

# Economics of Organizations

February-May 2010

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In this course, we will study the firm, and organizations more generally, through the lens of economic analysis. Our twin goals will be to build a set of analytical tools for the study of organizations and to put those tools to use by analyzing concrete problems faced by actual organizations.

The concepts discussed in the course will allow us to understand the organizational problems in financial institutions and markets that many researchers believe to be at the root of the current crisis. We will also apply the tools of the economic analysis of organizations to address questions such as: Should Microsoft be allowed to acquire Yahoo? Why have Nokia, Ericsson or Motorola gone from a vertically integrated organizational model to one in which key stages in cell phone production are outsourced to external firms? Why has Apple decided to go in the opposite direction by building the microprocessor for the I-Pad in-house? What explains a diversification strategy such as the one pursued by General Electric? Why is Benetton a “virtual firm”? Can it be optimal to pay for an MBA even if it does not teach anything useful? How should executives be paid? How do options work as a compensation mechanism? Is it optimal to compensate line workers with stock options? What do corporate governance codes try to achieve? Will they succeed? Should Professors be paid according to the grades obtained by their students?

As these questions illustrate, the tools developed in the course have a wide range of applications, including general management, strategic consulting, human resource management, financial management, and anti-trust regulation. The course’s attention to economic theory will also serve well those interested in pursuing further academic studies in Economics, Finance, or Management.

## References:

There are two main textbooks for the course:

- Besanko, D., D. Dranove, M. Shanley, and S. Schaefer (2003). *Economics of Strategy*. Third Edition. John Wiley & Sons, Inc. **(Besanko et al.)**
- Milgrom, P. and J. Roberts (1992). *Economics, Organization and Management*. Prentice Hall. **(M&R)**

A highly recommended complementary reading is:

Roberts, J. (2007). *The Modern Firm*. Oxford University Press

In addition to these references, readings and case studies will be distributed as we go along. You are also strongly encouraged to read the financial press. A particularly good source for case studies is the weekly *The Economist*.

### **Course organization**

There will be readings assigned for each class. You are expected to read the assigned readings *prior* to the class. In the lectures, I will present the main theories and provide examples and case studies to be discussed in class. Participation in the discussion of case studies is essential and may add up to 1 point to the final grade (see below).

### **Aula Global**

I will post class materials on *Aula Global*. You will be expected to check *Aula Global* regularly for updates.

### **Office hours and e-mail questions**

The office hour schedule will be announced the first week of the course. In general, e-mailed questions will not be answered. E-mail questions having to do with administrative issues dealt with during lectures or available on *Aula Global* will not be answered.

### **T.A. sections and quizzes**

There will be a T.A. section every other week. During the T.A. section, the T.A. will go over the assigned problem sets. She will also hand out a short quiz for you to solve in class. The grades of these quizzes will count towards the final grade.

### **Team case study**

There will be a case study assignment to be done in teams of 2 to 5 students (depending on enrollment). The assignment will consist of a written case study and a presentation in class. I will give you precise instructions about the case study and a time-line shortly.

### **Academic dishonesty**

Plagiarism or any other form of academic dishonesty will be considered a very serious offense and treated accordingly.

### **Final exam**

The final exam is scheduled for Friday **June 11**. If you are or will be an exchange student, make sure that you do not leave the country before that date. Extra exams on alternative dates will be provided only in those cases explicitly contemplated by university regulations. If yours is one of those cases, please let me know as soon as possible.

### **Class attendance**

This is not a distance-learning course, so you are expected to attend lectures, participate in the discussion of case studies, and turn in assignments before their deadlines. If you cannot attend the T.A. sections (and, thus, cannot take the quizzes) for some justifiable reason, please let me know before February 19 and I will come up with a solution for your individual case.

### **Grading**

The final grade will consist of the following components:

- Final exam: 70 %
- Team case study: 20%
- TA section quizzes: 10%
- Active participation in the discussion of case studies will be awarded with up to one extra point. This extra point is awarded on top of the final grade and will not be subtracted from those who did not participate in class discussion.
- Independently of the grade obtained for the case study, quizzes or class discussion, a minimum grade of **4** (in a 0 to 10 scale) on the final exam will be required to pass the course.

# Syllabus

## 1. Efficiency and Organization

- 1.1. Efficiency and organization
- 1.2. Asymmetric information and barriers to efficiency

**Required reading:** M&R, chapter 2.

## 2. Internal Organization: Selection and Incentives

- 2.1. Selection: signaling and screening

**Required reading:** M&R, 5.  
Additional reading: M&R 10.

- 2.2. Explicit incentives
  - 2.2.1. The Principal-Agent model
  - 2.2.2. Optimal compensation contracts and the trade-off between incentives and insurance
  - 2.2.3. Multi-tasking and optimal compensation
  - 2.2.4. The choice of performance measures

**Required reading:** M&R, 6 and 7; Besanko et al., 14; lecture notes.  
Additional reading: M&R, 12 and 13.

- 2.3. Implicit incentives and organization
  - 2.3.1. Incentives in teams
  - 2.3.2. Implicit incentives
  - 2.3.3. Careers and long term incentives

**Required reading:** Besanko et al., 15.  
Additional reading: M&R 10 and 11.

## 3. Firm Boundaries

- 3.1. Horizontal boundaries
  - 3.1.1. Scale and scope economies
  - 3.1.2. Diseconomies of scale
  - 3.1.3. The learning curve
  - 3.1.4. Network externalities
  - 3.1.5. Diversification

**Required reading:** Besanko et al., 2 and 5, M&R, 4.  
Additional reading: M&R 16.

- 3.2. Vertical boundaries
  - 3.2.1. The “make or buy” decision
  - 3.2.2. Transaction costs and vertical integration
  - 3.2.3. Specific investments, hold up and vertical integration
  - 3.2.4. Property rights theories of vertical integration
  - 3.2.5. Incentives and vertical integration
  - 3.2.6. Hybrid forms

**Required reading:** Besanko et al, 3 and 4. M&R, 2, 5, 8, and 9.  
Additional reading: M&R 16.