

14.282 ORGANIZATIONAL ECONOMICS

Wednesdays 1-4pm
Spring 2004
E51-385

L. Garicano and R. Gibbons

- 0. Introduction
- 1. Decision-Making in Organizations
 - 1.1 Team Theory and Garbage Cans
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 - 1.5 Social Relations
- 2. What Do Managers Do?
 - 2.1 Hierarchical Information Processing
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 - 2.4 Hierarchical Problem Solving
- 3. Structures and Processes in Organizations
 - 3.1 Conventional Organizational Forms
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- 4. Organizational Capital
 - 4.1 Growth
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 - 4.3 Leadership
 - 4.4 Change
- 5. Employment in Organizations
 - 5.1 Pay for Performance
 - 5.2 Job Assignments
 - 5.3 Skill Development
 - 5.4 Networks and Demography
 - 5.5 Integrative Models of Wages and Mobility
 - 5.6 Employment Systems
 - 5.7 Sorting and the Division of Labor
- 6. Between Firms: Contracts, Hybrids, and Competition
 - 6.1A Integration – Classic Theories and Evidence
 - 6.1B Integration – Recent Developments
 - 6.2A Formal Contracts Between Firms
 - 6.2B Relational Contracts Between Firms
 - 6.3A Joint Ventures, Alliances, and Other Hybrids

- 6.3B Hybrids and Innovation
- 6.4 Competition and Industry Dynamics
- 6.5 International Trade

- 7. Besides Firms: Institutions
 - 7.1 Communities
 - 7.2A Institutions in Markets
 - 7.2B Markets as Institutions
 - 7.3 Agencies
 - 7.4 States

- 8. Conclusion

Overview:

This syllabus describes a doctoral course in organizational economics. As in many courses, the syllabus offers a guide to further reading for those seeking to go deeper into particular topics. In this course, however, the syllabus also attempts to define the content and (blurry) boundaries of organizational economics.

One reason that the content and boundaries of organizational economics need to be defined is that the field overlaps many other fields in economics. For example, parts of the course are natural complements to a typical course in industrial organization, and others to labor economics. Also, much of the course can be seen as applying (and sometimes testing) material from a typical course in contract theory. These and other connections (such as to corporate finance, political economy, and organizational sociology) are summarized in the pictures of organizational economics at <http://web.mit.edu/rgibbons/www/index.html>.

The prerequisites for the course are first-year microeconomic theory (*e.g.*, 14.122 and 124) and econometrics (*e.g.*, 14.382), as well as the rudiments of contract theory (*e.g.*, 14.281). The latter can be gleaned from “Incentives Between Firms (and Within)” and “Four Formal(izable) Theories of the Firm,” available at the website above.

Requirements:

We fear that economists do not get out enough (ourselves certainly included). Because we cannot arrange for field trips as a part of this course, we rely on thick descriptions—detailed accounts from those who have been there. We will cover some such descriptions in class; others will be central to the term paper for the course.

We also fear that most economists never learn how to build a simple model “from scratch.” As a result, there are many published models that add a new element to an existing model or combine two existing models, but few that begin from a crisp statement of a fact and then develop a fresh model dedicated to explaining that fact. While the latter kind of model is not always an end in itself, the ability to develop such a model can be quite valuable.

In this course we try to calm both fears, by requiring students both to read thick descriptions (marked with a “C” below) and to build simple models. Specifically, there are two course requirements: six case write-ups (chosen from about two dozen); and one term paper (10 to 15 pages, due roughly three months after the course ends). The case write-ups should begin to build a very simple economic model based on the case, perhaps guided by the discussion questions given at the end of this syllabus. The term paper should develop a simple economic analysis (probably including a model) from the descriptions and analyses given in a book-length case study, such as those listed at the end of many sections of the syllabus.

Mechanics:

Many topics will begin with a 15-minute case discussion that focuses on the questions given at the end of this syllabus. Such a discussion will be of little value to you if you have not read the case and considered the questions, so please come prepared. The schedule of topics (and cases) will be as follows:

