



THE LONDON SCHOOL  
OF ECONOMICS AND  
POLITICAL SCIENCE ■

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**Firms and Markets**

Lent 2009

**SYLLABUS:**  
**Firms and Markets 2: Organizational Capabilities**

**ADMINISTRATIVE INFORMATION**

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**Materials**

- Course Packet (Required)
- Textbook (required): John Roberts (2004) *The Modern Firm: Organizational Design for Performance and Growth*. New York: Oxford University Press.
- Kenneth Arrow, “The Limits of Organization”
- Readings

**COURSE OVERVIEW**

The object of this course is to give you the tools to design the organization so that it obtains the capability required for its strategy given its environment. Capability is actionable knowledge. The organization needs to have (1) the relevant information/knowledge to act; (2) the agents must have the will/incentives to act. We cover these two topics in the course. We adopt a new perspective and a new set of tools, that have been developed by economists during the last 15 years, ‘organizational economics.’

I will introduce the concepts through a mixture of case studies, lectures and problem sets. The problem sets are designed to ensure that you get a good understanding of the key models that I’d like you to have clearly in your mind. The papers whether those models are introduced are marked with a star.

Your performance in the course will be evaluated based on a final exam (95% of grade) and participation in case discussions (5%). I expect you to participate and attend in all cases and to be well prepared for the discussion. This is crucial to make everyone's experience worthwhile.

## Class Schedule

### Part I. Firms and Markets

Week 1. Complementarities: Strategy and Capabilities

Lecture readings \* Roberts. Chapter 1 and 2.

Paul Milgrom and John Roberts. [Complementarities and fit strategy, structure, and organizational change in manufacturing](#), *Journal of Accounting and Economics*, 1995

(Illustration of Complementarities: Garicano, Luis and Paul Heaton: IT and the Police)

Week 2. Transaction Costs and Vertical Integration.

Lecture readings \* Hayek, F. “The Use of Knowledge in Society” AER, 1944.

\* Milgrom and Roberts: Transactions Costs; Adverse selection; moral hazard

\* Hubbard, Tom, Chapter ‘Fragmented Industries’

Grossman S. and Hart, O. “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration”

(Illustration: Garicano, Luis and Steven Kaplan: B2B E-Commerce and Transactions Costs)

Prof. Class Case Crown Design Corporation

TA Class Session Voluntary Class Session Reviewing Asymmetric Information Concepts

## **Part II. Knowledge and Talent**

Week 3. Knowledge (1): Specialization

Lecture Readings \* Gary S. Becker, Kevin M. Murphy, “The Division of Labor, Coordination Costs, and Knowledge,” *Quarterly Journal of Economics*, Vol. 107, No. 4. (Nov., 1992), pp. 1137-1160

\* Garicano, Luis. “Hierarchy and the Organization of Knowledge in Production” *Journal of Political Economy*, 2000.

\*Garicano, Luis and Tom Hubbard. “Managerial Leverage is Limited by the Extent of the Market”, *Journal of Law and Economics*, 2007.

Stigler, G. “The Division of Labor is Limited by the Extent of the Market.” *Journal of Political Economy*.

Prof. Class Case Enterprise Car Rental

TA Session: *Problem set 1 due: Asymmetric Information: Moral Hazard and Adverse Selection*

Week 4. Knowledge (2): Integration and Coordination

Readings: \* Kenneth Arrow, “The Limits of Organization”

\* Crémer, Jacques. 1993. “Corporate Culture and Shared Knowledge.” *Industrial and Corporate Change* 2:351-86.

Cremer, Jacques, Luis Garicano, Andrea Prat. “Language and The Theory of the Firm” (QJE, 2007).

Case: Michael J. Enright “Organization and Coordination in Geographically Concentrated Industries.” in *Coordination and Information (1995)*, Ed. Naomi R. Lamoreaux and Daniel M. G. Raff.

