is positive and significant (at the one-percent level).<sup>62</sup> This result continues to hold when we further include country fixed effects (column 2), output-industry fixed effects (column 3), and control for the size and age of the parent firm, as well as the plants' size and level of education of the workforce (column 4).<sup>63</sup> In terms of magnitude, the point estimates reported in column 3 of Table A-6 indicate that increasing *Vertical Integration* $_f$  by 1 standard deviation is associated with an increase in delegation of around 0.06 standard deviations.<sup>64</sup>

Concerning the auxiliary controls, the coefficients of  $\log(\text{Employment})_f$  and  $\log(\text{Age})_f$  included in column 4 are positive and significant, indicating that larger and older firms grant more authority to their plant managers. The coefficient of the variables *Share Employment* $_p$  and  $\log(\% \text{ Workforce with College Degree})_f$  are also positive and significant, suggesting that

<sup>61</sup>Given that the data on delegation were collected in different waves of surveys and by different interviewers, we also include in these regressions survey noise controls and fixed effects for the year in which the firm was surveyed to reduce measurement error in the dependent variable.

<sup>62</sup>This is the specification used to generate the scatterplot in Figure 1. The coefficient of *Vertical Integration* $_f$  is also significant (at the five-percent level) in an even more parsimonious specification, in which we do not include any fixed effects.

<sup>63</sup>The variables  $\% \text{ Workforce with College Degree}_p$  and  $\text{Employment}_p$  are missing for a few plants. To avoid dropping observations, in the specifications in which we include these variables, we replace missing values with -99 and use a dummy variable to control for these instances.

<sup>64</sup>The standard deviation of *Vertical Integration* $_f$  in the matched sample is 0.09, so  $0.691 \cdot 0.09 = 0.062$ .

firms delegate more to plants that are larger and have a more educated workforce.<sup>65</sup>

Table A-6  
Delegation and integration

	(1)	(2)	(3)	(4)
Vertical Integration <sub>f</sub>	0.685*** (0.246)	0.794*** (0.244)	0.691*** (0.250)	0.577** (0.250)
Input FE	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes
Firm controls	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes
R-squared	0.182	0.198	0.206	0.216
N. observations	3,444	3,444	3,444	3,444

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $Vertical\ Integration_f$  is the vertical integration index of firm  $f$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects are respectively the primary activities of the parent and of the plant (defined at 3-digit SIC). Standard errors clustered at the firm level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels respectively.

We have carried out a series of additional estimations to verify the robustness of the results of Table A-6. The results of these estimations are available upon request. First, we use more disaggregated industry fixed effects (defined at the SIC4 level instead of SIC3) to control for the primary activities of the plant and its parent firm. Second, we reproduce Table A-6 after winsorizing the vertical integration index at the 5th and 95th percentile. Finally, we restrict the analysis to single-plant firms, for which our measures of integration and delegation are less likely to suffer from measurement error. All specifications confirm that, in more vertically-related firms, HQ delegates more decisions to plant managers.

As discussed at the end of Section 3.2, simple extensions of our baseline model can explain the positive covariation between integration and delegation documented in Figure 1 and Table A-6: more valuable firms (e.g., those that have more productive HQs) should integrate more suppliers and grant more autonomy to them.

<sup>65</sup>We have also tried to control for management practices. The coefficient of  $Vertical\ Integration_f$  remains positive and significant.

### A-3 Robustness Checks

Table A-7  
Delegation and input value (4-digits SIC industry FE)

	(1)	(2)	(3)	(4)
$IO_{i,j}$	0.9323** (0.4583)	0.8621* (0.4641)	1.1891* (0.7038)	1.4256** (0.6914)
Input FE	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes
Firm controls	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes
Observations	3,179	3,179	3,179	3,179

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects are respectively the primary activities of the parent and of the plant (defined at 4-digit SIC). Standard errors clustered at the firm level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels respectively.

**Table A-8**  
**Delegation and input value (only multi-plant firms)**

	(1)	(2)	(3)	(4)
$IO_{i,j}$	1.1251** (0.5338)	1.0287* (0.5445)	1.4629** (0.6455)	1.5277** (0.6289)
Input FE	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes
Firm controls	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes
Observations	1,861	1,861	1,861	1,861

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects are respectively the primary activities of the parent and of the plant (defined at 3-digit SIC). Standard errors clustered at the firm level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels respectively.

