

# **Economics of Organization**

**Economics 420(WE), Fall 2016**

**Mondays and Wednesdays, 3:35-4:50**

**Classroom CCC 104, Office CPS 416**

**Scott Wallace**

**Office Hours: M W 2:30-3:30, T R 10:00 – 10:55**

**Phone: 715-346-4358**

**[swallace@uwsp.edu](mailto:swallace@uwsp.edu)**

## **Course Description**

“The mark of a capitalistic society is that resources are owned and allocated by such nongovernmental organizations as firms, households, and markets. Resource owners increase productivity through cooperative specialization and this leads to the demand for economic organizations which facilitate cooperative specialization.”

From *Production, Information Costs, and Economic Organization*, (Alchian & Demsetz, 1972).

This course will use economic theory to analyze the various organizational forms that support cooperative specialization within society. In doing so, the class will address a number of fundamental questions: What is a firm? What do firms do? Under what conditions will the allocation of resources occur within firms? When will resources be allocated by prices or by arm’s length contracts through markets? Why are some firms investor-owned while others are proprietorships? What special roles do mechanisms like long-term contracts, franchising, and leasing play? Students will find that the economic perspective provides a valuable framework within which to analyze management problems.

## **Learning Objectives**

*Enduring Understandings: Students will understand that...*

- human interactions are characterized by both cooperation and conflict.
- organizations can structure incentives in ways that encourage behavior that increase value.
- organizations can facilitate the coordination of complementary activities along a product’s supply chain.
- the appropriate organizational structure is contingent on a variety of internal and external factors that are subject to change

*Essential Questions*

- What exactly are firms?
- How can markets and firms facilitate cooperative specialization among resource owners?

- How can organizations align incentives among members who possess conflicting objectives?
- What role can organizations play in coordinating complementary activities that often require very different skills and knowledge?

*Knowledge (Know): Students will be able to/can:*

- explain the benefits that result from cooperative specialization.
- explain the different types of transaction costs that often characterize market relationships.
- describe the asset specificity and agency cost theories of the firm and explain how, under each, firms address incentive problems that exist within specific economic contexts.
- describe the importance of capabilities in determining the scope of activities that firms will optimally undertake.

*Skills (Be able to): Students will be able to/can:*

- use game theoretic concepts to analyze the strategic behavior of actors in situations of interdependence.
- critically identify the organizational structures that are optimal for given economic contexts.
- use theories presented in class in evaluating the strengths and weaknesses of different methods of compensation.

*Dispositions (Value/Appreciate): Students will be able to/can:*

- describe how the ideas presented in class illuminate their own personal experiences in the workplace and other organizational settings.
- explain how the ideas presented in this class relate to their learning experiences in other classes.

*Communication in the Major: Upon completing this class, students will be able to:*

- describe appropriate economic concepts and elaborate on their meaning in completing short written assignments and the literature review.
- understand the role literature reviews play in academic research.
- organize and complete a literature review on an appropriate academic topic.
- express their ideas through the proper use of appropriate syntax and grammar in completing written assignments.
- deliver a coherent and organized presentation of their ideas in completing class participation assignments.
- speak clearly and precisely in addressing the class in completing class participation assignments.

## Course Requirements

I will conduct this course in the style of a seminar in which class participation will be integral to the presentation of class material. Successful completion of the course requires the active input of each student. Both attendance and preparation are crucial. There are rather severe penalties for missing class. (See attendance policy on the next page.) Students will be responsible for writing and presenting answers in completing reading assignments. All students must come to class prepared to discuss the articles assigned for that day. We will allocate class time among lecture, class discussion, and group activities. In addition to class attendance and participation, your grade will be based on short writing assignments and a literature review. The weights are as follows.

Class Participation	30%
Short Writing Assignments	20%
Term Project: Literature Review	50%

The class participation and short writing assignments stress comprehension of the economic ideas presented in class reading assignments. The class participation grade consists of your contributions to class discussions and participation in group activities. Like the short writing assignments, the class discussions are largely based on the reading assignments. In addition, you will complete a literature review on a topic related to the economics of organization. (See the handout, *Economics of Organization Term Project: Literature Review* for details.)

Your final grade will be based upon the calculation of your final average based upon the above weights.

A	92.5+
A-	90.0 – 92.4
B+	87.5 – 89.9
B	82.5 – 87.4
B-	80.0 – 82.4
C+	77.5 – 79.9
C	72.5 – 77.4
C-	70.0 – 72.4
D+	65.0 – 69.9
D	60.0 - 64.9
F	59.9 and Below

### *Communications-in-the-Major:*

Econ 420 is a Communication-in-the Major elective for the Economics Major: Social Science Option. As such, this class will evaluate student learning in the areas of written and oral communication. (See above for the Communication-in-the-Major learning objectives). The weekly writing and class discussion assignments will expose students to these core economic concepts while the literature review requires you to focus narrowly on a related topic of your choice. The short writing assignments give me the opportunity to provide you timely feedback on your writing. A more formal rubric (see separate handout) will be used for both grading and

assessment of your writing in completing the literature review. In addition to the elements of writing style (grammar, syntax, and paragraph structure), the rubric stresses student's ability to research, organize, and complete a literature review on a specialized academic topic.

