

Economics 710  
The Economics of Organizations

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9:30-10:45 T, Th

BE 314

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**COURSE OBJECTIVES:** Economic activity is organized in a variety of ways. This course applies economic analysis, primarily transactions cost and principal-agent theories, to understanding the forces that shape the nature of economic organization. These issues are closely related to many business problems. The intent of the course is to provide students from all business disciplines with a broad-based foundation of economic analysis of important managerial and organizational problems. The goal is for the students to be able to apply this framework to more detailed analyses in their respective fields.

**PREREQUISITES:** An MBA-level course in managerial economics or equivalent.

**BACKGROUND READING:** There are several textbooks that appropriately serve as background treatment and summary of many course topics. They include:

Paul Rubin, *Managing Business Transactions*, Free Press, 1990.

James Brickley, Clifford Smith, and Jerold Zimmerman, *Managerial Economics and Organizational Architecture*, McGraw Hill - Irwin, 3<sup>rd</sup> edition, 2004.

**COURSE REQUIREMENTS:** Grades will be based on the following.

Midterm exam: 35% of grade.

Final exam: 35% of grade.

Presentation: 10% of grade. Each student will select a paper (or companion papers) to present to the class. The presentation is expected to be approximately 20 minutes. The instructor will assist you with selecting a paper and your choice must be approved by the instructor. Some of the papers on the reading list are eligible to be presented.

Paper: 20% of grade. Each student is to prepare a 10 to 15 page literature review and summary of articles pertaining to a course topic. Students are encouraged to find topics in their areas of concentration. The instructor will help with selection of topics, locating readings, etc. Topics must be discussed with and approved by the instructor. A paper discussed in this survey may serve for your class presentation.

COURSE OUTLINE AND READINGS: Papers to be emphasized most in class are marked with a ‘\*.’ Other papers listed will be discussed briefly or provide additional background reading. These readings are not an exhaustive list of relevant papers in the literature.

## I. The Economic Approach and Some Basic Ideas

\*Jensen, Michael and Meckling, William, "The Nature of Man," *Journal of Applied Corporate Finance*, Summer 1994.

\*Coase, Ronald, "The Nature of the Firm," *Economica*, 1937.

Machlup, Fritz, "Theories of the Firm: Marginalist, Behavioral, Managerial," *American Economic Review*, March 1967.

Alchian, Armen, "Uncertainty, Evolution, and Economic Theory," *Journal of Political Economy*, June 1950.

Alchian, A. and Demsetz, H., "Production, Information Costs, and Economic Organization," *American Economic Review*, Dec. 1972.

## II. Outsourcing: To Make or Buy

### A. Asset Specificity and Transactions Costs: Theory

\*Williamson, Oliver, "Transaction Costs Economics: The Governance of Contractual Relations," *Journal of Law and Economics*, October 1979.

\*Klein, B.; Crawford, R. and Alchian, A., "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics*, October 1978.

Tirole, Jean, *The Theory of Industrial Organization*, MIT Press, 1990, p. 21-28.

### B. Vertical Integration and Contracts: Empirics and Case Studies

\*Joskow, Paul, "Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants," *Journal of Law, Economics, and Organization*, Spring 1985.

Crocker, Keith and Reynolds, Kenneth, "The Efficiency of Incomplete Contracts: An Empirical Analysis of Air Force Engine Procurement," *Rand Journal of Economics*, Spring 1993.

\*Masten, Scott, "Transaction Costs, Mistakes, and Performance: Assessing the Importance of Governance," *Managerial and Decision Economics*, 14, 1993.

Klein, Benjamin, "Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited," *Journal of Law, Economics, and Organization*, Spring 1988.

Monteverde, K. and Teece, D., "Supplier Switching Costs and Vertical Integration in the Automobile Industry," *Bell Journal of Economics*, Spring 1982.

### C. Reputation and Norms

Macaulay, S., "Non-Contractual Relations in Business: A Preliminary Study," *American Sociological Review*, 1963.

\*Klein, Benjamin and Leffler, Keith, "The Role of Market Forces in Assuring Contractual Performance," *Journal of Political Economy*, August 1981.

Granovetter, Mark, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology*, November 1985.

### D. Asset Specificity, Incomplete Contracts, and Asset Ownership

\*Hart, Oliver, "The Property Rights Approach," Ch. 2 in Hart, *Firms, Contracts, and Financial Structure*, Oxford, 1995.

\*Baker, George and Hubbard, Thomas, "Make Versus Buy in Trucking: Asset Ownership, Job Design, and Information," *American Economic Review*, June 2003.

## III. Corporate Governance

### A. The Corporation: Basic Issues

\*Fama, Eugene and Jensen, Michael, "Separation of Ownership and Control," *Journal of Law and Economics*, June 1983.

Alchian, Armen, "The Basis of Some Recent Advances in the Theory of Management of the Firm," *Journal of Industrial Economics*, Nov. 1965.