TA Session: *Problem set 2 due: Hierarchy and Strategy*

Week 5.	<u>Talent Strategy (1): Choosing and Allocating People to Tasks.</u>
Readings	<p>* Michael Kremer . “The O-Ring Theory of Economic Development” <i>The Quarterly Journal of Economics</i>, Vol. 108, No. 3 (Aug., 1993), pp. 551-575.</p> <p>* Raaj Kumar Sah, Joseph E. Stiglitz. “The Architecture of Economic Systems: Hierarchies and Polyarchies”. <i>The American Economic Review</i>, Vol. 76, No. 4 (Sep., 1986), pp. 716-727</p> <p>Gene M. Grossman, Giovanni Maggi. “Diversity and Trade”. <i>The American Economic Review</i>, Vol. 90, No. 5 (Dec., 2000), pp. 1255-1275.</p>
Case:	Siebel Systems
TA Session	<i>Problem Set 3 due: Tasks and Talent</i>
Week 6.	<u>Talent Strategy (2): The Firm and the Labor Market</u>
Readings:	<p>*Robert E. Lucas Jr., 1978. "On the Size Distribution of Business Firms," <i>Bell Journal of Economics</i>, The RAND Corporation, vol. 9(2), pages 508-523, Autumn.</p> <p>*Garicano, Luis and Esteban Rossi-Hansberg “Inequality and the Organization of Knowledge.” <i>The American Economic Review</i>, Vol. 94, No. 2, (May, 2004), pp. 197-202</p> <p>Rosen, Sherwin. 1982. “Authority, Control, and the Distribution of Earnings.” <i>Bell Journal of Economics</i> 13:311-23.</p> <p>Garicano, Luis and Thomas N. Hubbard, The return to Knowledge Hierarchies, Mimeo, 2007.</p>
Cases:	Nanda, Asís, “McKinsey”, HBS No. 903-080.
TA Session	<i>Problem Set 4 due: Lucas Model</i>

## **Part III. Incentives**

Week 7. Incentives: The Firm as a Subeconomy

Readings \*Roberts: Chapter 3 and 4 Multitasking.

\*Gibbons, R. "Incentives Between Firms (and Within), *Management Science*, v51, n1, Jan 2005, 2-17.

(Illustration: Garicano and Palacios-Huerta. Sabotage in Tournaments)

Cases: ATH Technologies (HBS 2004)

WSJ articles: Amaranth technologies

TA Session: *Problem Set 5 due: Multitasking*

Week 8 Decision Rights and Incentives: Centralization and decentralization

Readings \*Luis Garicano and Richard Posner. "[Intelligence Failures: An Organizational Economics Perspective.](#)" *Journal of Economic Perspectives*, 2004

\*Jensen, Michael C., and William H. Meckling (1995), "Specific and General Knowledge, and Organizational Structure," *Journal of Applied Corporate Finance*, 8: 2, 4-18.

Alonso, Dessein, Matoushek Coordination vs. Initiative-... something from roberts

Roberts: Chapter 5, pp 230-240.

Cases: 9/11 Commission Report (National Commission on Terrorist Attacks, 2004)

TA Session: *Problem Set 6 due: Decision Rights and Incentives*

Week 9	<u>Organizational forms: The rise and fall (and rise?) of matrix</u>
Readings	* Roberts: Chapter 5a Dessein, Garicano, Gertner. Organizing for Synergies. Mimeo, 2007.
Cases:	Organizational change at BP: Introducing T-Shaped Managers, HBR 2001 Baker report on BP's Texas City accident (online)
TA Session:	<i>Problem set 7 due: relational contracts and repeated games</i>
Week 10.	<u>Culture and Relational Contracts.</u>
Readings	* Kreps, David. 1990. "Corporate Culture and Economic Theory." In J. Alt and K. Shepsle, eds. <i>Perspectives on Positive Political Economy</i> . Cambridge University Press.
Cases:	"Taking the Dare," The New Yorker, July 26, 1993. Human Resources at Hewlett-Packard (A) (HBS Case 1995) Slade Plating Department (HBS Case 1995)
TA Session:	Review last year's final