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| Feb. 4: | 0. INTRODUCTION. 1. DECISION-MAKING: Team Theory and Garbage Cans |
| Feb. 11: | Authority and Power (Johnson & Johnson); Politics and Influence; Routines (UPS); Social Relations (Miller) |
| Feb. 18: | 2. WHAT DO MANAGERS DO? Hierarchical Information Processing; Hierarchical Resource Allocation |
| Feb. 25: | Hierarchical Monitoring; Hierarchical Problem Solving |
| Mar. 3: | 3. STRUCTURES AND PROCESSES: Conventional Organizational Forms (Beatrice; Disney); Alternative Organizational Forms (ABB; Oticon); Theories of Structure |
| Mar. 10: | Capital Allocation and Transfer Pricing; Knowledge Management and Innovation; Contingency and Complementarities. 4. ORGANIZATIONAL CAPITAL: Growth |
| Mar. 17: | Culture (Sun Hydraulics); Leadership (Hewlett-Packard); Change (Jacobs Suchard; Andersen) |
| Mar. 24: | SPRING BREAK |
| Mar. 31: | 5. EMPLOYMENT: Pay for Performance (Brainard, Bennis, & Farrell; Alston and Higgs; Lincoln Electric; First Boston; Roy); Job Assignments |
| Apr. 7: | Skill Development (Motorola); Networks and Demography (Clendenin; Xerox Development Center); Integrative Models of Wages and Mobility |
| Apr. 14: | Employment Systems (People Express; NUMMI); Sorting and the Division of Labor |
| Apr. 21: | 6. BETWEEN FIRMS: Integration (Rudi Gassner); Formal and Relational Contracts (Crown Equipment) |
| Apr. 28: | Joint Ventures, Alliances, and Other Hybrids (Fuji Xerox; Honda-Rover); Hybrids and Innovation (Xerox Technology Ventures); Competition and Industry Dynamics (Birds Eye); International Trade |
| May 5: | 7. BESIDES FIRMS: Communities; Markets (Bestor) |
| May 12: | Agencies (Wilson); States (North & Weingast). 8. CONCLUSION. |

0. INTRODUCTION

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1. DECISION-MAKING IN ORGANIZATIONS

Overview

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4. ORGANIZATIONAL CAPITAL

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CASE QUESTIONS

The following questions are designed to focus your attention when reading the case, but not as a template for case write-ups. The generic assignment for case write-ups is to pick an interesting aspect of the case and begin to develop a simple economic model of that aspect.

Feb. 11: Johnson & Johnson; UPS; Miller

Johnson & Johnson: (i) What is J&J's structure? What is its culture? What is its strategy? (ii) What obstacles does Pete Ventrella face as president of the new Hospital Services Company? How do J&J's structure and culture affect its strategic options?

UPS: (a) What are UPS's key internal policies and how do they fit with each other? (b) What are the pros and cons of UPS's system? What are key factors for their continued success?

Miller: What were management's formal policies in the bank wiring room, and what were workers' (informal) responses to these policies?

Feb 18: Enright

Read carefully through the three cases presented by Enright. In all of them, the market intermediaries are performing functions that, were these industries more vertically integrated, would usually be performed by managers. Write down a description of what the 'managers' in these industries actually do. Think of it as writing an add looking for one of these guys in a newspaper in which you need to describe (albeit more carefully than you would in real life) the duties that they would undertake. Try to give a sense of the (1) coordination role broadly defined (i.e. information to process, knowledge to obtain etc.) and (2) incentive roles (monitoring and dealing with diverse informational asymmetries in several directions etc.) that these guys perform. List these as completely as you can.

Mar. 3: Beatrice; Disney; ABB; Oticon

Beatrice: (i) In what ways (if any) did Beatrice's corporate strategy in the Karnes era create value? What were the merits and drawbacks of this strategy? Given the sources of value creation in Beatrice's strategy under Karnes, was the company organized appropriately? Why or why not? (ii) Upon taking control, Dutt decides that Beatrice is in need of a strategic reorientation. Do you agree with this assessment? Explain how Dutt's strategy will or will not create value. Given Beatrice's resources and capabilities, do you think Dutt's 1983 strategic redirection will improve Beatrice's long-term prospects? Should Dutt be fired in August 1985?

Disney: xx

ABB: Why does Percy Barnevik want ABB to be a matrix organization? What are the key structures, processes, and managerial activities in a matrix organization? What are the major costs and benefits of such an organization? In what settings are the benefits likely to outweigh the costs?

Oticon: xx

Mar. 17: Sun Hydraulics; Hewlett-Packard; Jacobs Suchard; Andersen

Sun Hydraulics: (a) Pages 1-7 of the first case sketch the 34-page document that Koski used to solicit funding in 1970. Suppose someone brought you an analogous document today. What would be the key dimensions of your decision about funding the firm? (b) The rest of the first case suggests that the first 15 years at Sun Hydraulics were quite successful (and also quite unusual). But there are also hints of problems to come. The second case (called “C”) describes several issues that surfaced by 1991. What advice would you give Sun in 1991, concerning both actions to be taken and issues to be watched? (c) Compare Sun’s “clan” to the team-theoretic perspective of Marschak and Radner and the “garbage can” perspective of Cohen, March, and Olsen.

Hewlett-Packard:

Suchard: (a) How has Suchard been organized historically? What have been the strengths and weaknesses of this structure? (b) Why do they feel the need to change organizational structure? (c) Compare their two proposals for new structures? What are their strengths and weaknesses? (c) Begin to develop a very simple economic model of the organizational design problem at Jacobs Suchard. (d) Does your model suggest that Suchard made the optimal decision?