**Table A-9**  
**Delegation and input value**  
(excluding all plants in the same SIC3 industry as the parent firm)

	(1)	(2)	(3)	(4)
$IO_{i,j}$	1.5074*	1.5513*	1.7700*	1.6437
	(0.8830)	(0.8957)	(1.0400)	(1.0941)
Input FE	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes
Firm controls	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes
Observations	989	989	989	989

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects are respectively the primary activities of the parent and of the plant (defined at 3-digit SIC). Standard errors clustered at the firm level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels respectively.

**Table A-10**  
**Integration and input value (4-digits SIC industry FE)**

	(1)	(2)	(3)	(4)	(5)
$IO_{i,j}$	0.1471*** (0.0205)	0.1472*** (0.0205)	0.1756*** (0.0248)	0.1755*** (0.0249)	0.1991*** (0.0283)
Input FE	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	-
Firm FE	No	No	No	No	Yes
Firm controls	No	No	No	Yes	-
Observations	7,042,966	7,042,966	7,042,966	7,042,966	7,042,966

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 4-digit SIC. In the specification in column 5, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input-output level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-11**  
**Integration and input value (single-plant firms)**

	(1)	(2)	(3)	(4)	(5)
$IO_{i,j}$	0.1393*** (0.0204)	0.1396*** (0.0204)	0.1643*** (0.0247)	0.1643*** (0.0247)	0.1849*** (0.0278)
Input FE	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	-
Firm FE	No	No	No	No	Yes
Firm controls	No	No	No	Yes	-
Observations	6,361,633	6,361,633	6,361,633	6,361,633	6,361,633

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. In the specification in column 5, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input-output level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

Table A-12  
Integration and input value (matched sample)

	(1)	(2)	(3)	(4)	(5)
$IO_{i,j}$	0.0485*	0.0645**	0.1016***	0.1014***	0.1067***
	(0.0290)	(0.0300)	(0.0186)	(0.0184)	(0.0194)
Input FE	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	-
Firm FE	No	No	No	No	Yes
Firm controls	No	No	No	Yes	-
Observations	292,744	292,744	292,744	292,744	292,744

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. In the specification in column 5, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input-output level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.



**Table A-13**  
**Integration and input value (controlling for contracting frictions)**

	(1)	(2)	(3)	(4)	(5)
$IO_{i,j}$	0.2749*** (0.0350)	0.2734*** (0.0351)	0.2947*** (0.0318)	0.2943*** (0.0318)	0.3011*** (0.0334)
Contract intensity <sub><i>i</i></sub>	0.0115 (0.0350)	0.0222 (0.0332)	0.0354 (0.0298)	0.0345 (0.0298)	0.0902** (0.0374)
Rule of Law <sub><i>c</i></sub>	-0.0345** (0.0141)				
Contract intensity <sub><i>i</i></sub> × Rule of Law <sub><i>c</i></sub>	-0.0406 (0.0265)	-0.0542** (0.0225)	-0.0569*** (0.0208)	-0.0560*** (0.0208)	-0.1177*** (0.0324)
Input FE	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	-
Firm FE	No	No	No	No	Yes
Firm controls	No	No	No	Yes	-
Observations	1,194,737	1,194,737	1,194,737	1,194,737	1,194,600

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. The variables  $Contract\ intensity_i$  and  $Rule\ of\ Law_c$  are constructed as in Nunn (2007).  $Contract\ intensity_i$  is defined at 4-digit SIC. The sample is restricted to manufacturing inputs, for which  $Contract\ intensity_i$  can be constructed. Output and input fixed effects defined at 3-digit SIC. In the specification in column 5, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input-output level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-14**  
**Delegation and uncertainty (4-digits SIC industry FE)**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Mean Productivity $_{i,c}$	0.0257** (0.013)	0.0253** (0.0126)	0.0302* (0.0160)	0.0289* (0.0170)	0.0244* (0.0128)	0.0242** (0.0122)	0.0300* (0.0159)	0.0291* (0.0170)
CV Productivity $_{i,c}$	0.0027 (0.0043)	0.0026 (0.0045)	0.0077 (0.0075)	0.0087 (0.0072)	0.0022 (0.0043)	0.0023 (0.0044)	0.0076 (0.0076)	0.0086 (0.0073)
IO $_{i,j}$					0.7577 (0.4804)	0.7014 (0.4872)	1.2319* (0.7317)	1.4868** (0.7155)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes	No	No	No	Yes
Firm controls	No	No	No	Yes	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,928	2,928	2,928	2,928	2,889	2,889	2,889	2,889

