

Organizational Economics

Module 3, 2022-2023

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Course information

Course Website: <https://my.nes.ru>

Instructor's Office Hours: By agreement.

Room Number:

<https://us02web.zoom.us/j/6109208993?pwd=WDRsUGo4eVFRWlIBQWlwd0RtQnAxQT09>

TA: Alexander Tonis

Course description

"Today, for many economists, economics is to a large extent a matter of incentives: incentives to work hard, to produce good quality products, to study, to invest, to save, etc. How to design institutions that provide good incentives for economic agents has become a central question of economics." Laffont and Martimort (2009), page 1.

This course provides an introduction to the Economics of Organization. We will discuss the classic papers and some recent research in organizational economics. The core of the course is theoretical but we will cover empirical applications of the theory when available. We will also go through some case studies of real firms.

Neoclassical economics traditionally viewed a firm as a production set. Given market prices, the firm chooses a set of inputs to buy, turns them into outputs, and then sells those outputs on the market in order to maximize profits. This "black box" view of the firm captures many important aspects of what a firm does, but leaves many questions unanswered: why do firms exist?, why some firms decide to buy inputs and others to make them?, what do managers do?, what is the role of hierarchy?, why do firms often appear dysfunctional?, why do inefficient and efficient firms coexist?, should we care about their coexistence?

The purpose of this course is to move beyond the Neoclassical view of the firm and to provide you with a set of models that you can use as a first step when thinking about modern issues affecting private and public organizations. In doing so, we will recognize the fact that organizations consist of many individuals who almost always have conflicting objectives, that often, contracts are incomplete and the available information is imperfect.

Course requirements, grading, and attendance policies

Successful completion of Microeconomics 4 is a prerequisite for this course.

The grade will be a combination of:

- One homework (20%)
- Submission of ALL case studies to be done in pairs (10%)
- Write a case study (in pairs) (35%): The object of the case study is a Russian firm (or another type of organization) that is facing an organizational challenge. You need to describe the challenge and use the lessons from the class to discuss the possible different solutions. Alternatively, you can discuss what the organization chose as a solution and use the class material to discuss the pros and cons. For instance, Yandex recently wanted to buy Tinkoff (one of the country's biggest privately-owned banks) in what looked like "a match made in heaven". Yet, the agreement did not go through. One explanation is that the "two sides could not agree on how the bank should be managed". The break-up ended up with the owner of Tinkoff circulating an internal letter saying, "we, not they, will buy this shitty Yandex! I have no faith in this overly bureaucratic company."
- Final multiple-choice exam (35%): This will be a short test to check if the different concepts studied in class are understood. Attending the lectures and understanding the models should be enough to pass it. I will not penalized wrong answers. Here are two examples:
 - Suppose we have a career concerns model with many periods. As time passes by, effort increases because the employer gets a more precise estimate about the agent's ability.
A: True
B: False
Solution: B
 - In a relational contract between a principal and an agent, the contract is enforced by:
A: the courts.
B: a third party.
C: the value of the future.
D: the principal.
Solution: C

Below is the course content. The papers are organized by order of appearance in the lectures.

Course contents

1. Formal contracts: LEN Model. Multitasking. Relative Performance Evaluation. Short-termism and the financial crises.

- Bolton-Dewatripont, ch. 4.2. and , ch. 6.2.1, ch. 8.1
- Hölmstrom, Bengt., (1979), "Moral hazard and observability," *The Bell journal of economics*
- Gibbons, R., & Murphy, K. J., (1990), "Relative performance evaluation for chief executive officers" ILR Review.

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- Holmström, Bengt, and Paul Milgrom, (1991), "Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design," *Journal of Law, Economics, and Organization*
- Glewwe, Paul, Nauman Ilias, and Michael Kremer, (2010), "Teacher Incentives." *American Economic Journal: Applied Economics*
- Garicano, Luis, and Luis Rayo, (2016), "Why organizations fail: models and cases", *Journal of Economic Literature*
- **Case study:** "Performance pay at Safelite Auto Glass (A and B)", *Harvard Business School*
- Lazear, Edward, (2000), "Performance Pay and Productivity", *American Economic Review*