### B. Financial Structure and Agency Costs

\*Jensen, M. and Meckling, W., "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, Oct. 1976.

\*Jensen, Michael, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review*, June 1986.

\*Williamson, Oliver, "Corporate Finance and Corporate Governance," *Journal of Finance*, July 1988.

Titman, Sheridan and Wessels, Roberto, "The Determinants of Capital Structure Choice," *Journal of Finance*, March 1988.

### C. Ownership Concentration

\*Demsetz, Harold and Lehn, Kenneth, "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy*, Dec. 1985.

\*Morck, Randall; Shleifer, Andrei; and Vishny, Robert, "Managerial Ownership and Market Valuation: An Empirical Analysis," *Journal of Financial Economics*, Jan. 1988.

Shleifer, Andrei and Vishny, Robert, "Large Shareholders and Corporate Control," *Journal of Political Economy*, June 1986.

### D. Executive Compensation

\*Rosen, Sherwin, "Contracts and the Market for Executives," section III, in Lars Werin and Hans Wijkander (eds.), *Contact Economics*, Blackwell: Cambridge, Mass., 1992.

\*Garen, John, "Executive Compensation and Principal-Agent Theory," *Journal of Political Economy*, Dec. 1994.

Aggarwal, Rajesh and Samwick, Andrew, "The Other Side of the Trade-Off: The Impact of Risk on Executive Compensation," *Journal of Political Economy*, Feb. 1999.

\*Bebchuk, Lucian and Fried, Jesse, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*, Summer 2003.

\*Bertrand, Marianne and Mullainathan, Sendhil, "Do CEOs Set Their Own Pay? The Ones Without Principals Do," NBER Working Paper #7604, March 2000.

Jensen, Michael and Murphy, Kevin J., "CEO Incentives - It's Not How Much You Pay, But How," *Harvard Business Review*, May 1990.

Jensen, M. and Murphy, K. J., "Performance Pay and Top-Management Incentives," *Journal of Political Economy*, April 1990.

#### D. Other Forms of Governance

##### i. Takeovers and Buyouts

\*Jarrell, Gregg; Brickley, James; and Netter, Jeffrey, "The Market for Corporate Control: The Empirical Evidence Since 1980," *Journal of Economic Perspectives*, Winter 1988.

\*Baker, George and Wruck, Karen, "Organizational Changes and Value Creation in Leveraged Buyouts: The Case of O.M. Scott & Company," *Journal of Financial Economics*, Dec. 1989.

##### ii. Boards of Directors, Turnover, and Careers

Morck, R; Shleifer, A.; and Vishny, R., "Alternative Mechanisms for Corporate Control," *American Economic Review*, 79, Sept. 1989.

Denis, David and Aarin, Atulya, "Ownership and Board Structures in Publicly Traded Corporations," *Journal of Financial Economics*, 52, 1999, p. 187-223.

Brickley, James; Coles, Jeffrey; and Linck, James, "What Happens to CEOs After They Retire: New Evidence on Career Concerns, Horizon Problems, and CEO Incentives," *Journal of Financial Economics*, June 1999.

#### IV. Non-Corporate Organizations

\*Fama, E. and Jensen, M., "Agency Problems and Residual Claims," *Journal of Law and Economics*, 26, June 1983.

Hansmann, Henry, *The Ownership of Enterprise*, Belkap Press of Harvard University Press, 1996, Chs. 1-3.

\*Donahue, John, *The Privatization Decision*, Basic Books, 1989, Ch. 3.

Hart, Oliver; Shleifer, Andrei; and Vishny, Robert, "The Proper Scope of Government: Theory and an Application to Prisons," *Quarterly Journal of Economics*, 112, November 1997.

Tirole, Jean, "The Internal Organization of Government," *Oxford Economic Papers*, 46, January 1994.

## V. Incentives, Control, and Decision Making in Organizations

### A. Incentive Systems: General Ideas

\*Baker, G.; Jensen, M., and Murphy, K.J., "Compensation and Incentives: Practice vs. Theory," *Journal of Finance*, 43, July 1988.

\*Holmstrom, Bengt and Milgrom, Paul, "Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design," *Journal of Law, Economics, and Organization*, Spring 1991.

Holmstrom, Bengt and Milgrom, Paul, "Aggregation and Linearity in the Provision of Intertemporal Incentives," *Econometrica*, March 1987.

Prendergast, Canice, "The Tenuous Trade-Off Between Risk and Incentives," *Journal of Political Economy*, Oct. 2002.

Steinbrink, John, "How to Pay Your Salesforce," *Harvard Business Review*, July-Aug. 1978.

\*Kohn, Alfie, "Why Incentive Plans Cannot Work," *Harvard Business Review*, Sept.-Oct. 1993.

Knez, Marc and Simester, Duncan, "Firm-Wide Incentives and Mutual Monitoring at Continental Airlines," *Journal of Labor Economics*, 19, October 2001.