Andersen:

Mar. 31: BB&F; Alston and Higgs; Lincoln Electric; First Boston; Roy

Brainard, Bennis, and Farrell: Rank the BB&F partners in Exhibit 2 in terms of the compensation you would give to each. What are the most important factors in your compensation scheme, and why?

Alston and Higgs: What departures from the classic agency model do Alston and Higgs describe? To what extent do Alston and Higgs describe situations that correspond to various parameter values in the classic agency model (and its natural extensions), and to what extent do they describe wholesale departures from that model?

Lincoln Electric: (a) In 1975 (*i.e.*, when the case was written), what were the key features of Lincoln’s compensation plan? (b) In 1975, what were Lincoln’s other key internal policies, and how do they fit with the compensation plan? To what extent should Lincoln’s system be applied in other settings? Then or now, what factors are critical to the success of a system like Lincoln’s?

First Boston: What were the key elements of the pay plan at First Boston before 1990? Did Credit Suisse renege during the early 1990s? What are the key differences between First Boston and Lincoln Electric (if any)?

Roy: What aspects of the machine shop that Roy describes can be understood using the relational-contracts model? What aspects cannot? What would it take to turn Roy’s machine shop into Lincoln Electric?

Apr. 7: Motorola; Clendenin; Xerox Development Center

Motorola: How can Motorola afford to spend \$120 million per year on what appears to be general-purpose human capital? What are the implications for HR strategy, manufacturing strategy, and business strategy?

Clendenin and XDC: (i) What was the attraction of the MDC to Clendenin? Why did he feel that the existing structure needed to be changed? What were the key moves that Clendenin made to make the MDC a successful operation? (ii) To what extent does Clendenin make his subordinates more effective? Does he manage down in the same fashion as he manages up and across? Why or why not?

Apr. 14 People Express; NUMMI

People Express: xx

NUMMI: Assess the three standard rationales for NUMMI's superior performance, compared to GM-Fremont and GM-Van Nuys—fear, screening, and team production. (c) These three rationales are largely static. What dynamic story can you tell? In particular, what was the role of the union in your dynamic story?

Apr. 21: Rudi Gassner at BMGI; Crown Equipment

Rudi Gassner: By 1993, BMGI owned many operating companies around the world. What control rights did Gassner hold? What control rights did the operating companies hold? Which important control rights would have been held by a different party if the operating companies were independent firms, rather than operating companies owned by BMGI? What problems has this horizontal integration allowed BMGI to solve? What problems has horizontal integration created for BMGI?

Crown Equipment: What is the relational contract between Crown and Richardson Smith? Why is this relational contract self-enforcing for several decades? What potential changes (including but not limited to those that actually occurred) could cause this relational contract to stop being self-enforcing?

Apr. 28: Fuji Xerox; Xerox Technology Ventures; Honda-Rover; Birdseye

Fuji Xerox: (a) Begin to develop a very simple economic model of relationship between Xerox and Fuji Xerox. (b) How did the organization of the relationship contribute to its success? Specifically consider the roles of ownership structure, contracts, and personal relations. (c) What are the major threats to this relationship? What are the alternatives to this joint venture?

Xerox Technology Ventures: At XTV, what are the important relational contracts, what would constitute renegeing, and what are the available punishments? What was done to manage these relational contracts? Could Xerox have done a better job of organizing XTV to realize its overall strategic goals? What could Xerox do in the future to address the problems XTV was intended to solve?

Honda-Rover: (i) Evaluate the rationale for the initial and early stages of the Honda-Rover alliance. (ii) With respect to the Honda and Rover alliance, how would you characterize the relational contract (as opposed to the formal contract)? What steps did each side take to build it? What, if anything, could have been done more effectively on either side? (iii) In specific terms, assess BAe's negotiating moves (with respect to the possible sale of Rover) leading up through Simpson's January 27 trip to Tokyo. Do you think the extreme confidentiality was a good or a bad idea? What was the effect of the Honda-Rover relational contract on this process? (iv) Evaluate BMW's negotiating strategy. If successful, what should BMW do to build a new relational contract with Rover and, possibly, Honda?

Birdseye: Why did Birds Eye develop as a vertically integrated producer? Why did specialized intermediaries emerge? Could Birds Eye have prevented this occurring? Does a vertically integrated producer have a competitive advantage in the early 1980s? What should Birds Eye do in 1979?

May 12: Wilson; North-Weingast

Wilson: Begin to develop a simple model that encompasses the four types of agencies Wilson describes.

North-Weingast: Begin to develop a simple model of *one* of the issues raised by North & Weingast.