Students will also be responsible for participating in class discussions. Each student will be responsible for answering questions that pertain to the reading and other assignments related to the economic ideas presented in class. We have a small class so we will treat class time as a seminar in which all will contribute to class discussion.

I recognize that some of the assigned readings will be difficult; the intended audience of these articles typically are economists, not students. My expectation is that students demonstrate that they have read the assigned articles and have addressed the assigned questions. I am not expecting perfection but I am expecting a good faith effort by all students. My grading scheme is based on you making a good faith effort in completing assignments. I will make available a simple grading rubric to let you know how I am evaluating your in-class performance.

#### *Attendance Policy:*

It is critical that you make every effort to attend each class. There is a stiff penalty for those who do not regularly attend class. A student is allowed four absences without penalty. Every subsequent absence will result in subtracting five points from the student's final grade average. For example, if a student has a final grade point average of 90 and has missed five classes, I will subtract 10 points for the unallowed absences, resulting in a B- for the course.

## **Course Materials**

Most of the reading assignments will come from the following two texts. Several papers will be available on electronic reserve. The campus bookstore should have the following texts available.

- [P]: Putterman and Kroszner (eds.), *The Economic Nature of the Firm: A Reader*, Third Edition, Cambridge: Cambridge University Press, 2009.
- [M]: Masten (ed.), *Case Studies in Contracting and Organization*, New York: Oxford University Press, 1996.
- [ER]: Electronic Reserve.

## Course Outline and Reading Assignments.

### I. The Problem of Economic Organization.

#### A. *The Structure of Production.*

- Adam Smith, From The Wealth of Nations, pp. 35-41. [P].

#### B. *The Market and the Firm.*

- Friedrich Hayek, “The Use of Knowledge in Society,” [P].
- Ronald Coase, “The Nature of the Firm,” [P].

### II. Vertical Integration and the Theory of the Firm

#### A. *Asset Specificity and Incentives*

- Klein, Crawford, and Alchian, “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,” [P].
- Benjamin Klein, “Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited,” [M].

#### B. *Costs of Vertical Integration*

- Milgrom and Roberts, “Bargaining Costs, Influence Costs, and the Organization of Economic Activity,” [P].

### III. Agency Costs and the Theory of the Firm.

#### A. *Moral Hazard, Monitoring, and Multitask Problems.*

- Alchian and Demsetz, “Production, Information Costs and Economic Organization,” [P].
- Steven Kerr, “On the Folly of Rewarding A, While Hoping for B.” *Academy of Management Executive*, 1995, 9(1). [ER].
- Holmstrom and Milgrom, “Multi-task Principal-Agent Analyses, Linear Contracts, Asset Ownership, and Job Design,” [P].

#### B. *Economic Incentives and Human Resource Practices.*

- Lazear & Shaw, “Personnel Economics: The Economist’s View of Human Resources,” *Journal of Economic Perspectives*, Fall 2007, 21(4): 91-114. [ER]

#### **IV. Alternative Forms of Organization**

##### *A. The Corporate Form of Organization.*

- Jensen and Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” [P]
- Henry Manne, “Mergers and the Market for Corporate Control,” [P]
- Fama, “Agency Problems and the Theory of the Firm,” [P].
- Film: *Barbarians at the Gate*
- John McMillan, “Setting Executive’s Incentives” from Games, Strategies, & Managers, 1992, pp. 120-129, New York: Oxford University Press. [ER]
- Bebchuk & Fried, “Executive Compensation as an Agency Problem,” [P].

##### *B. Competing Organizational Forms in Comparative Analysis*

- Thrainn Eggertson, From Economic Behavior and Institutions, pp. 175-192 [ER].

##### *C. Cooperative Forms of Organization*

- Henry Hansmann, “Cooperative Firms in Theory and Practice,” *Finnish Journal of Business*, 1999, Vol. 4, pp. 387 – 403 [ER].

#### **V. The Capabilities of the Firm.**

- G.B. Richardson, “The Organization of Industry,” [ER].

#### **VI. The Nature of Contractual Relationships.**

- Williamson, “The Governance of Contractual Relations,” [P]
- Robert C. Ellickson, “A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry,” [M].
- Paul Joskow, “Contract Duration and Relationship-Specific Investments: Empirical Evidence from Coal Mines,” [M].
- Stephen Pirrong, “Contracting Practices in Bulk Shipping Markets: A Transactions Cost Explanation,” [M].

## **VII. Hybrids.**

### *A. Exclusive Dealing.*

- Edward Gallick, “Exclusive Dealing and Vertical Integration: The Efficiency of Contracts in the Tuna Industry,” [M].

### *B. Franchising.*

- Muris, Scheffman, and Spiller, “Strategy and Transaction Costs: The Organization of Distribution in the Carbonated Soft Drink Industry,” [M].
- Kaufmann and Lafontaine, “Costs of Control: The Source of Economic Rents for Franchisees,” [M].

### *C. Leasing.*

- Matsen and Snyder, “United States v. United Shoe Machinery Corporation: On the Merits,” [M].