2. Implicit Incentives: Career Concerns. Relational Contracts. Meaning-making.

- Holmström, Bengt, (1999), "Managerial Incentive Problems—A Dynamic Perspective," *Review of Economic Studies*
- Bolton and Dewatripont, Ch 10.5
- Meyer, Margaret, and John Vickers, (1997), "Performance Comparisons and Dynamic Incentives", *Journal of Political Economy*
- Markevich, Andrei and Ekatherina Zhuravskaya, (2011), "M-form hierarchy with poorly diversified divisions: A case of Khrushchev's reform in Soviet Russia," *Journal of Public Economics*
- Frydlinger, David, Oliver Hart, and Kate Vitasek. 2019. "A New Approach to Contracts." *Harvard Business Review*, Sept-Oct .
- Baker, George, Robert Gibbons, and Kevin J. Murphy, (1994), "Subjective Performance Measures in Optimal Incentive Contracts," *The Quarterly Journal of Economics*
- Levin, Johnathan, (2003), "Incentive Relational Contracts," *American Economic Review*
- Fong, Yuk-fai, and Jin Li, (2016), "Relational Contracts, Limited Liability, and Employment Dynamics", WP
- Overview relational contracts: Malcomson, James, (2013), "Relational Incentive Contracts," in *The Handbook of Organizational Economics* by Robert Gibbons and John Roberts
- **Case study:** "The Lincoln Electric Company", *Harvard Business School*
- Lincoln Electric's Harsh Lessons from International Expansion, *Harvard Business School*
- Li, Jin and Niko Matouschek, (2013), "Managing Conflicts in Relational Contracts", *American Economic Review*

3. Decision-Making in Organizations: Hierarchies. Authority. Delegation.

- Tirole, Jean, (1986), "On the Role of Collusion in Organizations," *Journal of Law, Economics, & Organization*
- Troya-Martinez, Marta and Liam Wren-Lewis, (2018), "Managing Relational Contracts", CEPR Discussion Paper No 12645
- Cole, Shawn and Anh Tran, (2011), "Evidence from the firm: a new approach to understanding corruption", International Handbook on the Economics of Corruption by Rose-Ackerman and Tina Søreide
- Overview hierarchies: Mookherjee, Dilip, (2013), "Incentives in Hierarchies," in The Handbook of Organizational Economics by Robert Gibbons and John Roberts
- Dessein, Wouter, (2002), "Authority and communication in organizations." *Review of Economic Studies*
- Aghion, Philippe, and Jean Tirole, (1997), "Formal and real authority in organizations." *Journal of Political Economy*
- Baker, George, Robert Gibbons, and Kevin J. Murphy, (1999) "Informal authority in organizations." *Journal of Law, Economics, and Organization*
- Dessein, Wouter, and Tano Santos (2006), "Adaptive organizations." *Journal of Political Economy*
- Overview delegation: Gibbons, Robert, Niko Matouschek, and John Roberts, (2013), "Decisions in Organizations," in The Handbook of Organizational Economics by Robert Gibbons and John Roberts
- **Case study**: "The Alibaba Group", *Harvard Business School*

4. Theories of the Firms: Neoclassical Theory. Transaction Costs Economics. Property Rights Theory.

- Coase, Ronald (1937), "The Nature of the Firm," *Economica*
- Williamson, Oliver E. (1979) "Transaction-cost economics: the governance of contractual relations." *Journal of Law & Economics*

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- Monteverde, K. and Teece, D. (1982), "Supplier Switching Costs and Vertical Integration in the Automobile Industry," *The Bell Journal of Economics*
- Masten, Scott E. (1984) "The organization of production: Evidence from the aerospace industry." *Journal of Law & Economics*
- Joskow, Paul L. (1985) "Vertical integration and long-term contracts: The case of coal-burning electric generating plants." *Journal of Law, Economics, & Organization*
- Overview TCE: Tadelis, S. and Williamson, O. (2013), "Transaction Cost Economics," in *The Handbook of Organizational Economics* by Robert Gibbons and John Roberts
- Grossman, Sanford J., and Oliver D. Hart. (1986) "The costs and benefits of ownership: A theory of vertical and lateral integration." *Journal of Political Economy*
- Hart, Oliver, and John Moore. (1990) "Property Rights and the Nature of the Firm." *Journal of political economy*
- Whinston, Michael D. (2003) "On the transaction cost determinants of vertical integration." *Journal of Law, Economics, and Organization*
- Holmstrom, Bengt and Milgrom, Paul. (1994), "The Firm as an Incentive System," *American Economic Review*
- Anderson, Erin, and David C. Schmittlein. (1984), "Integration of the sales force: An empirical examination." *Rand Journal of Economics*
- George P. Baker and Thomas N. Hubbard (2004), "Contractibility and Asset Ownership: On-Board Computers and Governance in U. S. Trucking", *Quarterly Journal of Economics*
- Forbes, Silke Januszewski, and Mara Lederman. (2009) "Adaptation and vertical integration in the airline industry." *American Economic Review*
- Klein, Benjamin, Robert G. Crawford, and Armen A. Alchian. (1978) "Vertical integration, appropriable rents, and the competitive contracting process." *Journal of Law & Economics*
- Casadesus-Masanell, Ramon, and Daniel F. Spulber. (2000) "The Fable of Fisher Body" *Journal of Law and Economics*
- **Case study**: "Coca-Cola in 2011: In Search of a New Model", *Harvard Business School*

Course materials

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[1] Gibbons, R. and Roberts, J. "Handbook of Organizational Economics"

[2] Bolton, P. and M. Dewatripont. "Contract Theory"

[3] Original papers on which the lectures are based