Ghemawat, Pankaj, "Competitive Advantage and Internal Organization: Nucor Revisited," *Journal of Economics and Management Strategy*, Winter 1995.

### B. Adverse Selection

Akerlof, George, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics*, 84, August 1970.

\*Leland, Heyne, "Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards," *Journal of Political Economy*, 87, Dec. 1979.

Salop, Joanne and Salop, Steven, "Self-Selection and Turnover in the Labor Market," *Quarterly Journal of Economics*, 90, November 1976.

Guasch, J. Luis and Weiss, Andrew, "Self-Selection in the Labor Market," *American Economic Review*, 71, June 1981.

\*Lazear, Edward, "Performance Pay and Productivity," *American Economic Review*, 90, December 2000.

## B. Decision Authority, Hierarchy, and Rewards

\*Jensen, Michael and Meckling, William, "Specific and General Knowledge and Organizational Structure," in Lars Werin and Hans Wijkander (eds.), *Contact Economics*, Blackwell: Cambridge, Mass., 1992.

\*Jensen, Michael and Meckling, William, "Divisional Performance Measurement," in Jensen, Michael, *Foundations of Organizational Strategy*, Cambridge, Mass.: Harvard University Press, 1998.

\*Williamson, O., "The Modern Corporation," Ch. 11 in *The Economic Institutions of Capitalism*, 1985.

Sah, R. and Stiglitz, J., "The Architecture of Economic Systems: Hierarchies and Polyarchies," *American Economic Review*, Sept. 1986.

## C. The Employment Relationship and Outsourcing

\*Masten, Scott, "A Legal Basis for the Firm," *Journal of Law, Economics, and Organization*, Spring 1988.

Holmstrom, Bengt and Milgrom, Paul, "The Firm as an Incentive System," *American Economic Review*, September 1994.

\*Garen, John, "Self-Employment, Pay Systems, and the Theory of the Firm: An Empirical Analysis," *Journal of Economic Behavior and Organization*, Aug. 1998.

Garen, John, "Independent Contractors and Self-Employment as Systems of Incentives and Control: Theory, Empirics, and a Survey of Evidence," *Research in Labor Economics*, forthcoming.

Bresnahan, Timothy; Brynjolfsson; and Hitt, Lorin, "Information Technology, Workplace Organization, and the Demand for Skilled Labor: Firm-Level Evidence," *Quarterly Journal of Economics*, Feb. 2002.

Anderson, E. and Schmittlein, D., "Integration of the Sales Force: An Empirical Examination," *Rand Journal of Economics*, 15, Autumn 1984.

## D. More on Employment: Other Methods of Pay and Specific Human Capital

\*Becker, Gary and Stigler, George, "Law Enforcement, Malfeasance, and Compensation of Enforcers," *Journal of Legal Studies*, Jan. 1974.

\*Hutchens, Robert, "Seniority, Wages, and Productivity: A Turbulent Decade," *Journal of Economic Perspectives*, 3, Fall 1989.

\*Hall, Robert and Lazear, Edward, "The Excess Sensitivity of Layoffs and Quits to Demand," *Journal of Labor Economics*, April 1984.

\*Leonard, Jonathan, "Carrots and Sticks: Pay, Supervision, and Turnover," *Journal of Labor Economics*, Oct. 1987, part 2.

Allgulin, Magnus and Ellingsen, Tore, "Monitoring and Pay," *JOLE*, April 2002.

\*Lazear, Edward, *Personnel Economics*, Cambridge, Mass.: MIT Press, 1995, Ch. 3

Eriksson, Tor, "Executive Compensation and Tournament Theory: Empirical Tests on Danish Data," *JOLE*, April 1999.

Garen, John, "Specific Human Capital, Monitoring Costs, and the Organization of Work," *Journal of Institutional and Theoretical Economics*, September 1996.

#### E. Franchising and Sharecropping

\*Rubin, Paul, "The Theory of the Firm and the Structure of the Franchise Contract," *Journal of Law and Economics*, 28, April 1978.

\*Brickley, James; Dark, Frederick; and Weisbach, Michael, "An Agency Perspective on Franchising," *Financial Management*, Spring 1991.

Klein, Benjamin, "Transactions Cost Determinants of "Unfair" Contractual Arrangements," *American Economic Review*, 70, May 1980.

Wimmer, Bradley and Garen, John, "Moral Hazard, Asset Specificity, Implicit Bonding, and Compensation: The Case of Franchising," *Economic Inquiry*, July 1997.

Lafontaine, Francine, "Agency Theory and Franchising: Some Empirical Tests," *Rand Journal of Economics*, 23, Summer 1992.

Allen, Douglas and Lueck, Dean, "Transactions Costs and the Design of Cropshare Contracts," *Rand Journal of Economics*, Spring 1993.

Allen, Douglas and Lueck, Dean, "The Nature of the Farm," *Journal of Law and Economics*, Oct. 1998, pt. 1.