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 4-digit SIC. Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-15**  
Delegation and uncertainty (winsorizing supplier productivity)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Mean Productivity $_{i,c}$	0.0478*** (0.0139)	0.0463*** (0.0116)	0.0590*** (0.0132)	0.0674*** (0.0132)	0.0475*** (0.0099)	0.0479*** (0.0114)	0.0601*** (0.0131)	0.0686*** (0.0129)
CV Productivity $_{i,c}$	0.0106 (0.0778)	0.0427 (0.0488)	0.0370 (0.0518)	0.0291 (0.0516)	-0.0048 (0.0494)	0.0270 (0.0504)	0.0187 (0.0530)	0.0120 (0.0529)
IO $_{i,j}$					1.0175*** (0.3940)	0.9951** (0.3945)	1.1585** (0.4691)	1.2442*** (0.4607)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	Yes	Yes	No	No	Yes	Yes
Country FE	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Plant controls	No	No	No	Yes	No	No	No	Yes
Firm controls	No	No	No	Yes	No	No	No	Yes
Noise controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,928	2,928	2,928	2,928	2,889	2,889	2,889	2,889

*Notes:* The dependent variable is  $Delegation_{f,p,i,j,c}$ , the degree of autonomy granted to plant  $p$  (with primary activity  $i$ , located in country  $c$ ) by the parent firm  $f$  (with primary activity  $j$ ).  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Plant-level controls include the percentage of the plant's employees with a bachelor's degree or higher and the plant's share of the firm's employment. Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 4-digit SIC. Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-16**  
Integration and uncertainty (4-digits SIC industry FE)

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)
CV Productivity $_{i,c}$	0.0004*** (0.0001)	0.0005*** (0.0001)	0.0005*** (0.0001)	0.0005*** (0.0001)	0.0005*** (0.0001)	0.0005*** (0.0001)
IO $_{i,j}$			0.1533*** (0.0130)	0.2125*** (0.0153)	0.2125*** (0.0153)	0.2117*** (0.0153)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	No
Observations	6,644,884	6,644,884	6,644,884	6,644,884	6,644,884	6,644,884

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 4-digit SIC. In the specification in column 6, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-17**  
Integration and uncertainty (winsorizing supplier productivity)

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	-0.0003 (0.0032)	-0.0134*** (0.0040)	-0.0136*** (0.0040)	-0.0137*** (0.0040)	-0.0137*** (0.0040)	-0.0139*** (0.0040)
CV Productivity $_{i,c}$	0.0041** (0.0016)	0.0066*** (0.0018)	0.0066*** (0.0018)	0.0066*** (0.0018)	0.0066*** (0.0018)	0.0066*** (0.0018)
IO $_{i,j}$			0.1512*** (0.0136)	0.1817*** (0.0148)	0.1815*** (0.0148)	0.2068*** (0.0165)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	No
Observations	5,484,936	5,484,936	5,484,936	5,484,936	5,484,936	5,484,936

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. In the specification in column 6, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

Table A-18  
Integration and uncertainty (single-plant firms)

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	-0.0000 (0.00001)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)
CV Productivity $_{i,c}$	0.0006*** (0.00008)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)
IO $_{i,j}$			0.1439*** (0.0137)	0.1715*** (0.0148)	0.1715*** (0.0148)	0.1943*** (0.0165)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	No
Observations	6,027,632	6,027,632	6,027,632	6,027,632	6,027,632	6,027,632

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. In the specification in column 6, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-19**  
Integration and uncertainty (matched sample)

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	-0.0000** (0.000001)	-0.0000** (0.0000)	-0.0031** (0.0000)	-0.0000* (0.0000)	-0.0000** (0.0000)	-0.0000** (0.0000)
CV Productivity $_{i,c}$	0.0006*** (0.0002)	0.0006*** (0.0002)	0.0006*** (0.0002)	0.0006*** (0.0001)	0.0006*** (0.0001)	0.0006*** (0.0002)
IO $_{i,j}$			0.0770*** (0.0120)	0.1263*** (0.0150)	0.1283*** (0.0149)	0.1375*** (0.0159)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	-
Observations	249,471	249,471	249,471	249,471	249,471	249,471

*Notes:* The dependent variable is  $Integration_{f,i,j,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. In the specification in column 5, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.

**Table A-20**  
**Integration and uncertainty (50+ suppliers per input sector)**

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)
CV Productivity $_{i,c}$	0.0005*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)	0.0007*** (0.0001)
IO $_{i,j}$			0.1602*** (0.0163)	0.1978*** (0.0178)	0.1977*** (0.0178)	0.2293*** (0.0203)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	-
Observations	5,484,936	5,484,936	5,484,936	5,484,936	5,484,936	5,484,936

*Notes:* The dependent variable is  $Integration_{f,j,i,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries.  $Mean\ Productivity_{i,c}$  is the mean of supplier productivity.  $CV\ Productivity_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ .  $IO_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. Output and input fixed effects defined at 3-digit SIC. In the specification in column 6, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.



Table A-21  
Integration and uncertainty (controlling for contracting frictions)

	(1)	(2)	(3)	(4)	(5)	(6)
Mean Productivity $_{i,c}$	0.0000*** (0.00001)	0.0000** (0.0000)	0.0000** (0.0000)	0.0000*** (0.0000)	0.0000*** (0.0000)	0.0000** (0.0000)
CV Productivity $_{i,c}$	0.0009*** (0.0002)	0.0006*** (0.0001)	0.0006*** (0.0001)	0.0006*** (0.0001)	0.0006*** (0.0001)	0.0005*** (0.0001)
IO $_{i,j}$			0.2835*** (0.0242)	0.3025*** (0.0277)	0.3021*** (0.0277)	0.3078*** (0.0301)
Contract intensity $_i$	0.0552 (0.0451)	0.0638 (0.0414)	0.0637 (0.0418)	0.0756* (0.0402)	0.0748* (0.0402)	0.1516*** (0.0435)
Rule of Law $_c$	-0.0483** (0.0203)					
Contract intensity $_i \times$ Rule of Law $_c$	-0.0896* (0.0463)	-0.1005** (0.0422)	-0.1031** (0.0420)	-0.1046** (0.0410)	-0.1038** (0.0410)	-0.1903*** (0.0453)
Input FE	Yes	Yes	Yes	Yes	Yes	Yes
Output FE	No	No	No	Yes	Yes	-
Country FE	No	Yes	Yes	Yes	Yes	-
Firm FE	No	No	No	No	No	Yes
Firm controls	No	No	No	No	Yes	-
Observations	1,080,628	1,080,628	1,080,628	1,080,628	1,080,628	1,080,454

*Notes:* The dependent variable is *Integration* $_{f,i,j,c}$ , a dummy equal to 1 if firm  $f$  producing final product  $j$  (defined at 4-digit SIC) and located in country  $c$  integrates input  $i$  (defined at 4-digit SIC) within its boundaries. *Mean Productivity* $_{i,c}$  is the mean of supplier productivity. *CV Productivity* $_{i,c}$  is the coefficient of variation of labor productivity of the independent suppliers in input industry  $i$  located in country  $c$ . *IO* $_{i,j}$  is the direct requirement coefficient for the sector pair  $ij$ . Firm-level controls include the employment and age of the parent firm. The variables *Contract intensity* $_i$  and *Rule of Law* $_c$  are constructed as in Nunn (2007)- *Contract intensity* $_i$  is defined at 4-digit SIC. The sample is restricted to manufacturing inputs, for which *Contract intensity* $_i$  can be constructed. Output and input fixed effects defined at 3-digit SIC. In the specification in column 5, firm controls and country and output-industry fixed effects are absorbed by the firm fixed effects (each firm  $f$  is associated to one location and one primary activity). Standard errors clustered at the input level in parentheses. \*\*\*, \*\* and \* indicate statistical significance at the 1%, 5% and 10% levels.